The New Normal: How the Dodd-Frank Risk Retention Rules Affect the Future of CMBS

"At some point the innovation in the private sector reaches a critical mass and it becomes a qualitatively different system than it started and the regulations have to catch up."[1]

I. INTRODUCTION

Before the beginning of the financial crisis in 2007, the residential and commercial real estate markets experienced a pricing bubble burst, which led to disastrous effects.[2] In the years leading up to the crisis, the American real estate sector was booming: housing prices rose substantially, banks were lending a large number of low quality "subprime" mortgages, and the securitization of these mortgages was unregulated.[3] Soon after housing prices began to fall in 2006, a wave of subprime mortgages defaulted.[4] Due to the significant interconnectedness of the financial system, the breakdown of national housing markets reverberated throughout the U.S. economy and set off a crippling recession that systemically weakened and even destroyed important American financial institutions.[5]

In response to the financial crisis, Congress passed the Dodd-Frank Wall Street Reform Act (Dodd-Frank Act) in 2010.[6] Among the most significant

1. *See* Trey Garrison, *Barney Frank: Risk Retention Is Enough to Regulate Mortgage Lending*, HOUSINGWIRE (Feb. 9, 2015), http://www.housingwire.com/articles/32878-barney-frank-risk-retention-is-enough-to-regulate-mortgage-lending [https://perma.cc/AC39-3DY9] (quoting Barney Frank, co-author of Dodd-Frank Wall Street Reform Act, on post-crisis legislation assessment).

2. *See* Adam J. Levitin & Susan M. Wachter, *Explaining The Housing Bubble*, 100 GEO. L.J. 1177, 1179 (2012) (explaining U.S. housing bubble pre-financial crisis). Between 1997 and 2006, housing prices rose by 188%, only to fall by 33% in 2009. *Id.*

3. *See id.* at 1182 (noting shift to unregulated securitization led to undervaluing of risk); *see also* 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 xxiii, 16 (2011) [hereinafter INQUIRY REPORT] (concluding deteriorating standards for mortgages and securitization events leading towards crisis).

4. *See* INQUIRY REPORT, *supra* note 3, at 214-15 (discussing severe downturn in housing market leading to significant mortgage delinquencies).

5. *See* CHRISTOPHER J. DODD, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, S. REP. NO. 111-176, at 39-42 (2010) (explaining causes and effects of financial crisis). The statistics of the financial crisis are devastating: more than 8 million jobs were lost, American household wealth declined by $13 trillion, and millions of homes entered foreclosure. *See id.* at 39.

6. *See* Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78*o* (2012)) (establishing widespread reform for U.S. financial system); *see also* Public Statement, Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Statement on

provisions of the Act were the risk retention rules, which required lenders to retain no less than 5% of the credit risk of any asset conveyed to a third party.[7] The rules aimed to increase investor protection by forcing banks to keep "skin in the game," thereby ensuring that lenders not only kept a stake in the issued loans, but also maintained an incentive to see them repaid.[8] The rules apply to both residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).[9]

As a significant source of pre-crisis funding for commercial real estate financing, the CMBS market imploded once the financial crisis hit.[10] Since then, the CMBS market has staged a comeback as issuance levels have continued to rise.[11] Now the industry faces a new challenge and period of uncertainty, as the risk retention rules will affect how CMBS deals are structured, and the commercial real estate market as a whole.[12]

The Dodd-Frank risk retention rules, as applied to CMBS, went into effect on December 24, 2016.[13] In anticipation of the risk retention regulations, the

the Anniversary of the Dodd-Frank Act (July 16, 2015), https://www.sec.gov/news/statement/statement-on-the-anniversary-of-the-dodd-frank-act.html [https://perma.cc/8DGT-5ZYM] (noting Dodd-Frank Act enacted to address issues leading to financial crisis).

7. *See* Dodd-Frank Act § 941 (codifying risk retention requirement). Barney Frank, co-architect of the legislation, would later call the risk retention rules "the single most important part" of Dodd-Frank. *See* Floyd Norris, *Mortgages Without Risk, At Least for the Banks*, N.Y. TIMES (Nov. 28, 2013), http://www.nytimes.com/2013/11/29/business/mortgages-without-risk-at-least-for-the-banks.html (quoting Frank while discussing impact of risk retention rules on lenders).

8. *See* S. REP. NO. 111-176, at 129 (highlighting goal of aligning securitizers' interests with investor protection); 17 C.F.R. § 246.4 (2017) (outlining 5% retention requirement); Norris, *supra* note 7 (using keeping "skin in the game" to describe risk retention); *see also* Public Statement, Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Skin in the Game: Aligning the Interests of Sponsors and Investors (Oct. 22, 2014), https://www.sec.gov/news/public-statement/2014-spch102214laa [https://perma.cc/BWP5-W7AC] (detailing flaws risk retention rules intended to correct and providing functional specifics of rules).

9. *See* 17 C.F.R. § 246.4 (noting rule applies to both CMBS and RMBS).

10. *See* Frank J. Fabozzi et al., *The Post-Crisis CMBS Market: Will Regulations Prevent Another Market Meltdown?*, J. PORTFOLIO MGMT., The Special Real Estate Issue 2015, at 118, 119 (highlighting significant downturn of CMBS loan origination after 2007).

11. *See id.* at 120 (observing increased CMBS issuance as market rebounded following financial crisis).

12. *See* Joshua Yablonski & Mike Schaffer, Article, *Risk Retention in Commercial Mortgage-Backed Securities: Look Back and Look Forward*, NAT'L L. REV. (Dec. 20, 2016), https://www.natlawreview.com/article/risk-retention-commercial-mortgage-backed-securities-look-back-and-look-forward [https://perma.cc/H4L4-FB3K] (discussing industry response following enactment of risk retention rules). During the first quarter of 2016, the industry saw a 38% drop in lending against commercial properties, as borrowers looked to alternative lenders. *Id.*; *see* Joy Wiltermuth, *New CMBS Deal Seen as Litmus Test for Industry*, REUTERS (June 10, 2016), http://www.reuters.com/article/usa-corpbonds-abs-idUSL8N18Z36L [https://perma.cc/FDH5-82L9] (naming rules as source of change for industry).

13. *See* Dodd-Frank Act § 941, 15 U.S.C. § 78*o*-11(i)(2) (2012) (establishing effective date for regulations two years after final publishing date of rules in Federal Register); Credit Risk Retention Rule, 79 Fed. Reg. 77,602 (Dec. 24, 2014) (codified at 17 C.F.R. pt. 246) (finalizing effective date for CMBS rules); *see also* Yablonski & Schaffer, *supra* note 12 (noting December 24, 2016 implementation date for CMBS regulations).

first risk-retention-compliant fund launched in August of 2016.[14] As of the date of this writing, federal regulators have not yet determined whether that fund sufficiently meets the risk retention guidelines, but any future decision will have extensive ramifications on the industry.[15]

This Note will provide background on the history of CMBS and describe how they became a leading source of funding for commercial real estate transactions.[16] Next, this Note examines securitization within the context of the CMBS market and its role within the financial crisis, which ultimately resulted in the enactment of the Dodd-Frank Act.[17] This Note then explains the risk retention rules under the Dodd-Frank Act and discusses their impact on the current CMBS market.[18] Finally, this Note evaluates whether the risk retention rules are reasonable and sustainable, and also argues that these regulations are necessary in order to prevent another financial crisis.[19]

II. HISTORY

A. How CMBS Developed into a Significant Funding Source for the Commercial Real Estate Market

Asset-backed securities are not a new phenomenon in real estate financing, nor are they unique to the commercial real estate (CRE) market.[20] In fact, securitization, the process of pooling illiquid loans and turning them into liquid assets by issuing securities backed by the loans sold on the secondary market, has long been a solution for the historic challenge inherent in mortgage financing: How does a company balance long-term assets with long-term liabilities over a short-term debt period?[21] Prior to the development of the

14. *See* Ely Razin, *Say Hello to the New Face of CMBS Deals, Courtesy of Dodd-Frank*, FORBES (Aug. 4, 2016), http://www.forbes.com/sites/elyrazin/2016/08/04/say-hello-to-the-new-face-of-cmbs-deals-courtesy-of-dodd-frank/#5aeca2aa45d2 [https://perma.cc/3H5B-TPRJ] (reporting launch of first CMBS fund compliant with risk retention rules).

15. *See* Beth Mattson-Teig, *CMBS Originators "Test the Waters" on Risk Retention*, NAT'L REAL EST. INV. (Aug. 17, 2016), http://nreionline.com/cmbs/cmbs-originators-test-waters-risk-retention [https://perma.cc/F4HN-R3D7] (discussing initial reactions to, and significance of, first compliant fund on industry outlook).

16. *See infra* Section II.A.

17. *See infra* Section II.B.

18. *See infra* Sections II.C-D.

19. *See infra* Parts III-IV.

20. *See* Robert A. Brown, *Financial Reform and the Subsidization of Sophisticated Investors' Ignorance in Securitization Markets*, 7 N.Y.U. J.L. & BUS. 105, 121-122 (2010) (noting mortgage securitization practice dates back several centuries); Georgette Chapman Phillips, *The Paradox of Commercial Real Estate Debt*, 42 CORNELL INT'L L.J. 335, 338 (2009) (discussing early asset-backed securitization, aided by government intervention, in residential real estate market). In 2007, the former U.S. Secretary of the Treasury, Henry Paulson, described securitization as "a process that has been extremely valuable in extending the availability of credit to millions of home-owners nationwide and lowering their cost of financing." Fabozzi et al., *supra* note 10, at 118.

21. *See* Tyler R. Morgan, *The Refinancing Crisis in Commercial Real Estate: Dodd-Frank Threatens to Curtail CMBS Lending*, 13 TRANSACTIONS: TENN. J. BUS. L. 361, 366-67 (2012) (describing origins of

CMBS market, its early counterpart—the RMBS market—originated in 1970, when Congress first allowed government-sponsored entities Freddie Mac and Fannie Mae to securitize mortgage loans by selling mortgages to entities that could more adeptly handle the risk of changes in market values and interest rates.[22] Through both public and private securitization vehicles, these government-sponsored entities, together with investment banks, purchased mortgage loans from loan originators, and then issued securities backed by the same mortgage loans to institutional investors.[23] By converting relatively illiquid mortgage loans into highly liquid assets that could be sold into capital markets, these securitization programs ultimately provided the banks and government-sponsored entities with a source of liquid assets that could in turn be used to issue new loans to a new class of homebuyers.[24] One notable feature of the original RMBS programs by government-sponsored entities was that the loans were backed by the U.S. government—meaning that the United States kept "skin in the game."[25]

As securitization expanded as a solution for raising capital, the CMBS market developed in the late 1980s after the Savings and Loan Crisis, a period when thousands of traditional savings and loan institutions closed.[26] Prior to

mortgage-backed securities); Thomas E. Plank, *Crisis in the Mortgage Finance Market: The Nature of the Mortgage Loan and Regulatory Reform*, 12 TRANSACTIONS: TENN. J. BUS. L. 135, 137 (2011) (explaining historical challenges, and governmental response, to financing residential housing). Before the 1930s, most homeowners financed their homes through short-term mortgages lasting three to six years, with the expectation that such loans could be refinanced after reaching maturity. Plank, *supra*, at 137. The Great Depression exposed the discrepancy between homeowners' assets and mortgage liabilities, however, when many could not refinance their loans and subsequently defaulted. *Id.* at 137-38. As a result, the United States government encouraged the implementation of the long-term fixed-rate amortizing mortgage loans, which were backed and funded by the savings and loan association industry. *See id.* at 138. By requiring homeowners to pay fixed, monthly payments to pay off the principal balance plus accrued interested over a fixed period time, long-term fixed-rate mortgages spread the risks of declining property values and changes in market conditions over the life of home ownership. *See id.*

22. *See* Morgan, *supra* note 21, at 368 (examining initial introduction of RMBS loans into market and subsequent market developments); Plank, *supra* note 21, at 139 (discussing government sponsored entities' initial securitization process).

23. *See* Plank, *supra* note 21, at 139 (providing simplified explanation of private and public mortgage loan securitization programs).

24. *See* Ronald S. Borod, *Belling the Cat: Taming the Securitization Beast Without Killing It*, 31 REV. BANKING & FIN. L. 643, 647 (2012) (describing process through which mortgage-backed securities provide liquidity for real estate financing).

25. *See id.* at 647-48 (noting loans held by government sponsored entities backed by U.S. government's full faith and credit). Because the U.S. government had an interest in seeing the loans repaid, the loans were required to meet strict underwriting standards. *See id.* at 648-49.

26. *See* Alan Kronovet & Chris van Heerden, *Chapter 2 in the History of CMBS: Coming to Terms with the New Rules*, 20 N.C. BANKING INST. 67, 68 (2016) (asserting Savings and Loan Crisis origin of CMBS market); *see also* Morgan, *supra* note 21, at 367-68 (providing explanation for failure of savings and loan institutions). The savings and loan institutions operated by funding long-term fixed-rate mortgages through customers' short-term deposits. *See* Plank, *supra* note 21, at 138. This scheme is commonly referred to as the "3-6-3" system because the savings bank would borrow from its depositors at 3%, lend to a home buyer at 6%, and then, in a nod to the simplicity of the transaction, allow bank officers to be on the golf course by 3 p.m. *Id.* Inflation and rising interest rates in the 1960s and 1970s devalued these loans and put many savings and loan

the era of securitization, residential and commercial real estate markets relied on savings and loans as the primary sources of financing.[27] Nevertheless, 1970s inflation and rising interest rates, together with falling real estate prices after the Tax Reform Act of 1986, deteriorated the value of long-term, fixed-rate mortgages held by the savings and loan institutions.[28] In response to the crisis, Congress created the Resolution Trust Corporation (RTC) to manage the underperforming CRE loans held by insolvent savings and loan banks and sell them as securities.[29] The RTC issued $18 billion in CRE securities between 1991 and 1995.[30] The private sector realized the potential growth in this area, and created the CMBS market in the early 1990s to provide much-needed capital in the CRE market.[31] Thus, the CMBS market was a product of initial securitization by government-sponsored entities and the structure put in place by the RTC.[32] With the exception of a few minor disruptions, the CMBS market continued to grow until the financial crisis hit in the late 2000s.[33] For example, the CMBS market grew to a high of $776.8 billion outstanding balance in 2007, accounting for nearly one-third of the mortgage market.[34]

Commercial mortgages have specific, unique characteristics that set them apart from traditional real estate mortgages.[35] As the name implies,

institutions out of business in the 1980s. *See id.*; *see also* Alaine Maysich, *The Savings and Loan Crisis and Its Relationship to Banking*, *in* 1 FED. DEPOSIT INS. CORP., AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, 167, 185-88 (1997), https://www.fdic.gov/bank/historical/history/167_188.pdf [https://perma.cc/JEY9-HAXJ] (explaining savings and loan institutions' overexposure in commercial real estate).

27. *See* Morgan, *supra* note 21, at 367 (noting standardization of savings and loan industry for mortgages after Great Depression).

28. *See* Brown, *supra* note 20, at 122-23 (discussing effect of 1986 Tax Reform Act on savings and loan institutions); Morgan, *supra* note 21, at 367-68 (finding Tax Reform Act's removal of tax shelter provisions detrimental to savings and loan institutions). These tax shelters were advantageous vehicles for real estate investment, and their removal triggered a decrease in real estate prices. *See* Morgan, *supra* note 21, at 367. *See* Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (creating influential tax reform).

29. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 101, 103 Stat. 183, 187 (establishing RTC in response to Savings and Loan Crisis); *see also* Kronovet & van Heerden, *supra* note 26, at 68 (calling creation of RTC significant influence on CMBS market).

30. *See* Morgan, *supra* note 21, at 368 (stating amount securitized by RTC in CMBS). The RTC securitized $14 billion in CRE loans in two years alone. *See* Phillips, *supra* note 20, at 339.

31. *See* Morgan, *supra* note 21, at 368 (tracing private sector creation of CMBS market to RTC).

32. *See* Brown, *supra* note 20, at 122-23 (noting CMBS rooted in government-sponsored entity residential programs); Phillips, *supra* note 20, at 339 (discussing impact of RTC on creation of CMBS market).

33. *See* Kronovet & van Heerden, *supra* note 26, at 72-73 (outlining three periods of market disruptions for CMBS). One significant period of disruption took place after the September 11th attacks due to a lack of available insurance covering terrorist attacks. *See id.* at 75-76. In 2002, Congress passed the Terrorism Risk Insurance Act, which successfully ignited the market again. *Id.*

34. *See id.* at 69-70 (stating record issuance of CMBS in 2007 market); Phillips, *supra* note 20, at 339 (identifying size of CMBS market).

35. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON RISK RETENTION 17-18 (2010) [hereinafter RISK RETENTION REPORT] (describing distinct features of residential and commercial attribute classes). Other asset classes include nonconforming residential mortgages, credit cards, auto loans, student loans, and commercial and industrial bank loans. *Id.* at 1. The largest section of asset-backed securities is the real estate sector, which includes both residential and commercial mortgages. *Id.* at 28.

commercial mortgages provide financing for properties with commercial uses such as office buildings, hotels, apartments, and retail complexes.[36] These properties, as the assets backing the securities, tend to be located in major urban markets and have well-established rental incomes.[37] Additionally, there are built-in protections in the underwriting of the CMBS market that are not present in the RMBS market.[38] Perhaps most notably, commercial real estate investors tend to be more sophisticated than residential real estate investors because the underlying assets in CMBS are normally larger than those underpinning single-family residential loans.[39] Standard characteristics of commercial mortgages typically include ten-year, fixed-rate loans with a thirty-year amortization period, and sometimes, a balloon payment, or the full balance remaining on the loan due at maturity.[40] Moreover, the terms of CRE loans make it such that the CMBS structures are focused less on interest risk, and more on credit risk.[41] Due to the smaller size of CMBS asset pools, its deals are susceptible to "idiosyncratic default risk," which means that since there are fewer loans in the pool, a smaller number of loan defaults has a more devastating effect on the entire pool.[42] All of these specific characteristics account for risk exposure, and ensure that backers of these loans retain some level of "skin in the game."[43]

B. Understanding Securitization in the Context of the CMBS Market

Understanding the causes and effects of the CMBS market during the financial crisis requires a grasp of the complexities of securitization and the

36. *See id*. at 18 (noting classic types of commercial properties).

37. *See* Adam J. Levitin & Susan M. Wachter, *The Commercial Real Estate Bubble*, 3 HARV. BUS. L. REV. 83, 93 (2013) (observing properties backing CMBS geographically concentrated). CMBS-backed properties are concentrated in approximately sixty of the major urban markets because the data factors that influence their value, such as vacancy rates, appraisal value, and market demand, are more favorable there. *See id*. CRE loans are for properties that produce income, meaning they are typically financed through the income they receive from rental payments. *Id*. at 89; *see* RISK RETENTION REPORT, *supra* note 35, at 18 (noting CMBS commercial properties generally have well-established cash streams).

38. *See* Borod, *supra* note 24, at 649-50 (differentiating restraints on CMBS imposed by market from those mandated by government). Despite the similarities to RMBS, CBMS are not guaranteed by the U.S. government, and as such, the government did not mandate the underwriting restraints. *See id.*

39. *See id*. (identifying factors unique to CMBS underwriting). The large size of each asset in a pool of large commercial real estate loans creates "lumpiness" in the pool, which requires credit rating agencies to look more closely at each individual asset when determining the credit rating of the pool. *Id*.

40. *See* RISK RETENTION REPORT, *supra* note 35, at 18 (explaining standard CRE mortgage loan terms).

41. *See* Levitin & Wachter, *supra* note 37, at 91 (observing reduced interest rate risk of CRE loans). The terms of a CRE loan result in CRE lenders' small exposure to interest rate risk, and smaller incentives for commercial borrowers to refinance if interest rates fall. *Id.*

42. Levitin & Wachter, *supra* note 37, at 98 (explaining idiosyncratic default risk and noting relationship between size of CMBS pools and default risk). In comparison, RMBS pools feature thousands of loans, which make them more immune to the risk of a small number of loan defaults. *See id.*

43. *See* Borod, *supra* note 24, at 650 (explaining additional level of risk retention in CMBS). The size of the asset pool and general sophistication of CRE investors increase the investors' comfort with the level of risk exposure involved in the deals. *Id*.

structure of the secondary mortgage market.[44] There are many reasons why securitization is an attractive option for CRE funding.[45] The first reason is rather uncomplicated: Securitization is an effective means of raising capital by taking illiquid mortgage loans and selling them on the secondary mortgage market.[46] This lowers transactional costs for investors and borrowers.[47] Additionally, securitization allows borrowers to have "long-term, assumable financing at lower interest rates," while also providing lenders with "the ability to monetize long-term assets to match short-term liabilities."[48] Securitization also limits investor risk by holding securitized assets in separate legal entities, called special purpose entities, that keep the assets outside of creditors' reach in the event of a parent company's bankruptcy.[49] In fact, most credit rating agencies require a true sale of the financial assets before issuing a credit rating of the securities.[50] Because securitized assets are protected from bankruptcy filings, a true sale of the assets occurs when the originator transfers all rights and interests into an independent special purpose entity.[51]

44. *See* RISK RETENTION REPORT, *supra* note 35, at 8 (providing overview of securitization).

45. *See* Morgan, *supra* note 21, at 368-69 (discussing attractiveness of securitization to originators of mortgage loans).

46. *See id.* at 369 (noting securitization's ability to raise capital and lower costs for consumers); *see also* RISK RETENTION REPORT, *supra* note 35, at 8 (describing positive advantages of securitization). One notable benefit of securitization is that it lowers the cost of credit for average consumers and businesses. *See* RISK RETENTION REPORT, *supra* note 35, at 8; *see also* Borod, *supra* note 24, at 645-46 (acknowledging "unprecedented liquidity" brought to global markets through securitization).

47. *See* Morgan, *supra* note 21, at 369 (noting investors enjoy lower financing costs due to decreased transactional risk through securitized transactions).

48. Brown, *supra* note 20, at 135 (describing transactional benefits lenders and borrowers derive from securitization).

49. *See* Brown, *supra* note 20, at 132 (recognizing bankruptcy protection significant benefit of securitized transactions). Securitization obstructs bankruptcy courts' ability to consolidate mortgaged assets with a borrower's other debts. *Id.*; *see* RISK RETENTION REPORT, *supra* note 35, at 10 (stating assets separated through securitization protected from seizure in event of bankruptcy); Kronovet & van Heerden, *supra* note 26, at 80-82 (describing securitization mechanism for bankruptcy remoteness). The Federal Reserve noted that "[t]he key aim of establishing such separation is that the assets transferred into the securitization cannot be seized by creditors upon the bankruptcy or failure of the transferors of such assets." RISK RETENTION REPORT, *supra* note 35, at 10.

50. *See* SECURITIZATION OF FINANCIAL ASSETS § 5.03 (Jason H.P. Kravitt et al. eds., 3d ed. 2017) (defining and discussing true sale requirements in context of securitization transactions). Courts will look at the primary intent of the parties in determining whether a transaction is a true sale, even if it appears to be a secured loan. *Id.*

51. *See* Kronovet & van Heerden, *supra* note 26, at 81 n.44 (stating true sale vital to securitization risk isolation structure). In the securitization context, funds generated from the true sale of assets via the special purpose entity revert back to the originator of the loan, who placed the assets into the special purpose entity in the first place. *See* Stephen J. Lubben, *Beyond True Sales: Securitization and Chapter 11*, 1 N.Y.U. J.L. & BUS. 89, 92-93 (2004). A current debate over the securitization process is whether securitization amounts to a sale of financial assets or a secured loan; if the latter, then control of the assets would fall under the purview of Article 9 of the Uniform Commercial Code (UCC), meaning that they would not be protected from creditors in the event of bankruptcy. *See* Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamics*, 9 AM. BANKR. INST. L. REV. 287, 296-97, 312-13 (2001) (discussing assets within, and outside of, reach of bankruptcy rules and UCC).

Traditionally, CRE loans were securitized by following the "originate-to-distribute" securitization model.[52] The model dictates that lenders make loans for the sole purpose of selling them to investors on the secondary mortgage market, as opposed to holding them until maturity.[53] This securitization model is comprised of three main parts: origination, securitization, and servicing.[54] The origination phase occurs when the originator of a loan extends credit to a borrower in the form of a loan.[55] The originator can then elect to sell or securitize the CRE loan to a third-party securitizer who creates and then sells securities backed by the loan.[56] Lastly, the servicing phase for the loans pertains to the administration of the loans, such as collecting monthly payments.[57]

While in a special purpose entity, CMBS deals are typically structured in distinct classes known as "tranches" in order to account for credit risk.[58] A variation in levels of tranches, from senior to junior subordinate, diversifies the risk across the different layers of the special purpose entity, with the most senior tranches taking on the least amount of risk and the most junior taking on the most.[59] CMBS credit risk is handled much differently than that of RMBS, because where an RMBS deal structure has only one part, a CMBS deal has

52. *See* Borod, *supra* note 24, at 649 (describing evolution of CMBS market regarding origination of loans). The securitization process can be described as "the child's game of hot potato," with the mortgages being quickly passed from origination, to sale, then to securitization to investors. *Id.* at 655; *see* INQUIRY REPORT, *supra* note 3, at 486 (using "originate-to-distribute idea" to describe securitization model). In its report, the Financial Crisis Inquiry Commission noted that under the originate-to-distribute model, an originator of a loan does not have any incentive to care about the quality of the mortgages, because they will eventually be sold. *See* INQUIRY REPORT, *supra* note 3, at 486.

53. *See* Borod, *supra* note 24, at 649 (describing originate-to-distribute model).

54. *See* Brown, *supra* note 20, at 133 (explaining three-part process of securitization).

55. *See id.* at 133-34 (outlining first stage of securitization process). At the initial stage, the borrower will receive a loan quote with an interest rate and loan amount. *Id.* at 133. The lender will also receive an appraisal and any other relevant reports on the property. *Id.* at 134. This typically means that there is significant due diligence undertaken on a commercial real estate property as compared to a residential property. *See id.*; *see also* RISK RETENTION REPORT, *supra* note 35, at 9 (describing origination process).

56. *See* RISK RETENTION REPORT, *supra* note 35, at 9-10 (describing origination phase within context of overall securitization process); Brown, *supra* note 20, at 138-39 (explaining transition from loans into securities). Investment banks are very involved in securitizing loans. Brown, *supra* note 20, at 138. The loans are typically held in a trust, known as a real estate mortgage investment conduit, or REMIC. *Id.* at 139.

57. *See* SECURITIZATION OF FINANCIAL ASSETS, *supra* note 50, § 16.05 (explaining loan servicing phase of securitization model).

58. *See* Borod, *supra* note 24, at 655 (noting securities structured as tranches). "Tranche" translates to "slices" in French. *Id.* at 655; *see* Levitin & Wachter, *supra* note 37, at 85-86 (describing hierarchy of risk allocation through senior-subordinate tranche mechanism). More junior tranches with greater risk are sold to investors at higher interest rates. Levitin & Wachter, *supra* note 37, at 85-86.

59. *See* Levitin & Wachter, *supra* note 37, at 85-86 (describing risk allocation); *see also* RISK RETENTION REPORT, *supra* note 35, at 12 (explaining risk exposure of tranche structure). Because the cash flows are distributed to the senior tranches first, the risk of default losses is spread out throughout the tranches, albeit unequally. *See* RISK RETENTION REPORT, *supra* note 35, at 12. The securities available through the varying tranche levels appeal to the different risk appetites of investors who evaluate the risk-return profile of the securities. *Id.* at 13.

two: an "A-Piece" and a "B-Piece."[60] The A-Piece consists of the most senior and low-risk part of the investment vehicle, while the B-Piece consists of the subordinate, and therefore riskier, investment.[61] Consequently, B-Piece investors tend to be more sophisticated and hold special rights and protections to account for the greater credit risk.[62]

B-Piece investors are integral to CMBS deals because they are seen as "gatekeepers" in the credit risk of CMBS.[63] As a condition for purchasing the most subordinated tranche, also called the "first-loss" tranche, B-Piece buyers require extensive due diligence—even more so than the credit rating agencies—to account for the riskier investment.[64] This in turn makes other investors in the more senior tranches more comfortable with the deal.[65]

Much has been written about the underlying causes of the financial crisis, but the focus of this Note is what happened in the CMBS market in particular.[66] After the fallout from the financial crisis, federal regulators criticized the lack of securitization regulation for contributing to the crisis.[67] Accordingly, there were developments in the CMBS market that affected its outcome in the financial crisis.[68] Most importantly, the quality of underwriting standards for commercial mortgages decreased in the years preceding the financial crisis.[69] New, less sophisticated investors entering the CMBS market and aggressively

60. *See* Levitin & Wachter, *supra* note 37, at 98 (explaining CMBS deal structure). The A-Piece and B-Piece sides of the CMBS deal account for the different credit risk concerns of investors. *Id.*

61. *See id.* (explaining differences between A- and B-Pieces).

62. *See id.* at 98-99 (outlining B-Piece investors' rights and protections). B-Piece investors have significant market power to control what properties are included in the deal, and in return, they provide appropriate due diligence for the securities. *Id.* B-Piece investors can also enforce "kickouts" in the deal, meaning they can remove certain loans from the mortgage pool that they find unfavorable or too risky. *Id.*

63. *See* Joseph Philip Forte, *The Reality of CMBS Risk Retention: A Real Solution or Just Another Illusion?*, PROB. & PROP., Sept.-Oct. 2012, at 31, 33 (describing important "gatekeeper" role of B-Piece investors). The financial crisis undermined the process, however, because many B-Piece buyers leveraged their positions and sold their first-loss tranches to collateralized debt obligations (CDOs). *Id.*

64. *See id.* (explaining underwriting process undertaken by B-Piece investors). By assuming the first-loss position of the CMBS, B-Piece investors require full access to all documentation including the property, leases and cash flow, third parties, and the lender's underwriting. *Id.*

65. *See id.* (stating other investors' comfort level with deals because of B-Piece investors' expertise and experience).

66. *See* Levitin & Wachter, *supra* note 37, at 84 (noting residential, and not commercial, price bubble's impact on financial crisis attracted popular attention). In addition to the residential real estate price bubble, a parallel commercial real estate price bubble also occurred, accompanied by a bubble in CMBS. *Id.*

67. *See* Jonathan C. Lipson, *Re: Defining Securitization*, 85 S. CAL. L. REV. 1229, 1248-49 (2012) (discussing vulnerabilities exposed by securitization in financial crisis). Former Treasury Secretary Henry Paulson acknowledged the role that securitization played in contributing to the overleveraging in the market because it "separated originators from the risk of the products they originated." *Id.* at 1249.

68. *See* Forte, *supra* note 63, at 32-33 (identifying factors in CMBS contributing to financial crisis). Specifically, a B-Piece buyer's ability to resecuritize or use CDOs created highly-leveraged deals that no longer had traditional loan-to-value ratios or underwriting standards that made the CMBS market relatively safe. *Id.*

69. *See* Levitin & Wachter, *supra* note 37, at 104 (discussing decline in underwriting standards for CMBS deals). Much of the decline could be seen through loan characteristics such as interest-only loans and loan-to-value ratios. *Id.*

pursuing the product in the form of CDOs caused a dramatic change in the B-Piece market and led to a decrease in standards.[70]

CDOs are vehicles developed to securitize CRE loans as an alternative to traditional pass-through securities.[71] The introduction of CDOs into the CRE market significantly changed the buying of B-Pieces by allowing new, less experienced B-Piece buyers looking to quickly resell the product to participate in CMBS.[72] As a result, underwriting standards declined because the B-Piece buyers were no longer holding onto subordinate tranches, but were instead repackaging them into CDOs.[73] The expansion of the B-Piece market led to a greater increase in credit for CMBS, while the declining underwriting standards simultaneously led to the underpricing of risk in the CMBS market.[74] Given the large demand for CMBS at the time, taken together with new and over-eager B-piece buyers, an oversupply of financing occurred, and CRE borrowers were permitted to acquire more debt.[75] Ultimately, this combination of weakened underwriting standards and less diligent B-Piece buyers made for a riskier and more volatile CMBS market.[76]

C. Congress Responds: The Dodd-Frank Act and the Risk Retention Rules

By 2009, it became clear that the United States government would need to intervene in the financial markets to prevent further meltdown.[77] Congress

70. *See id*. at 102 (identifying new B-Piece buyers). The new B-Piece buyers had less leverage than the traditional buyers and looked to package the B-Piece securities they bought into CDOs. *Id.*

71. *See* SECURITIZATION OF FINANCIAL ASSETS, *supra* note 50, § 16.02 (defining CDOs in CMBS transactions). CDOs still use special purpose entities, but have more flexibility than a traditional CMBS trust structure. *Id.* For example, the assets securing CDOs may include other mortgage-backed securities. *Id.*

72. *See* Levitin & Wachter *supra* note 37, at 99-100 (discussing changing B-Piece market since popularity of CDOs). The B-Piece buyer had very low investment risk in the CDO context. *Id.*

73. *See id.* at 102 (describing how B-Piece buyers became intermediaries instead of final investors in collateralized debt obligations).

74. *See id.* at 102-04 (highlighting increase of available credit and deterioration of underwriting standards in years before financial crisis). From 2004 to 2005, CRE CDOs tripled in volume, accounting for nearly one-fifth of the entire CMBS market. *Id.* at 102. The sudden and dramatic popularity of CRE debt obligations can be attributed in large part to their ability to restructure and create a highly-leveraged instrument. *Id.* Additionally, loan structures increasingly became interest-only instead of amortizing, which typically requires borrowers to pay one large balloon payment. *Id.* at 104. In 2004, only 47% of loans were interest only, while that number grew to 86% in 2007. *Id.* The debt service coverage ratio, or the ratio of incoming rent to the amount of the mortgage payment, also decreased, as many of the loans based the coverage ratio on potential rent income. *Id.*

75. *See id*. at 102-04 (describing overleveraging of CMBS market preceding financial crisis).

76. *See* Levitin & Wachter, *supra* note 37, at 102-04 (identifying factors resulting in weakened CMBS market during financial crisis).

77. *See* DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 2-4 (2011) (identifying roots of Dodd-Frank Act). Congressman Barney Frank and Senator Chris Dodd were the two main brokers of the legislation, and steered it to fruition through their respective positions as the chairs of the financial services and banking committees. *Id.* at 3-4.

responded to the crisis by passing the Dodd-Frank Act in July of 2010.[78] The Dodd-Frank Act is a massive financial reform act that targets many areas of the financial services and banking industries in order to avert a similar, future financial meltdown.[79] Consequently, the Dodd-Frank Act addresses many underlying causes of the financial crisis and grants rulemaking authority to various financial and bank regulators.[80]

A significant part of the Dodd-Frank Act targets securitization, which federal regulators identified as the main contributing factor to the crisis.[81] Section 941 of the Dodd-Frank Act addresses the regulation of credit risk retention, which is the most significant securitization reform.[82] The rule amends the Securities Exchange Act of 1934 by adding section 15G, authorizing federal banking agencies to create a rule mandating a securitizer to retain "not less than 5% of the credit risk for any asset."[83]

Before an administrative agency issues a final regulatory rule, there is typically a public notice and comment period on the proposal, which allows industry professionals to submit their recommendations on how to improve the proposed rule.[84] The comment process for the risk retention rule took more than three years to complete, and significantly shaped the strength of the rule.[85]

78. *See id.* at 3-4 (discussing Dodd-Frank Act's path to congressional enactment); Brady Dennis, *Obama Signs Financial Overhaul into Law*, WASH. POST (July 22, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/07/21/AR2010072100512.html [https://perma.cc/7KKS-N4E6].

79. *See* SKEEL, *supra* note 77, at 4 (stating goals of Dodd-Frank Act). The Dodd-Frank Act was enacted to limit the risk of the contemporary banking system and to mitigate the damage caused to the country's largest financial institutions. *Id.*

80. *See* Kronovet & van Heerden, *supra* note 26, at 86-87 (acknowledging Dodd-Frank Act's framework left significant room for rulemaking by federal agencies).

81. *See* CHRISTOPHER DODD, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, S. REP. NO. 111-176, at 43 (2010) (highlighting issues with excessive risk relating to securitization); Kronovet & van Heerden, *supra* note 26, at 86 (identifying securitization target of Dodd-Frank financial reform). The Dodd-Frank Act addressed, among others, two key objectives in securitization reform: aligning the interests of issuers and investors, and broadening disclosure to investors. *See* Kronovet & van Heerden, *supra* note 26, at 86.

82. *See* Dodd-Frank Act § 941, 15 U.S.C. § 78*o*-11 (2012) (authorizing risk retention rule); *see also* Kronovet & van Heeren, *supra* note 26, at 87 (discussing risk retention rules).

83. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 941, 124 Stat. 1376, 1890-91 (2010) (creating 5% risk retention provision). Section 941 defines a securitizer as "an issuer of an asset-backed security"; or "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." *Id.* The section also defines an originator as a person who "through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security"; and "sells an asset directly or indirectly to a securitizer." *Id.*

84. *See* OFFICE OF THE FED. REGISTER, A GUIDE TO THE RULEMAKING PROCESS, https://www.federalregister.gov/uploads/2011/01/the_rulemaking_process.pdf [https://perma.cc/UJ4H-YRHD] (providing overview of federal agency rulemaking process).

85. *See* Kronovet & van Heeren, *supra* note 26, at 87 (describing three years of notice and comment process for finalized rule); *see also* Stephen Hall, *Weakening Reforms in the Securitization Market to Protect Mortgage Financing From an Uncertain Threat Is a Bad Trade*, BETTER MARKETS (Oct. 23, 2014), https://www.bettermarkets.com/blog/weakening-reforms-securitization-market-protect-mortgage-financing-uncertain-threat-bad-trade [https://perma.cc/98XN-CARA] (discussing substantial loophole for qualified residential mortgages in final rule). The qualified residential mortgages loophole weakens the strength of the

Finally, over four years after Congress passed the Dodd-Frank Act, six agencies jointly issued the final credit risk retention rule in October of 2014, which applied to both residential and commercial mortgage securities.[86] On the day of the announcement, the Federal Reserve Chair, Janet Yellen, stated that the risk retention requirements "better align the interests of sponsors and investors by providing an economic incentive for sponsors to monitor the quality of securitized assets."[87] The final rule went into effect one year after publication in the Federal Register for RMBS, and two years after publication for all other types of securities.[88] As a result, the risk retention requirements for CMBS went into effect at the end of 2016.[89]

The final risk retention rule still requires securitizers to retain a 5% interest in the credit risk of its securitized assets, but expands the ways this may be accomplished.[90] There are three potential ways a securitizer may hold the risk in satisfaction of the requirement: eligible vertical interest, eligible horizontal residual interest, or a combination of the two.[91] The eligible vertical interest means holding a 5% interest in each securitization class, while the eligible horizontal interest means holding a 5% interest in the most subordinated class.[92] The last option is known as the "L-shaped" retention interest because it is a combination of both the vertical and horizontal retention interests.[93]

final rule because it means many residential mortgages are exempt from the risk retention requirement. *See* Hall, *supra*; *see also* Forte, *supra* note 63, at 38 (discussing effect of lobbyists on final rule). The Commercial Real Estate Finance Council actively participated in the comment period by submitting their industry standards to federal regulators, including standards such as underwriting best practices. *See* Forte, *supra* note 63, at 38.

86. *See* Joint Press Release, Bd. of Governors of the Fed. Reserve Sys., Six Federal Agencies Jointly Approve Final Risk Retention Rule (Oct. 22, 2014), https://www.federalreserve.gov/newsevents/press/bcreg/20141022a.htm [https://perma.cc/3AFJ-BMH2] (announcing adoption of final rule in accordance with Dodd-Frank Act). The six agencies that issued the final rule were the Department of the Treasury, Federal Reserve, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities and Exchange Commission, and the Department of Housing and Urban Development. *Id.*

87. *See* Press Release, Janet L. Yellen, Chair, Bd. of Governors of the Fed. Reserve Sys., Opening Statement by Chair Janet L. Yellen (Oct. 22, 2014), https://www.federalreserve.gov/newsevents/press/bcreg/yellen-statement-20141022.htm [https://perma.cc/89ES-ANQP] (providing Yellen's comments after issuance of final rule).

88. *See* Credit Risk Retention Rule, 79 Fed. Reg. 77,602 (Dec. 24, 2014) (codified at 17 C.F.R. pt. 246) (listing effective dates for retention rules); *see also* Joint Press Release, Bd. of Governors of the Fed. Reserve Sys., *supra* note 86 (stating time difference for RMBS and CMBS regulations to go into effect).

89. *See* Mattson-Teig, *supra* note 15 (noting December 24, 2016 effective date for CMBS retention regulations). Recently, the market has been more active with the experimentation of different deal structures in order to meet the new regulations. *Id.*

90. *See* Credit Risk Retention Rule, 79 Fed. Reg. at 77,605-08 (stating original purpose of Dodd-Frank Act and identifying new requirements).

91. *See id.* at 77,604-05 (discussing ways to satisfy risk retention requirement); *see also* Yablonski & Schaffer, *supra* note 12 (explaining eligible vertical and eligible horizontal interest options).

92. *See* Yablonski & Schaffer, *supra* note 12 (defining structure risk retention interests in satisfaction of final rule).

93. *See id.* (explaining "L-shaped" combination risk retention interest). The "L-shaped" interest holds both the most subordinate securities as well as slices across all of the tranches. *Id.*

D. CMBS 2.0: How the Market Reacted

1. Market Developments

From its origination peak at $166 billion in 2005, the CMBS market drastically contracted during the financial crisis in 2008, and its issuance plummeted in 2009.[94] Nevertheless, CMBS as an asset class still performed relatively well, even as the market collapsed.[95] Beginning in 2010, issuance started to pick up as originators returned to more traditional and conservative underwriting standards previously seen in the CMBS market.[96] Furthermore, since the low point of the financial crisis, the issuance of CMBS deals has increased every year since 2010, reaching $94 billion in 2014.[97]

In 2016, however, the CMBS market once again experienced difficulties and market uncertainty, as the deadline for the implementation of the risk retention rules approached, and investors questioned how the new rules would affect the market.[98] After the fourth quarter of 2015 realized $23.4 billion in CMBS deals, issuance slowed to $19.3 billion and $11.4 billion in the first and second quarters of 2016, respectively.[99] But CMBS rebounded in the second half of 2016 to $19.2 billion in the third quarter and $25 billion in the fourth quarter.[100] This resurgence in the CMBS market was partly attributable to the introduction of the first market deal that complied with the new Dodd-Frank risk retention rules.[101]

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94. *See* Fabozzi et al., *supra* note 10, at 119 (highlighting changes in CMBS market beginning in 2007). The CMBS market grew rapidly from 2005 to 2007, as origination peaked in 2007 with $228 billion in issuance. *Id*.

95. *See* Brown, *supra* note 20, at 108-09 (contrasting relatively strong CMBS asset class performance compared to other assets during financial crisis). Even though issuance dropped, the assets themselves did not see widespread defaults, which greatly differed from the residential real estate market. *See id.* at 105.

96. *See* Fabozzi et al., *supra* note 10, at 120 (arguing underwriting standards returned to conservative levels seen pre-financial crisis beginning in 2010).

97. *See id.* at 119 (outlining rebound of CMBS market after financial crisis began in 2008). Although the actual 2014 issuance amount did not meet the projection of $100 billion, it was still a significant increase from the 2013 originations. *Id.* In fact, Kroll Bond Rating Agency claimed "the CMBS market benefited in 2014 by improved CRE fundamentals resulting from 'meaningful' growth in the U.S. economy." *Id.*

98. *See* Wiltermuth, *supra* note 12 (detailing uncertainty facing investors in market); *see also Trepp Analyzes the First CMBS Deal Compliant with Risk Retention*, PRWEB (Sept. 1, 2016), http://www.prweb.com/releases/2016/09/prweb13654194.htm [https://perma.cc/3HUX-BNZ2] [hereinafter *Trepp*] (describing anxiety surrounding CMBS issuers before deal). Trepp, LLC, a leading information provider in the CMBS market, analyzed the market conditions by observing that many CMBS issuers were anticipating the first deal that would hit the market. *See id*.

99. *See* Beth Mattson-Teig, *CMBS Is Ready for Fresh Start in 2017*, NAT'L REAL EST. INV. (Dec. 7, 2016), http://nreionline.com/cmbs/cmbs-ready-fresh-start-2017 [https://perma.cc/Q69A-Q56Z] (describing market conditions for CMBS in 2016 before new rules took effect). The flow of new deals slowed while issuers tried to figure out the best way to structure deals compliant with the new rules. *See id.*

100. *See id.* (highlighting CMBS rebound in second half of 2016).

101. *See id.* (noting increased issuance of CMBS partly resulted from increased certainty following risk retention rules).

The first CMBS deal compliant with the Dodd-Frank risk retention rules launched in August of 2016.[102] Jointly originated by Wells Fargo, Bank of America, and Morgan Stanley, the deal was meant to gauge investor and regulator reaction to the new rules and serve as a potential model for future deals.[103] The deal featured forty CRE loans backed by forty-six different properties.[104] The deal received a favorable reception from investors for three reasons: The deal gave investors more confidence, relied on high-quality properties as collateral, and created an increased demand from investors because of low CMBS issuance in 2016.[105]

In order to comply with the Dodd-Frank risk retention guidelines, the deal was structured under a vertical risk retention method.[106] This meant that the banks, as originators of the loan, were required to keep a "sliver" of each class of security, from the most highly rated down to the most subordinated.[107] Specifically, the deal was comprised of a 5% "vertical strip" across all of the tranches, which was shared by originators Wells Fargo, Bank of America, and Morgan Stanley, who each retained a pro rata share of $43.53 million.[108]

102. *See* Razin, *supra* note 14 (outlining details of deal compliant under Dodd-Frank rules). The first compliant deal is a conduit pool with a balance of $870.6 million. *Id.* Otherwise known as the Wells Fargo Commercial Mortgage Trust 2016-BNK1, the deal does not provide a complete answer to how the risk retention regulations will impact commercial real estate, but it is a starting point for many investors who tepidly anticipated the new "skin in the game" rules. *Id.*

103. *See id.* (identifying deal model for future rule-compliant CMBS deals).

104. *See id.* (describing properties backing largest loans in deal); *Trepp*, *supra* note 98 (identifying properties involved in first CMBS deal compliant with rules). The three largest loans in the deal were an $80 million loan for a Las Vegas shopping center, an $80 million loan for a pharmaceutical company in Boston, and a $71.4 million loan for an office building in Connecticut. *See Trepp*, *supra* note 98. 70% of the loans involved in the deal were for properties located in the twenty-five largest metropolitan statistical areas. *Id.*

105. *See* Mattson-Teig, *supra* note 15 (listing reasons why investors found deal favorable). The deal was also successful because it was "conservatively underwritten"—meaning metrics such as loan-to-value ratios and debt yields were a low risk for investors. *Id.* The loan-to-value ratio for this deal was 55.6% compared to an average of 61% for other conduit deals that originated in 2016. *Id.*

106. *See* Razin, *supra* note 14 (articulating main structuring methods for risk retention rule compliance). Vertical and horizontal risk retention are two ways a deal can be structured to comply with the Dodd-Frank Act rules. *Id.* A vertical structure sponsor retains 5% of the face value of each tranche, while a horizontal structure sponsor retains the most subordinated tranche for 5% of the "fair value" of all issued CMBS. *See id.*; *see also Risk Retention for Commercial Mortgage Backed-Securities: Fact Sheet*, CADWALADER (Oct. 29, 2014), http://www.cadwalader.com/resources/clients-friends-memos/risk-retention-for-commercial-mortgage-backed-securitiesfact-sheet [https://perma.cc/4S67-MHQM] (noting "fair value" measurement for horizontal risk retention determined using generally accepted accounting principles (GAAP)). The horizontal method allows for the risk to be transferred to B-Piece buyers as in past CMBS deals. *See* Razin, *supra* note 14. There is also a third risk retention method that is a combination of vertical and horizontal risk retention. *See* Mattson-Teig, *supra* note 15.

107. *See* Wiltermuth, *supra* note 12 (defining what banks retain in vertical risk retention structure). This vertical strip across all of the classes of securities must be retained by the banks for the life of the loan, which is typically ten years in the CMBS market. *Id.*

108. *See* Mattson-Teig, *supra* note 15 (analyzing 5% vertical strip of deal). The 5% strip across all classes of the securities amounts to $43.53 million. *Id.* Of that, Wells Fargo, the bank with the biggest stake, will retain 39.4%, Bank of America will hold 35.5%, and Morgan Stanley will retain 25.2%. *Id.*

Unless federal regulators rule negatively on the structure of this attempt at a compliant deal, it does not appear that the new rules will prevent the future issuance of CMBS.[109] In January 2017, a group of four banks issued a new CMBS loan—compliant with the risk retention rules and amounting to almost $1 billion—to Paramount Group for a California office property.[110] The deal proved that CMBS lenders will continue to move forward with issuance until federal regulators take a stand on the Dodd-Frank rules.[111] At the end of 2017, and after an uncertain start to the year, the outlook for CMBS remains strong—loan volume has increased and borrowers continue to use CMBS as a main source of capital for CRE.[112] The most significant observation following the implementation of the rules appears to be a trend of more conservative underwriting for the loans.[113] As a result, there is continued optimism that the rules will not prevent continued CMBS issuance.[114]

2. The Credit Crunch: CRE's Refinancing Problem

Another issue in the CMBS market that coincides with the implementation of the risk retention rules is the severe refinancing crisis facing maturing CRE loans.[115] Because CRE loans typically have ten-year loan periods, many of the loans issued before the 2007 crisis are now maturing and are at risk for default.[116] By the end of 2018, an expected $154 billion in CRE loans will

109. *See* Mattson-Teig, *supra* note 99 (affirming notion CMBS market continues to improve under new rules). In particular, some vertical strip risk retention deals received a positive reception from investors due to the quality of the loans, and the feeling that the banks were behind the deal, which made investors feel more comfortable. *Id.* There is optimism that CMBS issuance will once again reach $100 billion in 2017. *Id.*

110. *See* Andrew McIntyre, *Near-$1B Deal Shows New Rules 'Will Not Chill' CMBS Market*, LAW360 (Jan. 24, 2017), https://www.law360.com/realestate/articles/883443/near-1b-deal-shows-new-rules-will-not-chill-cmbs-market [https://perma.cc/BU7W-FR57] (describing new CMBS deal compliant with Dodd-Frank risk retention rules).

111. *See id.* (asserting new rules will not slow CMBS market entirely). This particular deal demonstrates that the risk retention rules would not necessarily "chill" CMBS origination. *Id.*

112. *See* Mitch Paskover, *CMBS Market Strengthens in Second Half of 2017, Despite Market Fears*, NAT'L REAL EST. INV. (Sept. 6, 2017), http://www.nreionline.com/cmbs/cmbs-market-strengthens-second-half-2017-despite-market-fears [https://perma.cc/SJ2Q-TDFK] (noting steady holding of CMBS market amid risk retention rules). The forecast for total CMBS issuance in 2017 is between $70-75 billion, which follows the numbers from 2016. *Id.*

113. *See id.* (highlighting positive result of final rule implementation).

114. *See id.* (discussing strength of CMBS market despite new rules); *see also* Beth Mattson-Teig, *Investors Maintain Healthy Appetite for B-Piece CMBS*, NAT'L REAL EST. INVESTOR (Oct. 25, 2017), http://www.nreionline.com/cmbs/investors-maintain-healthy-appetite-b-piece-cmbs [https://perma.cc/9BC8-Z479] (stating robust B-Piece market demonstrates encouraging impact of rule implementation).

115. *See* Morgan, *supra* note 21, at 363 (predicting potential refinancing crisis when many pre-crisis CRE loans reach maturity); *see also* JLL Research, *Don't Forget CMBS*, INVESTOR (Feb. 22, 2017), http://www.theinvestor.jll/news/americas/00/experts-going-need-cmbs/ [https://perma.cc/3QKQ-869R] (discussing oncoming credit crunch for CMBS in 2017). Another wave of CMBS loans are set to mature in 2017, with another batch following at the end of the year. JLL Research, *supra*.

116. *See* Diana Bell, *Projected CMBS Issuance for 2017 Under $80 Billion*, NAT'L REAL EST. INV. (Jan. 20, 2017), http://nreionline.com/cmbs/projected-cmbs-issuance-2017-under-80-billion [https://perma.cc/CQ74-ZJ4P] (discussing potential for "significant delinquencies" for maturing CRE loans). Although CMBS issuance

mature.[117] This wave of loans is called the "wall of maturities" because there is a large number of them set to mature, stemming from the peak 2006 to 2007 origination period.[118] These loans were issued in the vastly different 2007 market landscape and may now enter into default due to less favorable conditions.[119]

Coinciding with the risk retention rules, refinancing these loans is challenging because the debt is more expensive, and improved underwriting standards require a lower loan-to-value ratio.[120] At the same time, the refinancing problem facing the CRE market makes the issuance of new CMBS particularly important.[121] Capital is needed to prevent significant defaults, so investors will not be able to abandon CMBS.[122]

3. Uncertainty Remains: The Effect of Potential Legislative Changes

The current political climate will also impact how the CMBS market progresses under the new risk retention rules, as President Donald J. Trump's election signaled a shift in economic policy.[123] In February 2017, President

may increase from 2016 to 2017, rising interest rates still pose a challenge, and market conditions are much less favorable than the peak origination period of 2006 to 2007. *Id.* Office and retail loans make up the majority of the maturing loans. *Id.*

117. *See* Sarah Borchersen-Keto, *CMBS Crosswinds Ahead*, NAREIT (Feb. 1, 2017), https://www.reit.com/news/reit-magazine/january-february-2017/cmbs-crosswinds-ahead [https://perma.cc/ZW6K-R7XU] (stating significant number of CRE loans due to mature by 2018).

118. *See id.* (referring to wave of maturing loans as "wall of maturities"). The decline in the wall began to appear in 2016 as a result of prepayments of debt for loans due in the fourth quarter of 2016 and in early 2017. *Id.* As the next wave of maturities hits, the default rate on CMBS loans is expected to hit 6%. *Id.* Originally, the default rate for all loans issued in the peak period of 2006 and 2007 was projected to reach 25% to 50%—a very high rate. *Id.* As of now, that default rate is expected to fall between 14% and 15%. *Id.*

119. *See* Debra Jackson, *The CMBS Wall of Maturities—Cracking the CMBS Code*, NAT'L REAL EST. INV. (Feb. 13, 2017), http://nreionline.com/cmbs/cmbs-wall-maturities-cracking-cmbs-code [https://perma.cc/CBY6-LQLA] (explaining favorable market conditions before financial crisis and current effect on loans). In one example, 91% of a $750 billion securitization from 2007 was maturing between December 2016 and March 2017, which amounted to $683 million in CRE loans. *Id.* Collectively, the pool was worth $100 million less than its appraisal in 2007. *Id.* To avoid default, 30% of the pool was involved "in some kind of workout situation." *Id.*

120. *See id.* (discussing challenges in refinancing during CMBS 2.0).

121. *See* JLL Research, *supra* note 115 (predicting need for CMBS even with market fluctuations). Although there are questions with the CMBS market moving forward, CMBS remains an important financing option, especially when there is a lack of capital. *Id.*

122. *See id.* (stating investors will continue to use CMBS financing option). A principal at a real estate capital firm predicted that there will be an increased need for CMBS as the markets balance out after the implementation of the risk retention rules. *Id.*

123. *See e.g.*, Marilyn Geewax, *Trump Team Promises to 'Dismantle' Dodd-Frank Bank Regulations*, NPR (Nov. 10, 2016), http://www.npr.org/sections/thetwo-way/2016/11/10/501610842/trump-team-promises-to-dismantle-dodd-frank-bank-regulations (referencing President Trump's campaign promise to repeal Dodd-Frank Act); Ben Protess & Julie Hirschfeld Davis, *Trump Moves to Roll Back Obama-Era Financial Regulations*, N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/business/dealbook/trump-congress-financial-regulations.html [https://perma.cc/G4SG-WM9D] (highlighting President Trump's executive order targeting Dodd-Frank Act); Martha C. White, *Dodd-Frank Financial Regulations Watered Down as Trump Signs Executive Orders*, NBC NEWS (Feb. 3, 2017), http://www.nbcnews.com/news/us-

Trump signed an executive order aimed at dismantling Dodd-Frank.[124] Although the executive order was vague, and congressional action will be necessary for any substantive changes, President Trump's actions demonstrate the uncertain future of Dodd-Frank moving forward.[125]

There is also pending legislation in Congress that could affect the risk retention requirements.[126] Two specific pieces of congressional legislation could impact the rules: the Preserving Access to CRE Capital Act of 2016 (Preserving Access Act) and the Financial Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs (CHOICE) Act.[127] The Preserving Access Act attempts to modify the Dodd-Frank risk retention rules by creating exemptions for qualified CRE loans and allowing more structures to hold eligible horizontal interest.[128] As an alternative to the Dodd-Frank Act, Republicans proposed the CHOICE Act, which would apply to a much broader range of bank regulations.[129] Specifically, the CHOICE Act repeals the risk retention rules for all asset classes except for residential mortgages, and would eliminate much of the banking reforms initiated by Dodd-Frank.[130] In June 2017, the U.S. House of Representatives passed the CHOICE Act, making the future of the risk retention rules under Dodd-Frank even more uncertain.[131]

news/trump-signs-executive-orders-watering-down-dodd-frank-financial-regulations-n716481 [https://perma.cc/PX8X-6S6B] (identifying portions of Dodd-Frank Act affected by President Trump's action).

124. *See* White, *supra* note 123 (expressing Trump's disdain for Dodd-Frank Act). President Trump previously called the Dodd-Frank Act a "disaster" and vowed to "do a big number" on the law. *Id.* He specifically targeted portions of the law that included the Consumer Financial Protection Bureau and fiduciary rules for financial advisors. *Id.*

125. *See* Protess & Hirschfeld Davis, *supra* note 123 (describing executive order's wording as "vague" and "expansive"); Ben Protess, *Republicans' Paths to Unraveling the Dodd-Frank Act*, N.Y. TIMES (Jan. 30, 2017), https://www.nytimes.com/2017/01/30/business/dealbook/republicans-unravel-dodd-frank-act.html [https://perma.cc/55AQ-J2V5] (stating limits of executive order, but identifying ways Republican Congress can repeal); *see also* E.B. Solomont, *Trump To Sign Order Rolling Back Dodd-Frank Regs*, REAL DEAL (Feb. 3, 2017), https://therealdeal.com/2017/02/03/trump-to-sign-order-rolling-back-dodd-frank-regs/ [https://perma.cc/9NAL-SNV8] (calling risk retention rules possible target for repeal).

126. *See* Yablonski & Schaffer, *supra* note 12 (noting potential legislative changes to Dodd-Frank risk retention rules). The pending legislation further provides uncertainty for the market, especially with President Trump's support for the repeal of the Dodd-Frank Act. *Id.*

127. *See id.* (outlining proposed legislation in Congress).

128. *See* Preserving Access to CRE Capital Act of 2016, H.R. 4620, 114th Cong. § 2 (2016) (proposing modifications to risk retention rule). Introduced in the U.S. House of Representatives by Congressman French Hill of Arkansas in February 2016, the bill proposes to amend section 15G of the Securities Exchange Act of 1934. *See id.*; *see also* Yablonski & Schaffer, *supra* note 12 (describing proposed modifications to risk retention rules).

129. *See* Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. (2016) (proposing repeal of Dodd-Frank Act). Representative Jeb Hensarling, a Republican from Texas, introduced the bill in September 2016 to dismantle the Dodd-Frank Act. *Id.* The bill would repeal the Volcker Rule, restructure the Consumer Financial Protection Bureau, and end bailouts and the concept of companies that are "too big to fail." *Id.*

130. *See id.* § 221 (noting provisions of Dodd-Frank Act subject to revision or repeal); Yablonski & Schaffer, *supra* note 12 (explaining proposed changes under Financial CHOICE Act).

131. *See Financial CHOICE Act of 2017*, DECHERT LLP (June 9, 2017), https://www.dechert.com/knowledge/hot-topic/financial-regulation-reform-tracker/financial-choice-act-of-2017.html [https://perma.cc/R6HN-KE

The CHOICE Act then headed to the Senate, where senators were not expected to pass the bill in its then-current form.[132] Although the House bill faltered in Senate committee hearings, senators introduced their own version of the bill in December of 2017 called the Economic Growth, Regulatory Relief and Consumer Protection Act.[133] At this time, the bill, which is still in the Senate Banking Committee, would not affect the risk retention rules.[134] Nevertheless, given President Trump's stated willingness to rescind the Dodd-Frank Act, coupled with a Republican majority in Congress that has uniformly backed proposed legislation, there is an increased likelihood of future legislative changes to Dodd-Frank's risk retention rules.[135]

III. ANALYSIS

The financial crisis had a devastating impact on financial markets across all asset classes.[136] After a significant period of uncertainty following the crisis, and the subsequent legislative response, the CMBS market has stabilized.[137] Although federal regulators have yet to weigh in on the structure of the deals, banks have adjusted to the Dodd-Frank Act's final rule for risk retention by launching compliant funds and retaining 5% of the securities' credit risk.[138]

As CMBS issuance steadily climbs, and investors become more comfortable with the risk retention rules, it is important to remember the reason why

ZK] (tracking potential changes to Dodd-Frank Act through legislation and regulations); Alan Rappeport, *Bill to Erase Some Dodd-Frank Banking Rules Passes in House*, N.Y. TIMES (June 8, 2017), https://www.nytimes.com/2017/06/08/business/dealbook/house-financial-regulations-dodd-frank.html (announcing passage of CHOICE Act by House of Representatives).

132. *See* Brena Swanson, *Is the Financial CHOICE Act DOA in the Senate?*, HOUSINGWIRE (June 9, 2017), https://www.housingwire.com/articles/40390-is-the-financial-choice-act-doa-in-the-senate [https://perma.cc/4VTG-HYNT] (noting lack of bipartisan support for CHOICE Act in Senate). The support for the bill has largely been along partisan lines, making its chance of passage less favorable in the Senate. *Id.* As a result, the likely resolution is for the Senate to create its own version of the bill, or only pass portions of the current bill. *Id.*

133. *See* Kelsey Ramírez, *Senate Banking Committee Introduces Repeal of Dodd-Frank Act*, HOUSINGWIRE (Dec. 5, 2017), https://www.housingwire.com/articles/42010-senate-banking-committee-introduces-repeal-of-dodd-frank-act [https://perma.cc/8BM3-6ZEG] (describing outcome of CHOICE Act and introducing new Senate bill).

134. *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, S. 2155, 115th Cong. (2017) (introducing Senate version of bill to rollback Dodd-Frank provisions). Senator Mike Crapo, a Republican from Idaho and chairman of the Senate Banking Committee, introduced the bill. *See id.*

135. *See* Protess, *supra* note 125 (outlining plans by Republicans to alter Dodd-Frank regulations in place); Yablonski & Schaffer, *supra* note 12 (recognizing favorable political climate for Republicans to repeal Dodd-Frank).

136. *See supra* note 5 and accompanying text (discussing devastating consequences of financial crisis); *see also* RISK RETENTION REPORT, *supra* note 35, at 1 (noting nine different asset classes impacted by financial crisis).

137. *See supra* notes 96-100 and accompanying text (discussing relative rebound of CMBS market after financial crisis).

138. *See supra* notes 102-108 (describing first compliant deal under risk retention rules); *supra* notes 110-115 and accompanying text (highlighting new CMBS deals under risk retention rules); *see also* Mattson-Teig, *supra* note 15 (announcing first CMBS deals compliant with Dodd-Frank risk retention rules).

Congress enacted the Dodd-Frank Act in the first place.[139] Dodd-Frank's risk retention provision safely provides for the allocation of risk in order to prevent another potential financial crisis.[140] Although the CMBS market was less volatile than the residential housing market, there were still significant breaches within the structure of the deals that make risk retention rules important and necessary.[141] While the current political climate has created uncertainty for the future of banking regulation under President Trump, the Dodd-Frank risk retention rules should not be repealed, and B-Piece investors should continue to be regulated as qualified third-party purchasers of a subordinated horizontal interest.[142]

A. The 5% Risk Retention Provision Is Reasonable in the CMBS Market and Does Not Unduly Burden Issuance of CMBS

When Congress passed the Dodd-Frank Act and issued the risk retention rule in 2014, there were many questions surrounding how the 5% risk retention rule would work in practice.[143] Critics of the provision feared that the rule would unnecessarily chill CMBS issuance and create problems with capital for the CRE market.[144] After the risk retention rules went into effect at the end of December 2016, it was clear that banks could adjust to the provision and continue with CMBS issuance, as seen in many of the new deals since the summer of 2016.[145] By the end of 2017, it did not appear that the rules significantly hampered CMBS issuance, as the market remained strong, albeit with more conservative underwriting standards.[146] The risk retention rules provide options for how deals may be structured, which consequently gives banks leeway to innovate and create new deals.[147]

Most importantly, the CMBS market has continued to deal with the wall of maturities, even under the new Dodd-Frank provisions.[148] Many feared that the

139. *See supra* notes 77-80 and accompanying text (examining market immediately before Dodd-Frank Act and reasons for enactment).

140. *See* Razin, *supra* note 14 (illustrating potential benefits of risk retention rules on market structure).

141. *See* Forte, *supra* note 63, at 33 (considering lingering problems in CMBS market regarding credit risk).

142. *See supra* notes 123-125 and accompanying text (discussing President Trump's desire to repeal provisions of Dodd-Frank Act).

143. *See supra* note 98 and accompanying text (conveying investors' anxiety over new regulations).

144. *See* Morgan, *supra* note 21, at 381 (predicting risk retention rules will hinder recovery of CMBS market for refinancing).

145. *See supra* notes 102-114 and accompanying text (outlining new CMBS deal issuance and investors' growing acceptance of rules).

146. *See supra* notes 113-114 and accompanying text (demonstrating strength of CMBS market post rule implementation indicates risk retention not unduly burdensome).

147. *See supra* notes 91-93 and accompanying text (explaining options for banks to structure risk retention of new deals).

148. *See supra* notes 115-119 and accompanying text (discussing how market will handle wall of maturities).

impending maturity of pre-crisis loans would cripple the market due to a restriction of capital under the risk retention rule.[149] There are still a significant amount of loans that will mature in the next year; however, these maturities will coincide with rising CMBS issuance as the banks continue to adjust to the new regulations.[150]

B. Regulation Is Necessary in the CMBS Market: The Dodd-Frank Risk Retention Rules Should Not Be Repealed

President Trump's administration and the pending congressional legislation threaten the future of the Dodd-Frank Act.[151] Although some provisions of the Dodd-Frank Act may in fact change, the risk retention rules for CMBS should remain in place because they successfully monitor the risk involved in the market.[152] The consequences of a lack of regulation have already been made apparent: The absence of regulation in the market before the crisis led to a decline in underwriting standards, a decrease in the quality of CRE loans, and an increase in the risk associated with those loans.[153]

Given their structure and underwriting standards, CMBS loans inherently have certain features that create built-in protections, which residential loans lack.[154] Nevertheless, in the years leading up to the financial crisis, these underwriting standards began to decline.[155] While CMBS loans did not suffer losses as significant as RMBS loans in the financial crisis, the declining standards created overleveraging in the market.[156] Therefore, the risk retention rules align with Dodd-Frank's stated goal: to prevent a similar financial meltdown.[157] The rules require banks to share in the responsibility of risk, as opposed to allowing them to pass risk along to a third party, thus incentivizing them to practice and maintain quality loan underwriting.[158]

149. *See* Morgan, *supra* note 21, at 363 (identifying approaching CMBS crisis due to maturing loans).

150. *See supra* note 118 and accompanying text (noting CMBS market beginning to handle maturity crisis by prepaying debt).

151. *See supra* Section II.D.3 (highlighting President Trump's desire to repeal Dodd-Frank and potential course of action).

152. *See* Kronovet & van Heerden, *supra* note 26, at 86-87 (discussing impact of risk retention rules under Dodd-Frank); *see also* Fabozzi et al., *supra* note 10, at 119 (demonstrating how improved CRE fundamentals allowed for increased financing and more stability); *supra* notes 106-108 and accompanying text (describing how risk retention interests held).

153. *See* Levitin & Wachter, *supra* note 37, at 104 (noting decline of underwriting standards three years prior to financial crisis).

154. *See supra* notes 41-44 and accompanying text (identifying certain risk-limiting features of CMBS).

155. *See supra* note 69-70 and accompanying text (noting decline in CMBS underwriting standards leading up to financial crisis).

156. *See* Levitin & Wachter, *supra* note 37, at 84-86 (discussing period leading up to CMBS price bubble).

157. *See supra* notes 77-80 and accompanying text (stating initial goal of Dodd-Frank Act to prevent similar financial crises).

158. *See supra* notes 106-108 and accompanying text (discussing amounts retained by loan sponsors under Dodd-Frank risk retention rules).

Although some have argued that the risk retention rules unnecessarily burden the market, given the market developments that occurred before the crisis, it is clear that B-Piece investors should be subjected to regulation.[159] B-Piece investors play a critical role in CMBS deals.[160] Even though CMBS investors are already generally more sophisticated than the average residential property buyer, protections are still necessary.[161] Before the crisis, the CMBS market depended on the built-in protections of the B-Piece buyer, which were not sustained, and ultimately the market suffered.[162] Additionally, the quality of the B-Piece buyer declined as CDOs became common practice in the CMBS market, and underwriting standards suffered as a result.[163] As "gatekeepers" of CMBS deals, B-Piece buyers maintain a significant responsibility and should continue to be regulated.[164]

IV. CONCLUSION

Even as the CMBS market adjusts to the new risk retention requirements under the Dodd-Frank Act, federal regulators have yet to conclude if the new deal structures proposed by banks are entirely compliant. As a result, the market may see future changes depending on regulatory decisions. But, more importantly, the early conclusion is that the Dodd-Frank risk retention rules are necessary for CMBS because they help ensure responsibility within the financial markets that deteriorated in the years preceding the financial crisis. Despite the relatively small sample size of newly issued CMBS that attempt to comply with the rules, the 5% retention provision is both reasonable and sustainable for the CMBS market, as demonstrated by an increase in CMBS issuance after the rules went into effect.

The consistent advancement of the financial markets demonstrates that the industry will always innovate ahead of and around the rules in place. Because the risk retention provision was not in place before the crisis, the quality of CMBS loans declined and led to overleveraging and volatility that resulted in the financial crisis. The risk retention rules, at the very least, will ensure that

159. *Compare* Forte, *supra* note 63, at 33 (describing decline in B-Piece investor standards), *with* Morgan, *supra* note 21, at 377-79 (arguing Dodd-Frank rules burdensome because of built-in protections of CMBS deals).

160. *See supra* notes 63-65 and accompanying text (discussing special importance of B-Piece investors in CMBS deals).

161. *See* Morgan, *supra* note 21, at 376-77 (differentiating between CMBS and RMBS deals).

162. *See supra* text accompanying notes 39-43 (describing specific features of CMBS loans); *supra* text accompany notes 58-62 (outlining B-piece portion of CMBS loans); *see also* Borod, *supra* note 24, at 649-50 (identifying factors unique to CMBS underwriting).

163. *See supra* notes 72-76 and accompanying text (illustrating how B-Piece investors changed and risk increased due to decline in standards).

164. *See* Forte, *supra* note 63, at 33-35 (discussing regulations of B-Piece investors under Dodd-Frank). In order for CMBS 2.0 to be successful, B-Piece investors should return to position of "gatekeeper" and enforce strict underwriting standards for CMBS deals. *Id.* at 39.

the rampant securitization risks present before the financial crisis are not possible in the future.

Even with the Dodd-Frank Act in place, the financial industry will find innovative ways to circumvent the rules. History has proven that regulation has been, and will continue to be, the necessary evil in preventing financial crises. As a result, financial regulation should not merely be reactionary to financial crises, but should instead be a standing regulatory scheme in order to further investor protection.

Maegan E. O'Rourke