Title: SECURITIZATION IS ILLEGAL: RICO, USURY, ANTITRUST AND TAX ISSUES.

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Abstract

Under US laws, securitization is illegal, primarily because its fraudulent and causes specific violations of RICO, usury, and antitrust laws. Securitization of many types of assets (loans, credit cards, auto receivables, intellectual property, etc.) has become more prevalent, particularly for financially distressed companies and companies with low or mid-tier credit ratings. This article focuses on securitization as it pertains to asset-backed securities and mortgage-backed securities, and analyzes critical legal and corporate governance issues.

Keywords:
Securitization; antitrust; RICO; Usury; Tax Avoidance; capital markets; complexity; fraud.

Introduction

Under US laws, securitization is illegal. Indeed many authors have illustrated the deficiencies in securitization.¹ This article focuses on securitization as it pertains to asset-backed securities and mortgage-backed securities²,³. The existing literature on legal

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² See: Steven Schwarz, Enron And The Use And Abuse Of Special Purpose Entities In Corporate Structures, 70 U. Cin. L. Rev. 1309 (2002).

² On securitization, see: Eastgroup Properties v. Southern Motel Association, Ltd., 935 F.2d 245 (11th Cir. 1991); Union Savings Bank v. Augie/Restivo Baking Co. (In Re Augie/Restivo Baking Co.), 860 F.2d 515 (2d Cir. 1988); In Re Bonham, 229 F.3d 750 (9th Cir. 2000); In Re Central


On “True-sale” and “assignment” distinctions, see: Major’s Furniture Mart, Inc. v. Castle Credit Corporation, Inc., 602 F.2d 538 (3rd Cir. 1979); In re Major Funding Corporation, 82 B.R. 443 (Bankr. S.D. Tex. 1987); Fox v. Peck Iron and Metal Company, Inc., 25 B.R. 674 (Bankr. S.D. Cal. 1982); Carter v. Four Seasons Funding Corporation, 97 S.W.3d 387 (Ark. 2003); A.B. Lewis Co. v. Nat’l Investment Co. of Houston, 421 S.W.2d 723 (Tex. Civ. App. - 14th Dist. 1967); Resolution Trust Corp. v. Aetna Casualty and Surety Co. of Illinois, 25 F.3d 570, 578 (7th Cir. 1994); In re Royal Crown Bottlers of North Alabama, Inc., 23 B.R. 28 (Bankr. N.D. Ala. 1982) (addressing 'reasonably equivalent value' in transfer by parent to subsidiary); Butner v. United States, 440 U.S. 48 (U.S. 1979); In re Schick, 246 B.R. 41, 44 (Bankr. S.D.N.Y. 2000); (state law determines the extent of the debtor's interest; bankruptcy law determines whether that interest is "property of the estate").


On Corporate governance issues pertaining to SPVs and securitization see the following materials:


and corporate governance issues pertaining to securitization is extensive, but has several gaps that have not been addressed at all or sufficiently:

- Whether securitization is legal.
- Whether securitization causes usury.
- The standards for usurious loans/forbearance.
- The specific components of cost-of-capital, for purposes of assessing usury violations.
- Antitrust liability in securitization transactions.
- Federal/state RICO liability in securitization transactions.
- The constitutionality of securitization transactions.
- The validity of contracts used in effecting securitization transactions.
- Whether securitization usurps the purposes of the US bankruptcy code.

See: Richard Graf, Use Of LLCs As Bankruptcy Proof Entities Widens, National L. J. , April 10, 1995 at B16.
See: Schwarcz Steven, Enron And The Use And Abuse Of Special Purpose Entities In Corporate Structures, 70 U. Cin. L. Rev. 1309 (2002).
This article seeks to fill these significant gaps in the literature. Although the following analysis is supported with US case law, the principles derived are applicable to securitization transactions in common-law countries and civil-law countries.

In analyzing the legality of securitization, the following criteria are relevant:

- Origins and history of securitization – legislative history, evolution of securitization processes, and current practices. Carlson (1998), Janger (2002) and Lupica (2000) traces the history of securitization to direct and specific efforts/collaborations to avoid the impact of US bankruptcy laws. Klee & Butler (_____) and other authors have traced the history of securitization to attempts to handle the problem of non-performing debt.

- Types of contracts used in securitization. The key criteria for enforceability.

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See: Klee K & Butler B (____). Asset-Backed Securitization, Special Purpose Vehicles And Other Securitization Issues. Uniform Commercial Code Law Journal, 35(2):.
See: Steven L. Schwarcz, The Impact on Securitization of Revised UCC Article 9, 74 Cm. - KENT L. REV. 947 (1999) ("Revised Article 9 attempts to broaden its coverage to virtually all securitized assets.").
See: Saayman, Andrea, Securitization And Bank Liquidity In South Africa, Working Paper, Potchefstroom University, South Africa.

• How the applicable laws are applied in securitization processes – by market participants, regulators and lawyers that represent investors.

• The people, markets, and entities/organizations affected by securitization.

• The usefulness of existing (if any), possible and proposed (if any) deterrence measures designed to reduce fraud/crime/misconduct.

• Transaction costs.

• The results and consequences of application of relevant laws.

**A. Securitization Violates State Usury Laws.**

Securitization violates usury laws, because the resulting effective interest rate typically exceeds legally allowable rates (set by state usury laws).\(^5\) There is substantial disagreement (conflicts in case-law holdings) among various US court jurisdictions, and also within some judicial jurisdictions, about some issues and these conflicts have not been resolved by the US Supreme Court.\(^6\) On these issues, even the cases for which the


US Supreme Court denied certiorari, vary substantially in their holdings. The issues are as follows:

1. What constitutes usury.

2. What costs should be included when calculating the effective cost-of-funds.


3. What types of forebearance qualify for applicability of usury laws.


Where the securitization is deemed an assignment of collateral, the effective cost-of-funds for the securitization transaction is not the advertised interest cost (investor’s coupon rate) of the ABS securities but the sum of the following:

- The greater of the sponsor’s/originator’s annual cost-of-equity (in percentages) or the percentage annual cash yield from the collateral (in a situation where the SPV’s corporate documents expressly state that the Excess Spread should be paid to the sponsor, the Excess Spread should be subtracted from the resulting percentage). The Excess Spread is defined as the Gross Cash Yield From The Collateral, minus the interest paid to investors, minus the Servicing Expense (paid to the servicer), minus Charge-offs (impaired collateral).

- **The Amortized Value Difference.** The difference between the Market Value of the collateral, and the amount raised from the ABS offering (before bankers’ fees), which is then amortized over the average life of the ABS bonds (at a discount rate equal to the US Treasury Bond rate of same maturity) and then expressed as percentage of the market value of the collateral. This difference can range from 10-30% of the Market Value of the collateral, and is highest where there is a senior/junior structure, and the junior/first-loss piece serves only as credit enhancement.

- **Amortized Total Periodic Transaction Cost.** The *Pre-offering Transaction Costs* are amortized over the average life of the ABS, a rate equal to the interest
rate on an equivalent-term US treasury bond. The *Periodic Transaction Costs* are then added to the Amortized Pre-Offering Transaction Costs to obtain *Total Periodic Transaction Cost* which is expressed as a percentage of the value of the pledged collateral. The *Pre-offering Transaction Costs* include external costs (underwriters’ commissions/fees, filing fees, administrative costs (escrow, transfer agent, etc.), marketing costs, accountant’s fees, legal fees, etc.) and internal costs incurred solely because of the securitization transaction (costs incurred internally by the sponsor/originator - direct administrative costs, printing, etc.). The *Periodic Transaction Costs* include administrative costs, servicing fees, charge-off expenses and escrow costs.

- **Foregone Capital Appreciation.** The foregone average annual appreciation/depreciation of the value of the collateral minus the interest rate on demand deposits, with the difference expressed as a percentage of the Market Value of the collateral.

The sum of these four elements is typically greater than state-law usury benchmark rates.

Where the securitization is deemed a ‘true-sale’, there is an implicit financing cost which is typically usurious, because it is equal to the sum of the following:

- **Base Cost of Capital.** The greater of the sponsor’s/originator’s annual weighted-average-cost-of-capital, or the annual percentage yield from the collateral.
• **The Amortized Total Periodic Transaction Cost.** The *Pre-Securitization Transaction Costs* paid by the sponsor/originator and directly attributable to the offering is amortized over the life of the ABS, at a rate equal to the interest rate on an equivalent term US treasury bond, and the result (the *Amortized Pre-Securitization Costs*) is added to the *Periodic Transaction Costs* for only one period to obtain the *Total Periodic Transaction Cost*, which is then expressed as a percentage of the market value of the collateral is the *Amortized Total Periodic Transaction Cost*. The *Pre-Securitization Transaction Costs* include external costs (underwriters’ commissions/fees, filing fees, administrative costs (escrow, transfer agent, etc.), marketing costs, accountant’s fees, legal fees, etc.) and internal costs incurred solely because of the securitization transaction (costs incurred internally by the sponsor/originator - direct administrative costs, printing, etc.). The *Periodic Transaction Costs* include servicing fees, administrative fees, and charge-off expenses.

• **The Value Difference.** The difference between the Market Value of the collateral, and the amount raised from the ABS offering (before bankers’ fees), is amortized over the average life of the ABS bonds and the result is then expressed as percentage of the Market Value of the collateral. This difference can range from 10-30%, and is highest where the senior/junior structure is used and the junior piece serves only as credit enhancement.

• **Amortized Unrealized Losses.** Any unrealized loss in the carrying amount of the collateral, is amortized over the estimated average life of the ABS, and the result for one period is expressed as a percentage of the book value of the
collateral. Most ABS collateral are recorded in financial statements at the lower-of-cost-or-market.

- **Foregone Capital Appreciation.** The foregone appreciation/depreciation of the value of the collateral minus the interest rate on demand deposits, with the difference expressed as a percentage of the market value of the collateral.

The sum of these five elements is typically greater that the state-law usury benchmark interest rates.

**B. All “True-Sale”, “Disguised Loan” And “Assignment” Securitizations Are Essentially Tax-Evasion Schemes.**

In the US, the applicable tax evasion statute is the US Internal Revenue Code Section 7201 which reads as follows: “…….Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution………..”. Under this statute and related case law, prosecutors must prove three elements beyond a reasonable doubt:

1) the “actus reus” (the guilty conduct) — which consists of an affirmative act (and not merely an omission or failure to act) that constitutes evasion or an attempt to evade either: a) the assessment of a tax or b) the payment of a tax.

2) the “mens rea’ or "mental" element of willfulness — the specific intent to violate an actually known legal duty.

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3) the “attendant circumstance” of the existence of a tax deficiency — an unpaid tax liability.

In the case of ‘true sale’ transactions, the tax evasion ⁸ occurs because: a) the sponsor determines the price at which the collateral is transferred to the SPV, and hence, can arbitrarily lower/increase the price to avoid capital gains taxes – its assumed that the sponsor is a profit-maximizing entity and will always act to minimize its tax liability and to avoid any tax assessment; b) the sponsor typically retains a ‘residual’ interest in the SPV in the form of IOs, POs and “junior piece”, which are typically taxed differently and at different tax-basis compared to the original collateral - hence the sponsor can lower the price of the collateral upon transfer to the SPV, and convert what would have been capital gains, into non-taxable basis (for tax purposes) in the SPV “residual”; c) there is typically the requisite “intent” by the sponsor – evidenced by the arrangement of the transaction and the transfer of assets to the SPV; d) before securitization, collateral is typically reported in the sponsors’ financial statements at book value (lower-of-cost-or-market - under both US and international accounting standards, loans and accounts receivables are typically not re-valued to market-value unless there has been some major impairment in value) which does not reflect true Market Values. and results in effective tax evasion upon transfer of the collateral to the SPV because any unrealized gain is not taxed; e) the Actus Reus is manifested by the execution of the securitization transaction and transfer of assets to the SPV; f) the Mens Rea or specific intent is manifested by the elaborate arrangements implicit in securitization transactions, the method of determination of the price of the collateral to be transferred to the SPV, the objectives of securitization, and the sponsor’s transfer of assets to the SPV; g) the unpaid tax liability consists of foregone tax on the capital gains from the collateral (transaction is structured to avoid recognition of capital gains), and tax on any income from the collateral which is ‘converted’ into basis or other non-taxable forms; h) income (from the collateral) that would have been taxable in the sponsor’s financial statements, is converted.

⁸ SEC v. Towers Financial Corp. et al., 93 Civ. 744 (WK) (S.D.N.Y.)
into non-taxable basis in the form of the SPV’s interest-only (IO) and principal-only (PO) securities - part of the Interest-Spread (the difference between the SPV’s income and what it pays as interest and operating costs) is paid out to PO-holders and this transforms interest into return-of-capital or just capital repayment, with no tax consequences.

In the case of ‘disguised loan’ or ‘assignment’ securitization transactions, the tax evasion occurs because: a) the sponsor determines the price at which the collateral is transferred to the SPV, and hence can lower/increase the price of the collateral to avoid capital gains taxes; b) the sponsor typically retains a ‘residual’ interest in the SPV which is typically taxed differently and at different tax-basis compared to the original collateral - hence the sponsor can lower the price upon transfer to the SPV, and covert what would have been capital gains, into non-taxable basis for tax purposes; c) the transfer of collateral to the SPV and the creation of interest-only and principal-only securities essentially converts what would have been taxable capital gains into non-taxable basis; d) any gain in the value of the collateral is not recognized for tax purposes, because there has not been any ‘sale’; e) where the ABS is partly amortizing, any capital gains are converted into interest payments; f) the Actus Reus is manifested by the execution of the securitization transaction and transfer of assets to the SPV; g) the Mens Rea or specific intent is manifested by the elaborate arrangements implicit in securitization transactions, the objectives of securitization and the sponsor’s transfer of assets to the SPV; h) the unpaid tax liability consists of tax on the capital gains from the transfer of the collateral (the transaction is structured to avoid recognition of a sale, whereas the transfer to the SPV is effectively a sale), and tax on any income from the collateral which is ‘converted’ into basis or other non-taxable forms (IOs and POs), by securitization.
C. In All “True-Sale”, “Disguised Loan” And “Assignment” Securitizations, The Conflict Of Interest Inherent In The Sponsor Also Serving As The Servicer, Constitutes Fraud And Conversion.

In most securitization transactions, the sponsor eventually serves as the servicer of the SPV asset pool. As servicer, the sponsor: a) determines when there has been impairment of collateral, and b) selects collateral for replacement; c) monitors collateral performance.

To prove fraud, prosecutors must prove several elements beyond a reasonable doubt:

1) The “actus reus” (the guilty conduct) — which consists of an affirmative act (and not merely an omission or failure to act) of misrepresentation of materials facts. In securitizations, the sponsor typically makes material mispresentations: a) the sponsor/servicer selects the assets to be transferred to the SPV, and the terms of the Offering Prospectus typically misrepresents the level of objectivity and fairness of the servicer/sponsor; b) the sponsor/servicer selects collateral for substitution where there are problems – the past and present disclosure statements and ABS offering documents materially misrepresent the sponsor/servicers objectivity/fairness.

2) The “mens rea’ or "mental" element of willfulness — the specific intent to misrepresent the sponsor/servicer’s acts, truthfulness and objectivity/fairness is manifested by the dual role of sponsor/servicer which constitutes a conflict-of-interest. Mens Rea is also clearly inferable from the facts and circumstances - the sponsor/servicer clearly has significant economic, psychological and legal incentives to maximize its profits by: a) delaying substitution of collateral for as long as possible, b) delaying recognition of collateral impairment, and c) substituting impaired collateral with sub-standard collateral; all of which make the sponsor very un-suited for the role of servicer.

3) The reliance element. ABS investors rely heavily on the structure/arrangements, contracts and disclosure statements in securitizations, which are relatively complex. These form the primary source of knowledge and valuation terms for the investor.
4) **The victim(s) suffers loss as a result of the misrepresentations** (direct or proximate causation). Investors suffer losses because of the sponsor’s/servicer’s misrepresentations of its obligations, fairness, objectivity and fiduciary duties – 

a) investors’ estimates of the values of ABS are inaccurate and too high due to the servicer’s/sponsor’s misrepresentations, 

b) investors incur unnecessary trading costs to re-balance their portfolios as the ABS becomes riskier, 

c) investors and the sponsor/servicer incurs additional monitoring costs whenever there is any report of impairment of collateral or substitution. Furthermore, in the ABS sales process, the underwriter makes certain representations concerning the effectiveness and predictability of the collection process. Under certain conditions, investors relying on such representations may have a securities fraud claim if the servicer fails to perform, such as in bankruptcy.

C. **In All “True-Sale”, “Disguised Loan” And “Assignment” Securitizations Where The SPV Is A Trust, The Declaration of Trust Is Void Because Its For An Illegal Purpose.**

   The declaration of trust relating to the SPV is void because the intent and purpose of the SPV is illegal and unconstitutional as described in this article and in Nwogugu (2006).

D. **Off-Balance-Sheet Treatment Of ABS (Both True-Sale And Assignment Transactions) Constitutes Fraud.**

   Under present accounting rules in the US and most countries, if certain criteria were met, the debt raised by the SPV in securitization can be treated as off-balance sheet debt — but this requires compliance with three criteria:
(i) The SPV should be truly independent from the sponsor and of the directors, fiduciary administrative duties notwithstanding.

(ii) The sponsor’s transfer of the assets to the SPV should be a “true sale” and the sponsor should not have any ongoing economic interest in the assets.

(iii) The form and substance should transparently be identical, and the structure should not appear to be illusory or deceptive.

However, this off-balance-sheet treatment criteria has been recently reformed by changes in accounting standards. The UK-based International Accounting Standards Board and the US FASB are moving towards stricter reporting standards:

- **FIN 46 (FASB):** Effective in 2003, FIN 46 applies only to companies subject to regulation by FASB. Its goal is to substantially tighten the criteria necessary to obtain off-balance-sheet treatment for SPVs, and its main thrust is capital adequacy. FIN 46 also imposes an obligation on originators to consolidate the accounts of an SPV (denying off-balance-sheet treatment) unless the total equity at risk is regarded as sufficient to enable the SPV to finance its own activities.

- **IAS 32, IAS 39, and IFRS 7:** International Accounting Standards (IAS) 32 covers the disclosure and presentation of financial instruments, but from 2007 onwards the disclosure aspects will be replaced by the introduction of International Financial Reporting Standard (IFRS) 7. IAS 39 deals with the recognition and measurement of financial instruments, and has been challenged in two aspects: introducing the concept of “fair value” accounting for financial instruments and whether SPVs should be consolidated back into the balance sheet of the originator. Like Fin 46, IAS 32 is likely to result in consolidation of most SPVs on-balance-sheet of the sponsors.

- **Basel II:** The proposals are aimed at the global banking industry and call for a more scientific measurement of risk and of capital requirements for banks in order to support that risk. Since the general expectation has been that, in overall terms, the proposals could require the banking industry to maintain a higher rather than lower capital base, the proposals have met resistance by many banks. The Basel Committee’s rules/codes are not binding because the committee is not a regulator.

The off-balance sheet treatment of ABS debt in securitizations, constitutes fraud because:
1) The “mens rea’ or "mental" element of willfulness — the specific intent to misrepresent the true “Trust” nature of the SPV debt is manifested by the elaborate arrangements and structure of the securitization transaction.

2) The “actus reus” (the guilty conduct). This consists of the affirmative act of misrepresentation of materials facts by not consolidating the SPV on the sponsor’s Balance Sheet. In Securitization, consolidation of the SPV in the Sponsor’s financial statements is warranted because the sponsor: a) typically retains a residual economic interest in the SPV; b) functions as servicer of the SPV asset pool – which grants the sponsor significant control over the assets and the SPV’s operations, c) determines recognition of impairment of collateral, and selects and provides assets for ‘substitution’ of collateral, d) typically misrepresents the level of objectivity and fairness of the servicer/sponsor in disclosure statements. Taken together, these factors and the aforementioned new/proposed accounting standards constitute sufficient Actus Reus.

3) The reliance element. The sponsor’s current and prospective shareholders and other investors rely heavily on the structure/arrangements of securitizations, associated disclosure statements and assurances of off-balance sheet treatment of SPV debt in securitizations, which are relatively complex. These form the primary source of knowledge and valuation terms for the investor.

4) The victim suffers loss as a result of the misrepresentation (direct or proximate causation). Investors suffer loss because of the sponsor/servicer’ misrepresentations of its obligations – a) investors’ estimates of the values of the sponsor’s equity are inaccurate and too high due to the servicer’s/sponsor’s misrepresentations of the SPV debt, b) investors incur unnecessary trading costs to re-balance their portfolios as the sponsor is deemed more risky, c) the investor and the sponsor/servicer incurs additional monitoring costs whenever there is any report of impairment of collateral or substitution.
E. Securitization Constitutes A Violation Of Federal RICO Statutes

In ‘true-sale’, ‘disguised loan’ or ‘assignment’ securitizations, there are fraudulent transactions which serve as ‘predicate acts’ under federal RICO statutes. The specific RICO sections implicated are:

- Section 1341 (mail fraud)
- Section 1343 (wire fraud)
- Section 1344 (financial institution fraud)
- Section 1957 (engaging in monetary transactions in property derived from specified unlawful activity).
- Section 1952 (racketeering).

The prices of the collateral are determined in negotiations between the sponsor/issuer and the intermediary bank and on occasion, the SPV’s trustees. This presents opportunities for “predicate acts” (ie. fraud, conversion, etc.) because:

1. The collateral could be under-valued or over-valued. There are no state or federal laws that require independent valuation of collateral or appointment of independent/certified trustees in securitization transactions. The parties involved are often business acquaintances. The originator/sponsor controls the entire process.

2. The trustees can be, and are influenced by the sponsor/originator and or intermediary investment-bank.

3. The required disclosure of collateral is sometimes insufficient – a) does not include historical performance of collateral pools, b) does not include criteria for

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selection of collateral and for substitution of collateral, c) criteria for replacement of impaired collateral is sometimes not reasonable.

4. Mail and wire are used extensively in communications with investors and participants in the transaction.

5. There is compulsion – because the intermediary/investment bank has very substantial incentives to under-price the securities, and to inflate/deflate the value of the collateral in order to consummate the transaction and earn fees.

The entire securitization process constitutes violations of federal RICO statutes because:

See: Shakespeare C (20030. Do Managers Use Securitization Volume And Fair Value Estimates To Hit Earning Targets? Working Paper, University Of Michigan (School Of Business)


1. There is the requisite criminal or civil “enterprise” – consisting of the sponsor/issuer, the trustees and the intermediary bank. These three parties work closely together to effect the securitization transaction.

2. There are “predicate acts”\(^{11}\) of:

a) Mail fraud - using the mails for sending out materials among themselves and to investors.

b) Wire fraud – using wires to engage in fraud by communicating with investors.

c) Conversion – where there isn’t proper title to collateral.

d) Deceit- mis-representation of issues and facts pertaining to the securitization transaction.

e) Securities fraud – disclosure issues.

f) Loss of profit opportunity.

g) Making false statements and or misleading representations about the value of the collateral.

h) Stripping the originator/issuer of the ability to pay debt claims or judgment claims in bankruptcy court – this may apply where the sponsor is financially distressed and the cash proceeds of the transaction are significantly less than the value of the collateral.

3. There is typically the requisite ‘intent’ by members of the enterprise – evident in knowledge (actual and inferable), acts, omissions, purpose (actual and inferable) and results. Intent can be reasonably inferred from: a) existence of a sponsor that seeks to raise capital – and obviously cannot raise such capital on better terms using other means, b) existence of an investment bank that has very strong incentives to consummate the transaction on any agreeable (but not necessarily reasonable) terms,

**F. Securitization Constitutes Violations Of US Antitrust Laws**

The various processes in securitization constitute violations of the US Antitrust statutes. 12, 13, 14. These violations are described as follows.

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F1. Market Concentration: The US ABS and MBS markets are dominated by relatively few large entities such as FNMA, Freddie Mac, the top-five investment banks (all of which have conduit programs), the top-five credit card issuers (MBNA, AMEX, Citigroup, etc.), etc.. Hence the top-five ABS/MBS issuers control more than 50% of the US ABS/MBS market. This constitutes illegal market concentration under US Antitrust laws.

F2. Market Integration: The ABS and MBS markets are essentially national and international (geographically-diverse entities/individuals participate in each transaction). Each ABS transaction/offering typically involves a ‘roadshow’ which consist of presentations to investors in various cities – the cost of the roadshow is often paid by the underwriter(s) before its fees are paid by the sponsor. In addition, there are printing, mailing, traveling and administrative costs that increase with the greater geographical dispersion of investors. This has two main effects: a) it reduces competitive pressure on dominant investment banks and groups of investment banks (to the detriment of smaller investment banks); and b) it raises market-entry barriers by making it more expensive to conduct ‘road-shows’ for new offerings. Hence, the market integration created by the


industry practices of securities underwriters is anti-competitive and violates the Sherman Act, and the FTC Antitrust statutes.

F3. Syndicate Collusion: the syndicates (of investment banks) used in distributing ABS/MBS essentially collude to determine: a) the price at which each ABS tranche is sold, b) which investors can purchase different tranches.

Collusion occurs because:

a) In the typical ABS offering, the price determination process is not transparent or democratic because the lead underwriters typically negotiate the offering price with the originator/sponsor and the prospective investors (but some underwriters use auctions). The lead underwriters purchase most of the new-issue ABS, and the balance is typically sold to ‘junior’ syndicate members (who presumably can arrange to buy more ABS from the lead underwriters than allocated to them). In essence, the true price-demand characteristics and negotiability of junior underwriting-syndicate members are very much hidden simply because of the structure of the underwriting/bidding process. Hence, the existing syndicate-based ABS distribution system for new issue ABS distorts the true demand for ABS, reduces competition, and facilitates and results in collusion, and constitutes violations of the Sherman Act and the FTC Antitrust statutes.

b) Similarly, the ABS allocation process is not transparent. The lead underwriter and junior underwriters allocate new-issue ABS to investors based on subjectively determined “suitability” and “in-house criteria”. There are no established or generally accepted major guidelines for such ‘in-house’ criteria and associated allocation. The lead and junior underwriters can typically collude to determine that only certain investors
deemed appropriate are allocated ABS. Hence, the antitrust violation (collusion) occurs solely by the underwriters’ discretionary choice of investors to whom ABS are allocated – this is more evident where the investor pool consists of mostly institutional investors, and thus, final offering prices are more sensitive to choice of investors, and prices can change significantly simply by changes in allocation to investors. In such circumstances, the collusion is reasonably inferable, so long as there are no statutory or generally accepted allocation criteria that have been approved by the NASD or other trade associations.

F4. Price Formation: The price of ABS securities is often linked to the price/yields of US treasury bonds – the credit risk of ABS/MBS is priced relative to risk of US Treasury bonds. This system distorts the true demand/supply balance for ABS/MBS, and erroneously incorporates the demand/supply relationships of the US Treasury Bond market, into the ABS/MBS markets. The key question then, is whether there are conditions under which the US Treasury Bond market is completely de-coupled from the ABS market, or phrased differently, whether there is sufficient justification for actual or perceived de-coupling of the US Treasury Bond market and the US ABS market. These conditions are as follows:

1. The credit fundamentals of the US treasury market differ substantially from those of the ABS market. The treasury market is much more sensitive to US Federal Reserve actions, currency fluctuations, consumer spending, federal/state fiscal policies, etc.). The ABS market tends to be more sensitive to industry-specific and sometimes company-specific risks/factors.
2. The use of various credit enhancement techniques/products further exacerbates the differences in the credit trends/quality in the US treasury and ABS markets. In ABS transactions, most forms of credit enhancement create a floor, but does not limit or affect other industry-exposure or company-exposure. In the US treasury market, investors are subject to more variety of risks.

3. The investor objectives in the US treasury bond markets differ from those of investors in ABS markets. Hence, investors are very likely to view these two markets and the underlying risks differently, and should value the securities differently.

F5. Vertical Foreclosure: In the ABS/MBS markets some investment banks and commercial banks are active in almost all phases of the securitization process – origination (through their in-house conduits), due diligence, disclosure and pricing, new-issue securities offerings, and secondary-market trading. Similarly, non-bank entities can use their own asset portfolios (origination of credit card receivables or mortgage receivables), shelf-registration procedures and or Regulation-D/Rule 144A procedures (pricing and new-issue offerings) and in-house trading desks (secondary-market trading) to participate in almost all aspects of securitization processes. Hence, these companies have almost no incentive to, and are not required to make their infrastructure and relationships available to competitors. Such vertical foreclosure constitutes violation of antitrust laws.
F6. Tying\textsuperscript{15}: a) the sponsor is sometimes formally or informally required to

\section*{§ 1 Sherman Act, 15 U.S.C. § 1}

\textbf{Trusts, etc., in restraint of trade illegal; penalty}

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

\section*{§ 2 Sherman Act, 15 U.S.C. § 2}

\textbf{Monopolizing trade a felony; penalty}

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

\section*{§ 3 Sherman Act, 15 U.S.C. § 3}

\textbf{Trusts in Territories or District of Columbia illegal; combination a felony}

Every contract, combination in form of trust or otherwise, or conspiracy, in restraint of trade or commerce in any Territory of the United States or of the District of Columbia, or in restraint of trade or commerce between any such Territory and another, or between any such Territory or Territories and any State or States or the District of Columbia, or with foreign nations, or between the District of Columbia and any State or States or foreign nations, is declared illegal. Every person who shall make any such contract or engage in any such combination or conspiracy, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.


\section*{§ 1 Clayton Act, 15 U.S.C. § 12}

\textbf{Definitions; short title}

(a) "Antitrust laws," as used herein, includes the Act entitled "An Act to protect trade and commerce against unlawful restraints and monopolies," approved July second, eighteen hundred and ninety; sections seventy-three to seventy-seven, inclusive, of an Act entitled "An Act to reduce taxation, to provide revenue for the Government, and for other purposes," of August
twenty-seventh, eighteen hundred and ninety-four; an Act entitled "An Act to amend sections seventy-three and seventy-six of the Act of August twenty-seventh, eighteen hundred and ninety-four, entitled 'An Act to reduce taxation, to provide revenue for the Government, and for other purposes,' " approved February twelfth, nineteen hundred and thirteen; and also this Act.

"Commerce," as used herein, means trade or commerce among the several States and with foreign nations, or between the District of Columbia or any Territory of the United States and any State, Territory, or foreign nation, or between any insular possessions or other places under the jurisdiction of the United States, or between any such possession or place and any State or Territory of the United States or the District of Columbia or any foreign nation, or within the District of Columbia or any Territory or any insular possession or other place under the jurisdiction of the United States: Provided, That nothing in this Act contained shall apply to the Philippine Islands.

The word "person" or "persons" wherever used in this Act shall be deemed to include corporations and associations existing under or authorized by the laws of either the United States, the laws of any of the Territories, the laws of any State, or the laws of any foreign country.

(b) This Act may be cited as the "Clayton Act".


Discrimination in price, services, or facilities

(a) Price; selection of customers

It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered: Provided, however, That the Federal Trade Commission may, after due investigation and hearing to all interested parties, fix and establish quantity limits, and revise the same as it finds necessary, as to particular commodities or classes of commodities, where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or promotive of monopoly in any line of commerce; and the foregoing shall then not be construed to permit differentials based on differences in quantities greater than those so fixed and established: And provided further, That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade: And provided further. That nothing herein contained shall prevent price changes from time to time where in response to changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned.

(b) Burden of rebutting prima-facie case of discrimination

Upon proof being made, at any hearing on a complaint under this section, that there has been discrimination in price or services or facilities furnished, the burden of rebutting the prima-facie case thus made by showing justification shall be upon the person charged with a violation of this section, and unless justification shall be affirmatively shown, the Commission is authorized to issue an order terminating the discrimination: Provided, however, That nothing herein contained
shall prevent a seller rebutting the prima-facie case thus made by showing that his lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor. 

(c) Payment or acceptance of commission, brokerage, or other compensation
It shall be unlawful for any person engaged in commerce, in the course of such commerce, to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid.

(d) Payment for services or facilities for processing or sale
It shall be unlawful for any person engaged in commerce to pay or contract for the payment of anything of value to or for the benefit of a customer of such person in the course of such commerce as compensation or in consideration for any services or facilities furnished by or through such customer in connection with the processing, handling, sale, or offering for sale of any products or commodities manufactured, sold, or offered for sale by such person, unless such payment or consideration is available on proportionally equal terms to all other customers competing in the distribution of such products or commodities.

(e) Furnishing services or facilities for processing, handling, etc.
It shall be unlawful for any person to discriminate in favor of one purchaser against another purchaser or purchasers of a commodity bought for resale, with or without processing, by contracting to furnish or furnishing, or by contributing to the furnishing of, any services or facilities connected with the processing, handling, sale, or offering for sale of such commodity so purchased upon terms not accorded to all purchasers on proportionally equal terms.

(f) Knowingly inducing or receiving discriminatory price
It shall be unlawful for any person engaged in commerce, in the course of such commerce, knowingly to induce or receive a discrimination in price which is prohibited by this section.

Discrimination in rebates, discounts, or advertising service charges; underselling in particular localities; penalties, 15 U.S.C. § 13a
It shall be unlawful for any person engaged in commerce, in the course of such commerce, to be a party to, or assist in, any transaction of sale, or contract to sell, which discriminates to his knowledge against competitors of the purchaser, in that, any discount, rebate, allowance, or advertising service charge is granted to the purchaser over and above any discount, rebate, allowance, or advertising service charge available at the time of such transaction to said competitors in respect of a sale of goods of like grade, quality, and quantity; to sell, or contract to sell, goods in any part of the United States at prices lower than those exacted by said person elsewhere in the United States for the purpose of destroying competition, or eliminating a competitor in such part of the United States; or, to sell, or contract to sell, goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor.
Any person violating any of the provisions of this section shall, upon conviction thereof, be fined not more than $5,000 or imprisoned not more than one year, or both.

Cooperative association; return of net earnings or surplus, 15 U.S.C. § 13b
Nothing in sections 13 to 13b and 21a of this title shall prevent a cooperative association from returning to its members, producers, or consumers the whole, or any part of, the net earnings or surplus resulting from its trading operations, in proportion to their purchases or sales from, to, or through the association.

§ 3 Clayton Act, 15 U.S.C. § 14
purchase other financial services (loans, letters of credit, custody services, etc.) from the investment bank, in order to effect the securitization transaction, b) the investors are sometimes required to simultaneously purchase two or more tranches of an ABS offering, or to promise to buy the same or similar ABS/MBS securities in order to be allocated ABS in new offerings; c) the sponsor and or investment may formally or informally require investors to purchase minimum dollar volume of ABS in specific offerings in order to get ‘allocations’ in future offerings. These acts constitute tying which is anti-competitive.

Sale, etc., on agreement not to use goods of competitor

It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented, for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.

FTC Regulations

Section 5 of the Federal Trade Commission Act outlaws "unfair methods of competition" but does not define unfair. The Supreme Court has ruled that violations of the Sherman Act also are violations of Section 5, but Section 5 covers some practices that are beyond the scope of the Sherman Act. It is the FTC’s job to enforce Section 5.

F7. Price-Fixing – The Locus-shifting Theory is introduced here. Locus-shifting occurs when a potential and obvious party to a price-fixing scheme is effectively replaced (in pricing negotiations) by a third party that has the resources and willingness to dramatically alter the pricing of goods/services in either the transaction, or a series of transactions or in the sector/industry as a whole. Normally, price-fixing would occur between two sponsors or two intermediary banks. Since the intermediary-investment bank is central to ABS offerings, and associated pricing and negotiations, the price fixing should be deemed to occur between the sponsor/originator and the investment bank (or between two sponsors). Since each active investment bank typically underwrites many offerings simultaneously, and essentially controls the pricing of each new-issue ABS, the investment banks are the locus of said price fixing and are potentially liable for the associated antitrust violations. Further evidence of price fixing maybe obtained by analyzing: a) the yield differentials of various ABS offerings in various asset classes (ie. autos, home equity, mortgages, etc.) by different sponsors within a specific block of time, b) the price differentials of various ABS offerings in various asset classes (autos, home equity, credit cards, mortgages, etc.) with the same rating, within a specific block of time.

F8. Exclusive Contracts


17 See: Standard Oil Co v. US, 337 US 293 (1949);
Exclusive contracts facilitate and enhance anti-competitive behavior by contractually restricting conduct by and trade among participants in the market. In the US ABS/MBS markets, existing illegal exclusive contracts include: 
a) contracts that prevent the intermediary investment bank from providing financial services to other prospective securitization sponsor-companies in the same industry/sector, 
b) contracts (by the sponsor, underwriter(s) or third parties) that prevent or limit the formation of a syndicate of securities dealers; 
c) contracts that prevent the sponsor from selling securities through other underwriters, other than an appointed intermediary investment bank. These types of contracts constitute direct violations of US antitrust statutes.

F9. Price Discrimination

There are several classes of ABS:

1) Securities that involve pure “pass-through” of cash flows, and hence rights to payment of cash from the SPV pool, but no ownership interest in the pool to: 
a) IO – interest only securities; 
b) PO – principal only securities; and 
c) traditional ABS that pay both interest and principal.

2) Securities that confer ownership interests in the underlying pool to: 
a) IO – interest only securities; 
b) PO – principal only securities; and 
c) traditional ABS that pay both interest and principal.

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3) Debt-type securities that involve a security interest in the underlying collateral
- a) IO – interest only securities; b) PO – principal only securities; and c) traditional ABS
that pay both interest and principal.

In many instances, the SPV offers many tranches in each of the above-mentioned
classes of ABS. The tranches within each class typically vary by term, interest rate,
duration, and bond-rating/risk-rating. Hence, in any situation where the tranches don’t
have any priority as to security interests or rights-to-payment of cash flows from the pool,
such stratified offerings within each class (IO, or PO or ordinary; or pass-through,
collateral-type or equity-interest) constitutes price discrimination because the underlying
asset and risk is essentially the same, although different securities are being offered in the
same transaction (or series of transactions), at different prices to investors, based on the
same underlying pool of assets. The distinguishing and critical element is that there is no
contractually agreed-upon priority of claims as to security interests or right-to-payment of
cash from the poll of assets.

F10. Predatory Pricing19

This occurs when investment banks under-price ABS offerings in order to obtain
more investors, and to build name recognition for a particular issuer (that does or intends
to come to the ABS market regularly). Evidence of predatory pricing may be inferred or
established by:

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19 See: Brooke Group Ltd. v. Brown & Williamson Tobacco, 509 US 209 (1993); Matsushita
Electric v. Zenith Radio, 475 US 574 (1986); Utah Pie Co. v. Continental Baking Co. et al, 386
US 685 (1967).
a) Comparing the offering prices of various new-issue ABS bonds sold by one sponsor/originator, in the same asset class (auto loans, home equity, credit cards, etc.), but at different times of the year, to offering prices of similar ABS bonds sold by other regular ABS sponsors/originators in the same time periods.

b) Running regressions to identify any statistically significant relationship between: 1) the difference in the yield of company XYZ’s ABS bond and the yields of other similar ABS bonds, and 2) various independent variables such as yield, price, asset type, bond rating, duration, industry, amount of offering, frequency of ABS offerings, types of investors, etc..

c) Comparing the offering prices of various new-issue ABS bonds underwritten by one investment bank (in the same asset class, but at different times of the year) to offering prices of similar ABS bonds underwritten by other investment banks in the same time periods.

F11. Rigging Of Allocations

Most ABS offerings are done via allocations of securities by investment banks to their brokerage customers.

1. Most sponsors issue ABS/MBS through bids by investment banks. Most bids for ABS securities are won by a few investment banking firms. This may suggest that customers have been “allocated” among investment banks. This is also an indication of collusion.

2. On occasion, the primary underwriters subcontract work (re-sell securities) to secondary underwriters.
G. Securitization Involves Void Contracts

The process of securitization involves several contracts that are either signed simultaneously or are all signed within a short time frame. Many of these contracts are void and illegal for the following reasons:

a) Lack Of Consideration — there is no consideration in many of the contracts used in effecting securitizations. Many of these contracts are unilateral executory promises and contain illusory promises. There are three main issues:

    i) Unilateral Executory Promise — A unilateral executory promise is not consideration. The following are some unilateral executory contracts in securitizations:

    • The promise made by the SPV to payout periodic interest, whether contingent or non-contingent on whether the collateral pays cash interest.
    • Collateral-substitution Agreement contains a promise in which the sponsor agrees to substitute impaired collateral.
    • Assignment Agreement - Assignment of future collateral (not yet existing) may be deemed a unilateral executory promise by the assignor.

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• Transfer Agreement. The sponsor agrees to transfer the collateral to the SPV, and the SPV in return pays cash to the sponsor.

  ii) Illusory Promises\textsuperscript{22} – An illusory promise is not a valid consideration for a contract. The following are some illusory promises inherent in securitization transactions:

  • The Subscription/purchase Agreement. The SPV’s promises to acquire the collateral with the cash raised from investors are essentially illusory promises. These promises are embedded in the offering Prospectus, but are typically not included other corporate documents. In most cases, the offering prospectuses don’t state the exact steps in the SPV’s promised purchase of the collateral.

  Purchase/Subscription Agreement. The SPV’s investors purchase beneficial interests in the SPV or the SPV’s debt. These beneficial interest evidence: a) right to payments from the SPV, or b) an ownership interest in the underlying collateral, or c) a ‘participation’ in the underlying collateral. However, at the time of executing this agreement, the only consideration that the SPV can grant to investors in exchange for the purchase amount, consist of promises to purchase the collateral in the future, and to make payments from the SPV’s assets. Hence, an existing asset is being exchanged for a future asset that does not exist as of the date of the purchase/subscription agreement.


• Furthermore, all securitization offerings are done pursuant to ‘Subscription Agreements’ and Investor Questionnaires – the two documents have to be signed by the prospective investor. None of the agreements signed by the investor as part of his/her purchase of the SPV’s ABS expressly incorporates the promises embodied in the Offering Prospectus. What typically exists is an implied agreement to subject the investor to the SPV’s articles of incorporation, Trust Indenture, and or Trusteess’/board of directors’ (or Board of Trustee’s) decisions.

• The SPV’s promise to pay interest/dividends on ABS IOs, Preferreds and POs are essentially illusory promises because the underlying collateral may not produce any cash flows, in which case there wont be any interest or dividend payments.

iii) No Bargain – some courts have held that there is no consideration (and hence, the contract is void) where one party was not allowed to bargain for the alleged agreement. 23 In some securitizations, the process of setting offering prices for new ABS issues does not afford all parties the opportunity to negotiate terms of the offering, especially individual investors, because the price of the ABS is typically determined primarily by the sponsor and the lead-underwriters. Furthermore, in securitizations, the originator sets the terms of the SPV (trust documents, articles of incorporation, Bylaws, etc.).

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23 Prudential Insurance v. Sipula, 776 F2d 157 (CA7, 1985)(no consideration where party to contract could not bargain for alleged agreement).
2. *No mutuality* \(^{24}\) – in the securitization context, for there to be mutuality: a) each party must have firm control of the subject matters of the contract and the underlying assets (consideration), and b) there should be a direct contractual relationship between the parties. At time of the Subscription Agreement, the SPV typically does not own or have rights to the collateral, and hence, there is not mutuality. Furthermore, the concept of ‘piercing the SPV veil’ is introduced here (and is similar to piercing the corporate veil) and applies since the following conditions exist:

- The economics of the transaction is an asset transfer from the sponsor/originator to the SPV investors, in exchange for a loan to the sponsor. However, there is no direct contractual relationship
- The sponsor typically controls the SPV before the ABS offering and determines (or substantially influences) the SPV’s post-offering operating characteristics. Since prospective ABS investors don’t have firm pre-offering control of the SPV and cannot influence its post-offering policies, there is no mutuality between the SPV and the ABS investors; and securitization is void.
- The sponsor influences the appointment of the SPV’s trustees or board of directors.

Thus, under contract law, the use of the SPV in securitization effectively eliminates any mutuality between the two main contracting parties - the sponsor and the investors. Secondly, there is no mutuality between the SPV and the investors: a) the SPV corporate documents (trust indentures or bylaws or articles of incorporation) typically limits the rights of each ABS investors and the group of ABS investors. Thirdly, there is no

mutuality between the SPV and the sponsor/originality because both entities are essentially the same, and are controlled by the sponsor before and after the securitization.

3. Illegal subject matter And Contravention Of Public Policy 25 – as explained in preceding sections of this article, securitization constitutes violations of antitrust statues and federal RICO statutes, and hence, the contracts used to effect securitizations are void and illegal.

Conclusion

Under US laws, Securitization is clearly illegal. The analysis in this article is applicable in most common-law jurisdictions.

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