A Public Choice Approach to the Unequal Treatment of Securities Market Participants and Home Borrowers

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This article contrasts the protections provided to participants in U.S. securities markets with the protections provided to participants in the U.S. mortgage markets. Participants in securities markets purchase and sell equity and debt securities. Participants in the mortgage markets borrow money to buy homes, using those homes as collateral for the mortgage loans they receive. Even after Dodd-Frank, participants in securities markets are afforded significantly higher levels of protection than participants in mortgage markets. The doctrine of suitability is a prime example of this inequity. Exploring possible explanations for this odd asymmetry of treatment, I conclude that interest group politics is to blame for the anomaly.

Keywords: securities, mortgages, regulation, consumer protections, interest groups

Reckless and predatory mortgage lending practices were among the key drivers of the financial meltdown of 2008.[1] I, along with my coauthors Geoff Miller, Maureen O'Hara, Gabe Rosenberg, have argued that changes in the nature of the mortgage contract make it both legally plausible and normatively desirable that subprime mortgage brokers be treated as securities broker-dealers for the purposes of the Securities Act of 1933 and the Securities and Exchange Act of 1934 (Macey et al. 2009). Given the recent revival in mortgage lending in general and higher-priced lending with interest rates greater than 1.5 points above the prime offer rate in particular—which made up 7.1 percent of home purchase loans in 2013, as compared to 2.2 percent in 2010 and 23.2 percent in 2006 (Board of Governors of the Federal Reserve System 2014)—this regulatory issue is in need of timely address.

As a technical matter, subprime mortgages are in large part derivative securities that contain embedded options (Quercia and Stegman 1992), but they are not subject to the significant anti-fraud and consumer protection provisions of the securities laws. Nor are mortgages subject to any alternative comprehensive regulatory regime. Unlike other financial contracts that are individualized and not fungible such as insurance contracts and annuities and certificates of deposit (CDs), mortgages are bundled together to formulate mortgage-backed securities. This differentiates mortgages from other types of private contracts, creating a unique need for securities-type regulation.

Writing from the perspective of legal theory

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1. "The Bubble Keeps Deflating," editorial, *New York Times*, October 19, 2008.

predicated on normative arguments about basic fairness and the desirability of logical symmetry between the protections for people trafficking in securities and people trafficking in home mortgage loans, in previous works I have argued that subprime mortgages should be regulated like securities, especially given their complicated, unusual lending terms and their thorny relationship with the mortgage-backed securities industry (Macey et al. 2009). From this analysis, it inevitably follows that home buyers who take out subprime mortgage loans should have the same protections as people who buy and sell securities such as options and common stock.

In this article I take a positive rather than a normative perspective. Here, I ponder the issue of why, as a descriptive matter, home buyers are afforded such paltry legal protections when compared to the robust panoply of legal protections enjoyed by buyers and sellers of securities subject to the Securities Act of 1933 and the Securities Exchange Act of 1934. Why, in other words, is it the case that a large investment bank that buys a security backed by home mortgages is entitled to so much more legal protection than an individual who incurred massive indebtedness by taking out one of the subprime mortgage loans bundled into that mortgage-backed security?

Simply put, as Kathleen C. Engel and Patricia A. McCoy (2002, 1319) argue, "If the duty of suitability is appropriate for financial instruments that have been the traditional province of the affluent, certainly it is appropriate for financial instruments that are peddled to the poorest rung of society." As I previously have pointed out (Macey et al. 2009, 790):

> Kafka would have loved this story: According to our current understanding of U.S. law there is far better consumer protection for people who play the stock market than for people who are duped into buying a house with an exotically structured subprime mortgage, even when the mortgage instrument is immediately packaged and sold as part of a security. We live on a peculiar legal landscape in which homeowners have almost no recourse under consumer protection laws against people who peddled unsuitable mortgages to them, unless the funds generated by the mortgage financing happened to have been used by the homeowner to purchase securities rather than a house.

Subprime mortgages incorporate abnormal, and arguably predatory, terms that are "present either because of the risk profile of subprime borrowers or the need of lenders to counteract the lower expected repayment rate of this group" (Macey et al. 2009). Examples of these terms include prepayment penalties for paying off a mortgage before it comes due, and a payment of a certain number of percentage "points" of the mortgage upfront (Macey et al. 2009). One acutely troubling facet of subprime lending is that foreclosure scars subprime borrowers' already low credit scores, leaving them with even less access to credit than they had at the origination of their defaulted mortgages.

Subprime mortgage loans are not garden-variety loans, and neither are the circumstances of their origination. Subprime mortgages, bundled together, constitute the base material of exotic securities such as CDOs and RMBSs. The issuance of these securities should be regulated as such to protect those borrowers suckered into entering them against their best interest. With subprime mortgage–backed securities "gearing up for a comeback," this pressing regulatory issue requires immediate attention (Shenn 2015).

SUITABILITY

A number of protections are afforded to securities transactions from which mortgage financings do not benefit. For the purpose of brevity, this article will focus on the protection most readily applicable to subprime mortgages: suitability.

> The doctrine of suitability requires that broker-dealers only recommend to their clients those financial transactions that are suitable given the customer's level of financial sophistication, current investments, financial status, personal circumstances, and anything else that might bear on the clients' ability to accept the risk associated with a particular investment. The suitability doc-

> trine requires broker-dealers to tailor the securities sold to a customer with that customer's specific financial needs and objectives, and forbids agents from simply pushing those products that offer the greatest profit margins for the seller. (Macey et al. 2009, 815)

The suitability doctrine arose from "fears about unsophisticated investors taken advantage of by financially savvy (and unscrupulous) professionals" and is administered federally by "overlapping, though not identical, rules" (Macey et al. 2009, 816).[2]

The first of these rules is the descendent of National Association of Securities Dealers (NASD) Conduct Rule 2310, Financial Industry Regulatory Authority (FINRA) (2015). Rule 2111(a):

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.[3]

The second rule is the descendent of the New York Stock Exchange suitability requirement or "Know Thy Customer rule," FINRA Rule 2090. This rule requires that members "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer." "Essential Facts" include those required to (a) effectively service the customer's account; (b) act in accordance with any special handling instructions for the account; (c) understand the authority of each person acting on behalf of the customer; and (d) comply with applicable laws, regulations and rules.[4]

Finally, broker-dealers are liable for suitability violations under section 10(b) of the Securities Exchange Act and Securities and Exchange Commission (SEC) Rule 10b-5. Section 10(b) of the Securities Exchange Act states:

> It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors).[5]
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> And SEC Rule 10b-5 states:
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> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) to employ any device, scheme, or artifice to defraud;
>
> (b) to make any untrue statement of a material fact or to omit to state a material

2. There are additional requirements under state laws that this article does not discuss.

3. For FINRA Rule 2111 see http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1; accessed June 8, 2016.

4. For FINRA Rule 2090 see http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9858

5. See SEC Rule 10b-5, 17 C.F.R. 240.10b-5, "Employment of Manipulative and Deceptive Devices," www.law.cornell.edu/cfr/text/17/240.10b-5.

fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security.[6]

Basic product-suitability claims are not the only conflict-of-interest, broker-buyer issues that implicate the suitability doctrine. Regulators also rein in churning, or "encouraging customers to engage in more trades than are in the customers' best interests," as well as flawed commission structures such as recommending that customers "pay a flat fee to the broker-dealer for a number of services rather than paying for each transaction individually" through the suitability doctrine (Macey et al. 2009, 830).

Given that in the subprime mortgage context brokers sometimes encourage "borrowers to engage in an excessive number of costly refinancing transactions in order to generate [more] fees" and that brokers receive yield spread premium incentives to "steer their customers towards higher cost loans," the suitability doctrine appears particularly apt to address issues of conflicting interests in the subprime mortgage industry (Macey et al. 2009, 830).

The purpose of these suitability rules is clear. They serve as an "ex ante protection against improper investment, not a way for investors to recoup losses from investing insecurities with full knowledge of, and ability to handle, the attendant risks" (Macey et al. 2009, 819). Providing a regulatory framework for suitability claims on behalf of subprime mortgage borrowers would allow an opportunity for regulatory agencies, and the mortgage borrowers themselves, to curb predatory lending executed through unsuitable financial products, excessive refinancings, and problematic broker compensation structures. If given the regulatory green light, suitability claims in the subprime mortgage context could theoretically be brought in the same ways as their sister claims in the securities context: (1) via individual suits, (2) via class actions, and (3) via interventions of regulators on behalf of mortgage holders.

Some might argue that the suitability doctrine as it applies to securities is relatively toothless, and thus the lack of its application for individual mortgage holders is irrelevant. In regard to the first avenue just discussed, although individual suitability claims may not always involve large financial penalties, studies show that securities buyers embrace them as a mechanism for policing the investment recommendations they receive. In fact, in a random sample of 422 arbitrators' cases from 1992 to 2006, 49.76 percent of customer arbitrations against broker-dealers involved a suitability claim (Choi, Fisch, and Pritchard 2010). Given that "virtually all brokerage customer agreements contain a clause requiring disputes between the customer and the broker to be submitted to arbitration," this finding is highly salient (Choi, Fisch and Pritchard 2010, 110). Moreover, a separate study found that 48.9 percent of arbitrations involving a suitability claim were victorious, and in 9.9 percent of those successful arbitrations, punitive damages were awarded (Choi and Eisenberg 2010). Sure, this figure is underwhelming, but keep in mind: 0 percent of subprime mortgage borrowers are awarded punitive damages on the basis of suitability claims. They currently have no right to bring them.

In regard to the second avenue for suitability claims discussed, admittedly, "Class actions are not necessarily easy to certify in predatory-lending cases. In damages class actions under Federal Rule of Civil Procedure 23(b)(3), plaintiffs must show that the common issues predominate over the individual ones in order to achieve class certification. Loan-underwriting decisions often turn on facts that are unique to the borrowers, making commonality difficult to prove" (Engel and McCoy 2002, 1362). That said, it is unlikely that class actions would play a large role, if any at all, in suitability claims against subprime lenders.

Nevertheless, supervision of the subprime mortgage industry via the suitability doctrine

6. Ibid.

would allow for increased regulatory oversight of subprime lenders that could be exceptionally effective, given the concentrated nature of the subprime lending industry.[7] Regulators have brought about nontrivial suitability penalties in the securities industry,[8] and could do the same in the subprime mortgage industry.

Alternatively, critics of a suitability requirement for subprime mortgages sometimes focus on the threat of the suitability requirement constraining the subprime mortgage market too much. Yet arguments about regulation in this arena causing a credit gap fall flat. Studies show that many subprime borrowers (somewhere between 10 and 35 percent) could have qualified for prime loans (Mahoney and Zorn 1996). In addition, the predatory lending that the suitability requirement seeks to isolate and eliminate creates undesirable and financially fatal loan options without which mortgage borrowers would be better off.

THE POSSIBILITIES

One mechanism for protecting home borrowers would be to classify subprime mortgages as securities, and give them the same antifraud protections that are given to swap agreements. The more likely regulatory apparatus, however, would be to regulate the fraudulent actions of subprime mortgage brokers on the grounds that securitized mortgages are made "in connection with the purchase and sale of" mortgage-backed securities. Doing so would give the SEC as much jurisdiction over subprime mortgage brokers as it has over securities broker-dealers. As I have previously argued (Macey et al. 2009, 814):

> It seems clear that maneuvering an unsophisticated client into taking on an unsuitable mortgage on which the borrower is bound to default unless interest rates stay low and housing prices stay high is done in connection with the purchase and sale of a security, where all parties understand that the payments being made on the mortgage are an integral part of a securitization. Thus, even if a mortgage itself is not a security, where the mortgage is used as part of a securitization, that transaction is done in connection with the purchase or sale of a security and the protections of Rule 10b-5 should protect the mortgagee. Similarly, there appears to be little distinction between cases in which a mortgage broker convinces a person to refinance in order to purchase securities (where 10b-5 clearly applies), and cases in which a mortgage broker convinces a person to refinance so that the mortgage broker himself can participate in the creation of a new security.

RECOGNIZING THE PROBLEM

The government's primary response to the problem of struggling, unsophisticated home buyers saddled with expensive subprime mortgages was the creation of a new bureaucracy, the Consumer Financial Protection Bureau, an organization that has yet to fully address this problem. The CFPB recognizes that subprime mortgages contain high rates of interest that "can rise significantly over time." But they also recognize that lenders and brokers are not obligated to offer consumers the best deal available in the market for them. Additionally, the CFPB recognizes that consumers shunted into high-interest subprime loans may be eligible for a prime mortgage or the Federal Housing Administration (FHA) program of loan insurance that can reduce interest payments dramatically, but neither of these facts need be disclosed to subprime borrowers (Consumer Financial Protection Bureau 2016).

Although the "ability to pay" requirement of Regulation Z of the Truth in Lending Act of 1968 is a step in the right direction, it does not go so far as to implicate the full-fledged suitability requirement for which I advocate here. Regulation Z forbids lenders from making "a

7. Seventy-two percent of the loans made between the boom of subprime mortgages in 2005 and the Financial Crisis were made by twenty-five leading subprime lenders (Dunbar 2009). Moreover, there were only 213 subprime lenders in 2005 identified by the U.S. Department of Housing and Urban Development (2006).

8. For example, FINRA recently fined Barclays Capital $13.75 million and Royal Bank of Canada (RBC) $1.4 million for suitability violations (Financial Industry Regulatory Authority 2015a, 2015b).

loan that is a covered transaction unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms."[9]

This inquiry into a prospective mortgage holder's ability to pay is necessary, but not sufficient, for determining the suitability of a particular mortgage for an individual's unique investment situation. For example, when a candidate is presented with several alternative mortgage options, he or she may be "able to pay" at least initially what is required on a monthly basis for all of them, and thus a simple ability-to-pay analysis would fail to distinguish among these. If one option in particular is starkly better suited for the candidate's situation, however, a suitability analysis would forbid a broker to recommend any alternative that is inferior from the borrower's point of view.

ANALYSIS: WHY CHANGE DOESN'T HAPPEN

If mortgage financings had qualified for the protections of rules such as SEC Rule 10b-5, which forbid the sale of financial instruments to any person unless investing in those instruments is appropriate (suitable) to the investment needs and risk tolerance of that investor, it is likely that the financial crisis of 2008 never would have occurred.[10] As I have argued before (Macey et al. 2009, 804):

> The inability of subprime borrowers to pay the interest on their mortgages, and the foreclosures that resulted, percolated through financial markets via mortgage-backed securities, collateral debt obligations, and other esoteric financial contracts. The resulting "credit crunch" stopped business lending in its tracks, ended Wall Street's ability to employ leverage, and shut down a multi-billion dollar industry, leaving investment banks scrambling to find buyers for illiquid, suddenly worthless securities.

The mortgage industry of today generates an entirely different set of incentives than the historical mortgage industry that status quo mortgage regulations were intended to tame. As I previously acknowledged (Macey et al. 2009, 838):

> The current legal landscape is informed by the view that the agents selling the mortgages did not securitize them, but instead kept them as assets on their books until the principal and interest had been repaid, or until there was default and foreclosure. This, of course, closely aligned the interests of the mortgagee and the mortgagor, since, in sharp contrast with today, in bygone times, the person originating the mortgage was as interested in making sure that the principal and interest on that mortgage could be repaid as the person receiving the financing from the mortgage transaction. This is no longer the case, of course, as mortgage originators today are brokers who do not plan to hold the mortgage note, but rather to sell it immediately so that it can be bundled into a security and sold to investors.

Meaningful reform addressing the underlying cause of the financial crisis has not occurred because lawmakers and bureaucrats lack the incentives to effectuate change. As I will discuss further, consumers are not sufficiently resourced and the plaintiff's bar—the portion of the legal profession that specializes in representing consumers and other prototypical plaintiffs—is not sufficiently motivated to advocate for this necessary suitability update to the current regulation structures governing subprime mortgages. Mortgage lenders and the banks that structure mortgage-backed securities, in complete contrast, have both the resources and incentives to push to retain the status quo.

Consumers seeking subprime mortgage loans (and consumers on whom such loans are foisted) are not sophisticated and are not able

9. Truth in Lending Act (Regulation Z), 12 C.F.R. Part 226, www.law.cornell.edu/cfr/text/12/part-226; accessed June 8, 2016.

10. References to "the crisis" or the "financial crisis" refer to the global financial crisis of 2008.

to transform themselves into the sort of well-organized, well-financed interest group that is able to lobby successfully for protection. Moreover, sophisticated borrowers are insulated from problems in the subprime mortgage market by their ability to shop for desirable terms when they are in the market for a mortgage.

Some may look to the plaintiff's bar as a powerhouse to provoke reform through litigation. Unfortunately, however, pursuing individual suitability claims is uneconomical for plaintiffs' lawyers, and class actions, as discussed earlier, are not a plausible vehicle for these highly individualized claims.

It could even be argued that lawmakers are dis-incentivized to bring about this reform. The commercial and investment banks and the mortgage brokers who benefit by gaining access to a large pool of high-interest assets are well organized and capable of resisting reform. We saw subprime lobbying play a central role in the lead-up to the financial crisis, with subprime lenders such as Ameriquest "maneuver[ing] to defeat legislation that might have contained some of the damage" (Simpson 2007). This influence has not disappeared.

Lobbying expenditures for the real estate sector rank fourteenth among the 121 industries that the Center for Responsive Politics monitors. In fact, lobbying in the real estate industry, including by the Mortgage Bankers Association, the Federal Home Loan Bank, and the Association of Mortgage Investors, reached a ten-year high in 2014: $95,293,540. The Mortgage Bankers Association—which argued that Congress "should resist pressure to enact a suitability standard which would harm consumers" via decreased access to credit (Mortgage Bankers Association 2007)—spent approximately $2.7 million lobbying in 2015. That same organization has lobbied against bills such as the Mortgage Choice Act of 2013, and the Housing Finance Reform and Taxpayer Protection Act of 2014 (Center for Responsive Politics 2015a, 2015b).

On the other hand, it appears likely that the Securities and Exchange Commission (SEC) would benefit from expanding its regulatory turf to include home mortgages. However, the SEC appears to be captured by the very financial firms—investment banks—that profit most from the status quo (Macey 2010).

The current incentive landscape, dominated by well-funded interest groups that drown out subprime borrowers' needs regardless of how hard they try to voice them, is the reason no suitability requirement has surfaced for subprime mortgages. Nevertheless, there is hope for the reform.

Should the SEC affirmatively create a rule that subjects subprime mortgage lending to a suitability requirement, it is likely that it would benefit from *Chevron* deference, or "the deference that federal courts give to the interpretations of statues made by administrative agencies where those interpretations fall within the agencies' delegated zone of expertise" (Macey et al. 2009, 841).[11] Section 10(b) of the Securities Exchange Act of 1934 increases the likelihood of this deference, as it conveys upon the SEC the ability to create "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" in order to prevent fraud, manipulation and deception in connection with the sale of securities (Securities and Exchange Act of 1934 Section 10[b]).[12]

IT'S TIME

"Residential mortgage-backed securities tendered on the private market jumped to 78 percent of all new offerings last year from 46 percent in 2013 and just 10 percent in 2007" (Levinson 2015). If subprime mortgage-backed securities make a comeback in the markets, mortgage brokers will be incentivized to origi-

11. The term "*Chevron* deference" refers to a rule of administrative law that requires courts to defer to the interpretations of statutes that previously have been articulated by the government agency charged with enforcing that statute unless such interpretations are unreasonable. The term "*Chevron* deference" is derived from the landmark case that first articulated the principle. See *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

12. Securities Exchange Act of 1934, Section 10(b), "15 U.S. Code § 8j(b), Manipulative and Deceptive Devices," www.law.cornell.edu/uscode/text/15/78j.

nate increasing amounts of subprime loans to serve as raw material for those securities. Without regulatory reform discouraging mortgage brokers from saddling mortgage borrowers with unsuitable loans, brokers blinded by profits could build a new generation of mortgage-backed securities on the backs of unsuspecting Americans, herded into subprime mortgages sometimes for the sole reason of creating subprime securities.

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