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COMMENTS

The Dysfunctional "Family Resemblance" Test: After Reves v. Ernst & Young, When are Mortgage Notes "Securities"?

JOHN C. CODY†

INTRODUCTION

This Comment discusses the Supreme Court's 1990 securities law decision in Reves v. Ernst & Young1 and its ramifications for mortgage-related financial instruments and transactions. Securities Exchange Commission (SEC) rules prohibit fraud in the purchase or sale of securities,2 which the Securities Exchange Act defines to include "notes."3 In Reves, the Supreme Court for the first time established a specific test to determine the extent to which notes fit the definition of "securities" under the Securities Acts. In so doing, the Court adopted a modified "family resemblance" approach taken by the Second Circuit.4

Mortgage notes "evidenc[e] a loan for which real estate has been offered as a security."5 They are issued in real estate transactions as simple as single-family residence purchases and as complex as multi-million dollar commercial development projects. Back in the "good old days," when a family purchased a home, the family's

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1. 494 U.S. 56 (1990) (holding that a note must be presumed to be a "security" as defined in both the 1933 Securities Act and the 1934 Securities Exchange Act unless it bears a strong family resemblance to an item on a list of approved exceptions). See discussion infra part III.


4. Previously, the Court had created tests for instruments cited in the securities laws as investment contracts and stock. The Court did not create a test for notes until its decision in Reves. See, respectively, SEC v. W.J. Howey Co., 328 U.S. 293 (1946), and United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).

promise to the bank to pay back its loan was secured by the pur-
chased property and generally stayed with the bank. In recent years,
such promises, or mortgage notes, increasingly have been packaged
and sold by banks and traded in a secondary mortgage market.
Often their issuers, the SEC or the courts have denoted the repack-
aged instruments mortgage-backed "securities." The Court in Reves
held that a "note secured by a mortgage on a home" does not meet
the Security Exchange Act's definition of "security." Thus Reves
made unavailable federal securities law protection to those claiming
fraud in such a purchase or sale.

However, the questions remain, what is a "note secured by a
mortgage on a home" and of what significance is the pooling and re-
packaging into ever more complex instruments? The courts have in-
consistently answered these questions.

Since a myriad of real estate-related financial instruments and
transactions are implicated in the federal securities regulatory con-
text, this Comment does not purport to be wholly comprehensive.
Instead, its primary focus is upon what is commonly refered to as
the "secondary mortgage market." The significance of this market
can be traced to its phenomenal growth in recent years, the vast
losses that the savings and loan industry incurred as its member

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6. The federal government also has attempted in myriad ways to extend home
ownership to low and moderate-income Americans. See, e.g., Tim Vettel, Donnelly and Ri-
egle Propose Four-Year Extension for Mortgage Revenue Bonds, TAX NOTES, July 6, 1987,
at 24, 25. Mortgage Revenue Bonds (MRBs) are tax-exempt instruments distributed to
the states by the federal government and then sold to investors. The proceeds are used as
subsidies to allow low-interest rate loans to homebuyers. Mortgage Credit Certificates
(MCCs) entitle low and moderate-income homebuyers to a "nonrefundable income tax
credit of 10 to 50 percent of the interest paid on qualified mortgage loans to finance the
acquisition or rehabilitation of an individual's principal residence." Id. This Comment is
concerned with government assistance to homebuyers through its guarantees in what is
traditionally referred to as the "secondary mortgage market," rather than through the
federal tax system. Surprisingly, there has been a dearth of commentary and research in
this area, despite one practitioner's comment that securities lawyers "have some studying
ahead" if they want to understand new mortgage-backed securities. Francis X. Sulger,
Esq., quoted in Kim Masters, Mortgage-Securities Weddings to Boom, LEGAL TIMES, June
20, 1983, at 1, 8.

7. "Today the mortgage-backed securities market is second only in size to the U.S.
Treasury market. It outperformed all other fixed income securities from 1991 through
1991 . . . ." Marcia Parker, Hyperion's Sun is Rising Again; Ranieri Revives With New

The title of Ms. Parker's article refers to Lewis Ranieri, the anti-hero of LIAR'S
POKER, Michael Lewis' non-fiction account of 1980s mortgage-backed securities trading.
Ranieri, the former Salomon Brothers Vice Chairman, who is often credited with single-
handedly creating the mortgage-backed security market, now is running his own firm,
Hyperion Capital Management, Inc., which specializes in mortgage-backed instruments.
See MICHAEL LEWIS, LIAR'S POKER (1989).
banks (S&Ls) traded in these types of investments,\textsuperscript{8} and the continuing extension of asset-backed securitization to instruments other than mortgages.\textsuperscript{9}

Part I of this Comment provides an introduction to mortgages and the various types of mortgage-related financial instruments in existence today and examines the explosive growth of mortgages in the financial market. Part II discusses the federal regulatory scheme as it pertains to the fraudulent sale or purchase of securities, and the ongoing quest of the federal courts to define securities. Part III examines the \textit{Reves} decision, and Part IV assesses its impact on mortgage/security case law to date. Finally, Part V discusses why the "family resemblance" test for notes fails in the mortgage realm. This Comment concludes that the Supreme Court must clarify whether the "family resemblance" test provides plaintiffs with a federal fraud remedy in note cases, and urges the Court to explain in a future mortgage note case precisely how the test is to be employed.

I. WHAT ARE MORTGAGE NOTES?

A. The Primary and Secondary Mortgage Markets

The idea of using land as security for a borrower's promise can be traced back at least five thousand years to the Babylonians.\textsuperscript{10} Old Germanic law referred to the practice as a \textit{gage}, with the French word \textit{mort}, for "dead" or "frozen," being added later to signify a locked pledge on property. Hence, we now refer to a lien on real property enforceable upon nonperformance of the borrower as a "mortgage."

A potential homeowner desiring funds to purchase applies for a loan from a mortgage originator. The lender evaluates the risks in terms of the applicant's ability to pay (payment-to-income ratio, or "PTI")\textsuperscript{12} and the value of the property (loan-to-value ratio, or

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\textsuperscript{8} More than seven hundred thrifts (savings and loans) collapsed in the late 1980s and early 1990s at an expected cost to taxpayers of $220 billion. Kenneth H. Bacon, \textit{Ernst Agrees to Pay U.S. $400 Million}, WALL ST. J., Nov. 24, 1992, at A3. For a discussion of how the thrift collapse relates to the secondary mortgage market, see infra part I.B.

\textsuperscript{9} Asset-backed securitization has been extended to everything from car loans, credit card receivables, and aircraft and boat leases. See Suzanne Woolley & Stan Crock, \textit{You Can Securitize Virtually Anything}, BUS. WK., July 20, 1992, at 78. For a fuller discussion, see infra part I.C.

\textsuperscript{10} WILLIAM BARTLETT, \textit{MORTGAGE-BACKED SECURITIES: PRODUCTS, ANALYSIS, TRADING} 3 (1989).

\textsuperscript{11} Id. at 4; see also 55 AM. JUR. 2D \textit{Mortgages} §§ 1-9 (1971).

\textsuperscript{12} The PTI is the ratio of monthly payments to monthly income. See FRANK J. FABOZZI & FRANCO MODIGLIANI, \textit{MORTGAGE AND MORTGAGE-BACKED SECURITIES MARKETS} 41-42 (1992) [hereinafter FABOZZI & MODIGLIANI].
If the application is approved, the lender is responsible for loaning funds according to the agreed terms in a commitment letter. When the mortgage loan closes, the lender holds a mortgage note in which the borrower agrees to repay the loan with the real estate serving as security. After the loan is closed, the originator has three choices as to what it can do with the individual mortgage: (1) hold it in its portfolio as an investment; (2) sell it in the secondary market; or (3) warehouse it prefatory to its aggregation with other such loans and their eventual sale or securitization.

The primary and secondary mortgage markets are interrelated: a strong secondary market provides funding for primary mortgage loans, and a strong primary market provides loans which may be packaged and securitized. The secondary market consists almost entirely of single-family mortgage loans which are resold. Mortgages backed by multifamily houses and commercial real estate comprise a small part of the secondary market.

The phrase "secondary mortgage market" refers specifically to any sale of mortgages originated in the primary market. However, with the explosive growth of mortgage-backed securities, the phrase has come to be commonly understood to refer to repackaged "mortgage-backeds" alone. Real estate markets are both unique and inefficient. Secondary mortgage markets attempt to combat

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13. The LTV is the ratio of the amount of the loan to the assessed value of the property. Id. at 42.
14. For a description of the general mortgage origination process, see id. at 41-44.
15. Id. at 44.
16. Id.
17. Id. Forty percent of the $2.74 trillion single family mortgage debt outstanding in 1991 had been securitized, compared with only ten percent of multi-family mortgage debt. This is because multi-family dwellings and commercial properties tend to be unique and their mortgages are not as readily packagable. Id. at 24.
19. Id. at 974. Laypeople sometimes confuse the phrase "secondary mortgage market" with the practice of securing a second mortgage on a home or other real estate. "The phrase 'secondary mortgage market,' as used today, suffers from imprecision." Id. at 973. "Secondary mortgage" refers to a lender's re-sale of the first, primary mortgage, not to an individual's securing of a second mortgage in addition to the primary one, whether from the original lender or another. It is estimated that as of 1991, only $2 billion of second mortgages have been securitized. FABOZZI & MODIGLIANI, supra note 12, at 324.
20. Peter Chinloy explained:
Underlying all real estate markets are the basic and possibly unique characteristics of land. Since real estate markets are shown to be relatively inefficient, the efficient markets theories from other areas in finance may not be completely appropriate. Under efficient markets, one cannot obtain a superior-to-average return, except by accident.... Compared with financial markets as a whole, real estate physical and financial markets are relatively inefficient.... The presence of the inefficiency is what leads to potential profit making, and corre-
this inefficiency and to reduce the inherent risks associated with real estate investment. Mortgage-backed securities, packaged so as to defeat these risks, are the major component of the secondary mortgage market. They are one of the most significant developments in real estate finance in this century.

1. Public Issuance of Mortgage-Backed Securities. Just as the modern securities laws arose from the economic travails of the Great Depression of the 1930s, the secondary mortgage market was created in response to that era's depressed housing market. The National Housing Act of 1934 created the Federal Housing Admini-

PETER CHINLOY, REAL ESTATE: INVESTMENT AND FINANCIAL STRATEGY 7-8 (1988). Real estate's heterogeneity can be traced to differences in local zoning laws, building codes, environmental regulations and rent controls, as well as its own basic non-portability and finite supply. Id. at 8-14.

21. Some of these risks include interest rate risk and refinancing risk. Interest rate risk on mortgages arises as a result of the inverse relationship between asset prices and interest rates. In other words, as interest rates rise, mortgage lenders are at risk of capital loss because their lendable funds are locked in at a lower rate than the one prevailing at a time when prices inflate. This is especially true in the case of the usual fixed rate, long term mortgage. Id. at 211-12.

Refinancing risk occurs because borrowers respond to declining interest rates by refinancing their mortgages at the lower rate, thus reducing the yield and return to the mortgage lender. The secondary mortgage market allows the lender to unload inherently risky real estate loans from its portfolio, and to receive in return funds with which to make additional loans. Id. at 212.

22. As Christopher Farrell states:

For better or worse, the mortgage-backed security may be the supreme postwar financial innovation on Wall Street. The traditional fixed-rate, 30-year mortgage is essentially a stream of monthly payments. By pooling a group of similar mortgages, investment bankers can sell slices of that stable cash flow to investors, who provide fresh funds for still more mortgage lending.


It has helped minimize the problem caused by the fact that savings and loan associations (S&Ls), the historic providers of [mortgage] funds, are less able to supply the needs of homebuyers due to problems caused by competition for deposits, the deregulation of the federal depository system, and the danger of rising interest rates.


23. Bradner, supra note 18, at 973.
stration, which in turn originated the Federal National Mortgage Association (FNMA), colloquially known today by the moniker "Fannie Mae."

The FNMA was authorized to buy, sell or trade in mortgages insured or guaranteed by the federal government through the Federal Housing Administration or the Veterans' Administration (VA), in order to:

establish secondary market facilities for residential mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible, and to authorize such facilities to provide stability in the secondary market for residential mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing . . . .

As a result of the congressional enactment of Title VIII of the Housing and Urban Development Act of 1968, FNMA was spun off into a federally-sponsored private corporation, which buys mortgages from banks, thrifts, insurance companies and mortgage banking companies, pools them, and sells securities issued in its own name backed by these mortgage pools. FNMA purchases both conventional, i.e. nonguaranteed, and government-guaranteed mortgages, and issues a standard security based on a 30-year loan term but assuming prepayment after 12 years. FNMA guarantees timely payment of principal and interest. However, this guarantee is not backed by the full faith and credit of the federal government.

The Government National Mortgage Association (GNMA), colloquially known as "Ginnie Mae," was created in 1968 by the Housing and Urban Development Act as a wholly owned corporation of the federal government, administered by the Department of Housing and Urban Development (HUD). GNMA pools mortgages issued by

27. "Mortgage banking companies are nondepositary institutions providing funds for mortgages. These firms attract funds from institutional investors, such as insurance companies, pension funds, and . . . payments by other borrowers on existing loans." CHINLOY, supra note 20, at 306-07.
28. Id. at 214-15.
29. Id. at 215. Yields, then, are calculated on a 30-year amortization schedule. This allows for the assumption that the borrower will prepay the loan after 12 years, and pay a small annual servicing fee to the original lender.
31. CHINLOY, supra note 20, at 216.
the FHA, VA, or the Farmers' Home Administration, and insures and guarantees the securities it issues as to timely payment of interest and principal backed by the full faith and credit of the federal government. GNMA issues both standard “pass-through” securities, through which both principal and interest payments are “passed through” monthly or quarterly to the certificate holder, and mortgage-backed bonds. GNMA also re-sells some whole mortgages itself.

Title III of the Emergency Home Finance Act of 1970 created the Federal Home Loan Mortgage Corporation (FHLMC), colloquially known as “Freddie Mac.” FHLMC was created to establish a secondary market for conventional, i.e. non-government guaranteed or insured, mortgage loans. This federally sponsored private corporation, directed by the Federal Home Loan Bank Board (FHLBB), buys mortgages from depository institutions and mortgage bankers and issues securities in either bond or pass-through form. FHLMC, like FNMA, guarantees timely interest and principal payments. However, FHLMC securities are not backed by the full faith and credit of the government.

Behind the burgeoning mortgage-backed securities market are these three governmental and quasi-governmental entities affectionately known as Fannie, Ginnie, and Freddie. The federal government’s backing enticed investors previously worried about real estate related risk to enter the mortgage market. Although GNMA

32. Id. These are the only securities besides U.S. Treasuries and EE Savings Bonds that carry the full faith and credit guarantee. Nancy Dunnan, Mortgage-Backed Securities, A.B.A. J., Apr. 1989, at 108.
33. Id. These include: sinking fund bonds, for which principal is paid in fixed amounts; and staggered maturity bonds, for which interest and principal are paid regardless of mortgage payments made.
34. CHINLOY, supra note 20, at 216.
36. Bradner, supra note 18, at 978.
37. CHINLOY, supra note 20, at 213.
39. This government policy was effective. Between the 1930s and 1987, the percentage of American families owning their own home increased from 44% to 66%. WILLIAM GREIDER, SECRETS OF THE TEMPLE 43 (1987). For a clear description of public secondary mortgage market instruments and procedures, see GEORGE M. BOLLENBACHER, THE PROFESSIONAL’S GUIDE TO THE U.S. GOVERNMENT SECURITIES MARKETS 90-109 (1988), and for a description of the governmental policies implicated therein, see ANTHONY DOWNS, THE REVOLUTION IN REAL ESTATE FINANCE 234-62 (1985).
40. Bradner, supra note 18, at 978.
is backed to the extent of the Full Faith and Credit Clause, standard mortgage-backed securities “are guaranteed only against default risk, and not against either interest rate or refinancing risk.” Thus, the efforts of mortgage-security brokers in recent years have been directed towards reducing these remaining risks by packaging mortgage-related instruments in ever more clever risk-reducing ways.

2. Private Issuance of Mortgage-Backed Securities. The Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) was enacted by Congress to enhance nongovernmental, private issuances of mortgage securities at the expense of the government monopoly. It amends the securities acts to, inter alia, lessen registration re-

41. CHINLOY, supra note 20, at 7. The author notes that the former interest rate risk is shared by other popular instruments, such as Treasury bonds, while refinancing risk is unique to mortgage instruments. See infra part I.C. for a discussion of the burgeoning popularity of asset-backed securities, including credit card receivables, boat and other personal property loan re-packaging. These also are susceptible to refinancing risk unless packaged to safeguard against it.

42. The disincentives for investing in mortgage instruments without these risk-reducing factors have been characterized in the following way:

First, mortgages have historically paid both interest and principal monthly, whereas government and corporate bonds pay interest semiannually and all principal at maturity. Since the investor must reinvest principal and interest income more frequently, transaction costs and interest rate risk are greater for mortgages . . . .

Second, the cash flow and maturity of a mortgage are deemed more uncertain because the borrower can supplement the required monthly payments, or repay the entire loan, or default at any time. Investors, therefore, have difficulty determining the maturity and expected yield on the mortgage . . . .

A third disadvantage of investing in whole mortgages in the commercial property market (and to a lesser extent in the residential property market) is that they are not homogenous commodities . . . and are, therefore, less marketable than conventional securities . . . .

Finally, servicing and originating mortgages entail substantial administrative costs per dollar of investment.

David Alan Richards, “Gradable and Tradable”: The Securitization of Commercial Real Estate Mortgages, 16 REAL EST. L.J. 99, 100-01 (1987). Examples of the many ways in which mortgage securities have been structured to reduce these risks and problems are found infra part I.B.


By 1987, almost half the total securitized market consisted of GinnieMae MBSs ($320 billion). A similar number were FannieMaes and FreddieMacs ($370 billion); and, only a small percentage of the market consisted of privately issued MBSs ($19 billion). BARTLETT, supra note 10, at 56.
quirements for private issuers. SMMEA was enacted to forestall a shortage of mortgage funds given projected increasing demand. The "ultimate goal was to facilitate private sector participation in the secondary market for mortgages." SMMEA defines privately issued "mortgage-related securities" as such:

(1) The security is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization; and

(2) The security must either represent ownership of one or more promissory notes or certificates of interest or participations in such notes; or be secured by one or more promissory notes or certificates of interest or participation in such notes and, by its terms, provide for payments of principal in relation to payments or reasonable projections of payments, on notes, or certificates of interest or participations, in promissory notes; and

(3) The underlying notes or certificates must be directly secured by a first lien on a single parcel of real estate; stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure; or on a residen-


Unlike private issuances, mortgage-backed securities issued by the quasi-governmental agencies (Fannie, Freddie, etc.) are exempt from SEC registration requirements. FABOZZI & MODIGLIANI, supra note 12, at 33.


47. Examples of statistical rating organizations include Standard & Poor's and Moody's. Their two highest rating categories are: Standard & Poor's, AAA or AA+, AA, and AA-; Moody's, Aaa or Aal, Aa2, and Aa3.

The rating companies do intensive analyses of mortgage pools, rating their quality based upon: lien status; types of property; occupancy status; amortization type; mortgage term; age of the mortgage; location and geographic dispersion of mortgages; size of mortgages; loan to value ratios; size of the pool; mortgage default insurance; pool insurance; and degree of over-collateralization. Federal Credit Union Investment in Mortgage Securities, 52 Fed. Reg. 27,994-01 (1987) (to be codified at 12 C.F.R. ch. VII).
tial manufactured home; and

(4) The underlying notes or certificates must have been originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority; or by a mortgagee approved by the Secretary of Housing and Urban Development.48

The Bank of America initiated private issuance of mortgage securities in 1977 with the placement of $150 million of pass-through certificates.49 Other financial institutions followed suit.50 Between 1984 and 1988, the total amount of annually privately issued mortgage securities increased from $10 billion to more than $71 billion.51 However, the largest participants in the secondary mortgage market remained the government-related entities: Fannie Mae, Ginnie Mae, and Freddie Mac.52 This was because government-issues retain some advantages over private issues: (1) instruments issued by each of the three entities are exempt from Securities Acts registration requirements; (2) these issues are considered less risky than private issues because they are either backed by the full faith and credit of the federal government (GNMA) or the government guarantees payment (FNMA and FHLMC),53 and (3) until recently private issues were unrated by bond rating agencies,54 making them less palatable to investors.55

B. Growth of the Secondary Mortgage and Other Asset-Backed Markets

1. Increase in Volume. The growth of the secondary mortgage market in recent years has been phenomenal. A former bond trader for Salomon Brothers, in a notable insider's financial history of the bond market of the 1980s,56 traced the explosion of the market to an

49. Bradner, supra note 18, at 979. The instruments, according to one insider, were legal at the time they were issued in only three states. Lewis, supra note 7, at 100-01.
50. For example, Norwest issued $300 million of certificates representing interests in three mortgage pools, each pool containing a different kind of mortgage loan. Masters, supra note 6, at 1, 8.
52. Bradner, supra note 18, at 980.
53. Private issues require private insurance and the resulting costs, because, unless issued through the intermediation of the government agencies, they lack government guarantees. See Sears Family Studies Pooling of Mortgages to Create New Product, SEC. WK., Feb. 21, 1983, at 8.
54. For examples of statistical rating organization, see supra note 47.
55. Bradner, supra note 18, at 980.
56. Lewis, supra note 7.
incident occurring on a particular day in 1979. On October 6th of that year, Federal Reserve Chairman Paul Volcker announced that the money supply would be fixed, and interest rates allowed to float. If interest rates swing wildly, then bond prices do, too, inversely. After Volcker's speech, bonds for the first time became objects of speculation.

Whether or not that was actually the precipitating event, it is true that in the 1980s American governments, consumers, and corporations borrowed more money than ever before. Their combined indebtedness in 1977 (mostly in loans made by commercial banks) was $323 billion. By 1985, the indebtedness had grown to $7 trillion. A greater percentage of that debt was in bonds, as outstanding mortgage loans grew from $55 billion in 1950 to $1.2 trillion in 1980, the mortgage market surpassing the combined United States stock markets as the largest capital market in the world. Between 1977 and 1986, the holdings of mortgage bonds by American thrifts grew from $12.6 billion to $150 billion.

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57. Id. at 35; Greider, supra note 39, at 124-25.
58. Lewis, supra note 7, at 35. Bonds are usually long-term debt instruments, commonly secured by mortgages as differentiated from stock, which is an equity representing an ownership interest. See Black's Law Dictionary 178, 1415 (6th ed. 1990). Michael Lewis points out that after Volcker's speech, short-term interest rates skyrocketed and new housing starts dropped to post-war lows. In 1980, there were 4,002 S&L's in America. Within three years, 962 of those had collapsed. Lewis, supra note 7, at 100.
59. Lewis also points to September 30, 1981, when Congress passed a tax break allowing thrifts to receive previously-paid tax dollars back from the federal government if they could show losses on their books. The S&Ls eagerly sold the bad loans on their books at a loss. Lewis, supra note 7, at 103-04. Not to sell would have been to risk bankruptcy, since the thrifts were paying out 14% interest rates on deposits while taking in 5% rates on old mortgage loans. By late 1982, short-term rates declined below long-term interest rates, so the thrifts could make new mortgage loans at 14% while taking in money for which they paid just 12%. Id. at 106.
60. Id. at 36.
61. Id. Between 1977 and 1986 the holdings of mortgage bonds by American Savings and Loans grew from $12.6 billion to $150 billion. Despite their dwindling numbers, S&Ls as a group nearly doubled in asset size, from $650 billion in 1981 to $1.2 trillion in 1986. Id. at 114.
62. Id. at 83. Lewis also states: The U.S. mortgage market is now [in 1989] the largest credit market in the world and may one day be the single largest bond market in the world. [This signals] a shift in the focus of Wall Street. Wall Street, historically, had dealt with only one side of the balance sheet: liabilities. Mortgages are assets. If home mortgages could be packaged and sold, so could credit card receivables, car loans, and any other kind of loan you can imagine.
Id. at 149. For a discussion regarding the accuracy of Lewis' predictions, see infra part I.C.2.
63. Id. at 114. The Resolution Trust Corp., formed in order to salvage the assets of S&Ls that failed after real estate and other values crashed, is itself selling billions of dollars worth of mortgage-backed securities, dubbed "Ritzy Maes" by financial pundits.
Sales of mortgage related securities continued to set records during the early 1990s economic recession—a time of falling yields on real estate investments.\(^6^4\) Issuance of REMICs and CMOs alone totaled $180 billion in 1991, surpassing 1990's record of $110 billion.\(^6^5\) The sales of non-mortgage asset-backed securities also continue to set new records, as banks and other financial institutions “use securitization to lower their financing costs, increase liquidity or improve their balance sheets.”\(^6^6\)

2. Extension of Securitization to New Areas. As mentioned previously, the notion of pooling mortgages and packaging them in various forms for sale as mortgage-related securities has been extended to other types of assets, giving rise generally to the category “asset-backed securities.” The emergence of hybridized and inventive new packages has led to concern that “today’s financial markets may require a fundamental reconsideration of the nature of ‘assets’ and ‘liabilities’ . . . .”\(^6^7\) For example, Merrill Lynch issued $140 million worth of 30-day commercial paper, backed by credit card receivables in June 1985. However, most asset-backed issuances are more straightforward than the hybrids.\(^6^8\)


64. REMICS, CMOs, Asset-Backed Securities Set New Volume Records, PSA Says, SEC. Wk., Dec. 23, 1991, at 8. Mortgage pass-through issuance is being driven by the numbers of homeowners refinancing their mortgages in a time of falling interest rates. Id.

65. Id.

66. Id. Asset-backed securities set a new record in 1991—at least $44 billion of issuance. Credit card securitization was down slightly from $20.4 billion in 1990 to $18 billion in 1991, after Congress threatened to cap consumer credit card interest rates. However, car loan and home equity asset-backeds increased in volume dramatically. Id. See also Michael Siconolfi, Securities Backed by Mortgages, Assets Show Signs of Slowing After 1980s Surge, WALL ST. J., Mar. 21, 1991, at Cl. This title was proven wrong, at least as it regarded mortgage-backeds, after an “avalanche” of mortgage security sales set a new record in the first quarter of 1992, representing 47% of all stock and bond underwriting in that quarter. Id.


68. An example of a typical asset-based transaction, one which, despite its normalcy still raises troubling financial questions, is the issuance of $103 million of certificates for automobile receivables by the Home Federal Savings and Loan Association on August 1, 1985. The certificates represented fractional undivided interests in a trust formed from a pool of motor vehicle installment loans, the motor vehicles themselves securing the loans. The certificates for this private placement were registered with the Securities and Exchange Commission pursuant to the Securities Act of 1933, so the issue as to whether the certificates were securities did not arise, but difficult tax and Uniform Commercial Code questions did. For information regarding the taxation of mortgage related securities, see
Receivables financing has been used in the past to raise cash for troubled companies, to maintain lines of working capital from banks, and to raise funds for captive automobile finance companies. Its increasing use today has raised questions regarding the economic impact on shareholders of selling entities. Critics contend that managements are selling off their corporations' most desirable assets to avoid raising capital, and inefficiently allocating resources.

In addition to mortgages, assets which have been securitized to date include: automobile loans, credit card receivables, boat loans, computer and photocopier leases, aircraft and railcar leases, small business loans, hospital and trade receivables, and home equity loans. The SEC has expressed its support for expanding the asset-backed market. Former SEC Chairman Richard Breeden stated that he would like to see small business loans securitized as a way to lessen the effects of the credit "crunch" and a means to divert more funding to small businesses.

Another significant area to which asset-based securitization has been extended is commercial real estate. Commercial Mortgage Backed Bonds (CMBBs) were first issued in a $200 million offering by Olympia & York Maiden Lane Finance Corp. in 1985. Rental income from a large office building is packaged to create an interest


Since the vehicles themselves secured the automobile installment loans in the Home Federal issuance, the perfection of security interests under the UCC was implicated. For example, if the owner of a vehicle had moved to another state, re-registration procedures might have defeated the perfection of a security interest in the vehicle. Lipkin, supra note 67, at 18. Thus, while the non-portability of real estate poses certain problems in the mortgage-backed financial sphere, portability can defeat risk-reducing precautions for other asset-backeds. For a discussion of UCC problems with mortgage-backed securities, see William H. Jennings, Problems in Buying and Selling Mortgage Loans: The $3 Trillion Ambiguity, 19 UCC L.J. 255 (1987) [hereinafter Jennings, Problems].

69. Lipkin, supra note 67, at 18.
70. Id. at 19.
71. Woolley & Crock, supra note 9, at 78. By 1988, the total of all asset-backed securitization had reached almost $30 billion. BARTLETT, supra note 10, at 44.
72. Woolley & Crock, supra note 9, at 79. See also Sandra Block, SEC May Ease Asset-Backed Securities Rules, WALL ST. J., Nov. 19, 1992, at C21. Critics contend that unsophisticated investors may purchase asset-backed bonds without a full understanding of the risks and thus expose themselves to riskier-than-normal investments, because a sharp economic downturn may cause widespread defaults on the loans securing the investor offerings. Id.

payment stream with the property itself serving as security. The offeror benefits by receiving less costly funding than if it had to borrow from private sources, and the purchaser benefits from relatively high bond yields.

Commercial real estate securities dwarf any others in terms of potential size. To date, however, they have not met that potential because of problems peculiar to these types of offerings. For one thing, commercial property is so heterogeneous as to make residential real property appear homogenous. Commercial real estate obtains its value from individual markets, leases, and changes in supply and demand which can vary region by region and even block by block. Such heterogeneous mortgages are more difficult to pool, and virtually always secure nonrecourse obligations. That is, there is no recourse to the borrower's credit, only to the mortgaged asset, which may have become devalued. While the Resolution Trust Corporation (RTC) has been successful in placing a few billion dollars worth of performing commercial real estate backed offerings, for the most part this area of asset-backeds has not expanded because the risks to investors are still seen as outweighing the potential benefits.

3. Implications of the Growth of the Markets. The federal securities laws are, in essence, information-transfer devices; they seek to provide to the investor disclosure of information necessary to make reasoned investing decisions. Mortgage-securities instruments and

74. Id.
The estimated size of the commercial real estate mortgage market is said to be upwards of $650 billion, roughly the same as the outstanding U.S. corporate debt, and a figure which makes even the $350 billion in residential mortgage securities pale in comparison. . . . There is reportedly a total of $2.5 trillion in commercial real estate value in the United States, of which $1.8 trillion is equity.

Richards, supra note 42, at 112.
75. Richards, supra note 42, at 111.
76. Id.
77. Id.
78. Woolley & Crock, supra note 9, at 79. Investors are uncomfortable with the risks and, as a result, demand in return yields so high that the deals become uneconomical.
79. Regarding the Securities Act of 1933, the Senate declared:
The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.
The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation, to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to
transactions are especially complex, requiring perhaps a higher degree of investor disclosure.\footnote{80} Congress, in its passage of the Secondary Mortgage Market Enhancement Act of 1984, considered even those institutions engaged in these types of transactions as part of their normal business practices in need of special protection:

\ldots [T]he Committee was of the view that small banks, thrifts and credit unions lacking in financial expertise should be provided additional protection against risky purchases. Accordingly, \ldots the bill requires the appropriate regulators to consider this question and provide regulations where necessary governing the size and determination of the purchases that are authorized. In this way, the bill endeavors to protect the liquidity of less financially sophisticated institutions on whom many of our citizens rely for the protection of their savings.\footnote{81}

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The House Report for the same legislation also focused upon the information gap between investors and dealers in securities:

During the post-war [World War I] decade some 50 billions of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of vast wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.

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\footnote{80. LEWIS, supra note 7, at 118-19 ("Mortgages were acknowledged to be the most mathematically complex securities in the marketplace. The complexity arose entirely out of the option the homeowner has to prepay his loan \ldots "). Compare BARTLETT, supra note 10, at 56 (contending that despite the complexities of many of the instruments derived from mortgages, the fact that the single-family home mortgage underlies all of the mortgage security cash flows reduces their complexities). Bartlett suggests that to understand mortgage cash flows, a homeowner need only ask himself what action he would take in a given interest-rate and economic environment.}

\footnote{81. H.R. REP. NO. 994, 98th Cong., 2d Sess. at 13 (1984). Some observers agree with this view. See generally LEWIS, supra note 7; MARTIN MAYER, NIGHTMARE ON WALL STREET 155, 157 (1993) (stating "[Wall Street was] dealing with very poorly informed people at the S&L's"). Mayer had developed his view in an earlier work by pointing to the intentional theft of a good portion of S&L managements. See MAYER, BANK ROBBERY, supra note 22, at 53. Mayer noted that the thrifts often snookered the deposit brokers, and}
The volatility of the enormous and relatively new secondary market places great strains on existing technologies and leads to occasional worries concerning the market's possible collapse. This is somewhat ironic, given that in 1984 Merrill Lynch Mortgage Capital's Richard T. Pratt, a former Federal Home Loan Bank Board Chairman, characterized technological advancement as allowing for creation of the secondary mortgage market to begin with:

Technology is the underlying force that actually is changing the whole face of the financial world. It affects much more than the secondary mortgage market, of course, but it does have an extraordinary impact on this market because two of the major technological areas have been communication and computation. Communication in the development of the mass media and in the ability to reach any point in the U.S. at a low cost immediately. This capability is combined with computer technology, which allows you to handle a very transaction-intensive instrument.

The mortgage is a much more transaction-intensive vehicle than a U.S. government bond. You have a transaction associated with a mortgage every month, while with a long-term bond the figure is every six months. Computers allow these to be handled at low cost, and it also permits a very complicated assemblage of portfolios and investors to be coordinated. I would think that the secondary market could not have developed without technology, and it is the technological foundation that underlies this whole market.

not vice-versa. Id. at 126-27.

Another observer pointed to the complicity of Congress members who were supposed to be monitoring S&L activity:

In 1980, 129 House members and 38 senators reported that they earned part of their income from stock shares in commercial banks, S & L's and other financial institutions. As a private interest of congressmen and senators, ownership of financial institutions far exceeded their holdings in manufacturing, law firms, or oil and gas. Even some elected representatives were engaged in finance beyond the passive ownership of bank stocks. Forty House members and four senators were active as directors, officers or partners of commercial banks, S & L's and investment companies.

GREIDER, supra note 39, at 163-64.

82. See, e.g., Christopher Farrell, How Wall Street is Driving the Mortgage Market, BUS. WK., May 4, 1987, at 108; Stephen G. Finn, Real-Estate Industry Turns to Wall Street; Banks are Skittish, But Developers Need Capital, LEGAL TIMES, Nov. 9, 1992, at S-31. Concerned about the stability even of government-sponsored secondary mortgage market entities such as Fannie Mae and Freddie Mac, Congress has regulated these institutions by requiring minimum capital standards similar to those recently imposed on savings and loans. See House Votes for Regulation of U.S. Mortgage Agencies, N.Y. TIMES, Oct. 5, 1992, at D8.

83. Richard T. Pratt was single-handedly responsible for the S&L collapse. See MAYER, BANK ROBBERY, supra note 22, at 61.

This "technological foundation" has had its problems. In 1986, with "fail rates" in the GNMA market near 50%, the SEC and the New York Federal Reserve Bank moved to quell widespread complaints about the market and its technological inadequacies, including its lack of automation. Trading volume in these securities had increased so dramatically that many firms had difficulty keeping up with the need to clear the tremendous volumes of associated paper. In response, Morgan Stanley & Co. scaled back its mortgage-securities trading considerably.5

As often happens in cases of technological advancement, increased efficiency in one link of the market chain exposes its absence elsewhere. Thus, at a time when mortgage bankers were successfully speeding up their mortgage origination through computerization, problems such as the GNMA slowdown were acting as a drag on the system.6 But by 1991, one of the primary reasons given for the phenomenal success of CMO issues was the growing computer capabilities of issuers and investors.7

Nevertheless, the risk of real estate-based issues for technological or other reasons remains.8 Some commentators attribute the late 1980s S&L crisis in part to the thrifts' investment in real estate

85. SEC and New York Fed Considering Improvements for GNMA Market, SEC. WK., Apr. 7, 1986, at 10; see also Leah Nathans, Small Players Complain About Big Players in Burgeoning GNMA Market, SEC. WK., May 26, 1986, at 3. Because market participants were required, in the absence of automation, to deliver paper GNMA, firms became backlogged in their paperwork. Some smaller buyers complained that the larger firms were strategically allowing themselves to become backlogged. While the buyers were forced to pay for the trades on settlement day, the sellers took as long as three months to deliver the securities, earning interest on the monthly principal and interest payments while the buyers lost interest on the money they already had spent. Id.

86. See Todd Mason, How Electronic Genies Are Moving Mortgages Faster, BUS. WK., May 9, 1988, at 138. Mortgage bankers using networked computerized loan origination systems (CLOs) were able to grant mortgage loans in as little as two days, but complained that paperwork required by government-sponsored agencies, such as FNMA, was slowing down their loan closure. Id.

87. Issuance of Mortgage-Related Securities Exceeds Corporates, Munis, SEC. WK., Aug. 26, 1991, at 10. According to one dealer, "[t]he computer systems of primary dealers, the largest investment banks and the biggest commercial banks are now able to analyze and store the vast amounts of data generated by these deals." Id. Bear, Stearns and Credit Lyonnais actually invested in millions of dollars worth of hardware, software and programmers' time in order to handle a single issuance of asset-backed securities sold in Europe. Id. See also Telerate, Bear, Stearns Plan Data Services for Mortgage Market, WALL ST. J., Nov. 20, 1991, at C14.

88. Indeed, the SEC is considering tightening control over the asset-backed and mortgage-backed securities markets. See, e.g., Parker, supra note 7, at 1 (stating that "[t]he agency might insist on greater disclosure and more warnings about the potential risks to investors"); Kevin G. Salwen & Constance Mitchell, SEC is Weighing Steps to Control Market in Asset-Backed Securities, WALL ST. J., June 28, 1991, at C1.
development and the real estate market's collapse,\textsuperscript{99} specifically the collapse of the commercial real estate market.\textsuperscript{90} While the consensus is that other factors, i.e., risky investments generally, are to blame for the crisis,\textsuperscript{91} a reasonable argument may be made that thrift in-

\textsuperscript{99} In 1986, more than a third of the profits of healthy thrifts came from sales of mortgage-backed and related bonds. With rising interest rates in 1987, according to one dealer, "the impact on thrifts' net worth could be substantial." Farrell, supra note 22, at 108. A number of commentators tie thrift losses to "real estate development activities." See, e.g., Mayer, Bank Robbery, supra note 22, at 171; Michael A. Robinson, Overdrawn: The Bailout of American Savings 25-26, 184-85 (1990); Roy C. Smith, The Money Wars 227 (1990). Robinson also notes how American Savings' back-office records were in such shambles that in many cases American Savings had no idea by whom it was owed mortgage payments. Id. at 136.

\textsuperscript{90} As a government economist declared: "Few commentators cite the overall real estate slump as the dominant cause of the S&L disaster. Some, however, do." Carl Felsenfeld, The Savings and Loan Crisis, 59 FORDHAM L. REV. S7, S32 (1991) (citing Where the Lost Thrift Money Went, WALL ST. J., Nov. 5, 1990, at A6 (quoting government economist declaring that "thrift crisis is a real estate crisis"). One commentator who does attribute the S&L crisis to the thrifts' investments in mortgage-related securities is former Salomon Brothers bond trader Michael Lewis:

In any market, as in any poker game, there is a fool. The astute investor Warren Buffett is fond of saying that any player unaware of the fool in the market probably is the fool in the market. In 1980, when the bond market emerged from a long dormancy, many investors and even Wall Street banks did not have a clue who was the fool in the new game. Salomon [Brothers] bond traders knew about fools because it was their job. Knowing about markets is knowing about other people's weaknesses. And a fool, they would say, was a person who was willing to sell a bond for less or buy a bond for more than it was worth.

Lewis, supra note 7, at 35. Referring to the S&Ls, Lewis says:

Stupid customers (the fools in the market) were a wonderful asset, but at some level of ignorance they became a liability: They went broke. . . .

. . .

The situation was aggravated by the ignorance of the thrifts. . . . They didn't know the mentality of the people they were up against. They didn't know the value of what they were selling. In some cases, they didn't even know the terms (years to maturity, rate of interest) of their own loans. . . .

. . .

What was happening—and is still happening—is that the guy who sponsored the float in the town parade, the 3-6-3 Club member and golfing man, had become America's biggest bond trader. He was also America's worst bond trader. He was the market's fool. Id. at 101, 104-05, 114.

Despite some criticism of Lewis' point of view, more recent findings support him. See, e.g., RTC Chronicles Widespread Securities Speculation By Thrifts in Congressional Report, RTC Watch, Mar. 30, 1992, at 3 (finding that S&L losses in mortgage-backed security investment, both governmentally and privately issued, were far more significant than originally anticipated).

\textsuperscript{91} See Fabozzi & Modigliani, supra note 12, at 101; Richard C. Breeden, Thumbs on the Scale: The Role that Accounting Practices Played in the Savings and Loan Crisis, 59 FORDHAM L. REV. 71, 71 (1991); Felsenfeld, supra note 90, at 57; Alex M. Azar, II, Note, FIRREA: Controlling Savings and Loan Association Credit Risk Through Capital Standards and Asset Restrictions, 100 YALE L.J. 149, 152 (1990).
solvency is partially attributable to money-losing real estate portfolios and trading in the secondary mortgage market.92

There is some relation between the performance of the huge secondary mortgage market and the other financial markets in general. Concern for the unsophisticated mortgage market buyer or seller by securities market regulators is ubiquitous.93 But when an unsophisticated investor is defined so broadly as to include what the average person might consider a sufficiently financially literate entity, namely, the neighborhood thrift, then the need for greater protection when trading in mortgage markets seems obvious. What is less obvious, however, is whether that enhanced investor protection is to come from the existing securities laws or elsewhere.

One observer reflects that the S&L crisis was precipitated first by decades of long-term fixed-rate mortgage lending carried against short-term, variable-rate liabilities. High inflation rates lowered the market value of the long-term, fixed-rate residential loans. Thrift managers, trying to overcome that problem by seeking risky, short-term loans at high returns, found that the promise of these loans evaporated as inflation subsided and brought down real estate values. See BARTLETT, supra note 10, at 25-26.

92. In 1978, the portion of thrift portfolios in real estate mortgages was only forty-six percent, and by 1988 had declined to just twenty-eight percent. Felsenfeld, supra note 90, at S32. One commentator attributes this reduction to mortgage bankers taking away some of the thrifs' traditional mortgage origination business so as to make greater profits by selling the originated mortgages in the secondary market. Breeden, supra note 91, at S73. Losing both primary and secondary mortgage market business, and approaching insolvency because their costs for borrowing funds were exceeding the returns that they were receiving on existing mortgages in their portfolios, the thrifs pressured Congress to allow them to engage in ever more risky investing. The thrifs thus caused their own collapse. Id. at S73-74.

93. See, e.g., NASAA Urges House Panel to Modify Legislation on Mortgage-Backeds, SEC. Wk., March 19, 1984, at 4. The North American Securities Administrators Association, a national organization composed of state securities regulators, testified before Congress that the Secondary Mortgage Market Enhancement Act inadequately protected unsophisticated purchasers in its attempt to further the economic goal of providing more private capital for mortgage lending. NASAA has taken the general position that interests in mortgage pools are securities. See Joseph P. Hildebrant, Regulation of Real Estate Securities, in BLUE SKY LAWS 243 (1990). The SEC also takes this position despite court decisions to the contrary. See, e.g., Exclusion From the Definition of Investment Company For Certain Structure Financings, 17 C.F.R. pt. 270 (1992). For further discussion about concern for unsophisticated buyers and sellers, see Self-Regulatory Organizations, 57 Fed. Reg. 49,732 (SEC 1992) (discussing how NASD, a self-regulatory organization for over-the-counter (OTC) sales of securities, proposed tighter control over sales of CMOs because they are "extremely complex and require full and fair disclosure to assist the investor in understanding them"); Block, supra note 72, at B16 (quoting SEC Commissioner Richard Roberts who, concerned that asset-backed deals may be too complicated for small investors, stated: "What's good for sophisticated investors isn't necessarily good for Ma and Pa Kettle . . . "); Parker, supra note 7, at 1 (discussing how SEC, worried that investors did not understand the risks associated with complex asset-backed securities, considered requiring greater disclosure and more warnings about potential risks).
C. Different Types of Mortgage Instruments

1. Primary Mortgage Market Instruments. The types of mortgages available in the primary market can be easily summarized, and help place those sold in the secondary market in contextual perspective. The mortgage on an individual family residence with which we are all most familiar is the fixed-rate percentage mortgage (FRPM). While typically for a term of thirty years, the FRPM is now being offered for loan terms anywhere between five and forty years. The interest rate for a fixed-rate mortgage remains constant during the term of the loan, and the loan is amortized; that is, the borrower makes equal monthly payments of interest and principal.

An adjustable rate mortgage (ARM) has its interest rate adjusted periodically, usually at intervals of one year, although sometimes at six months up to five years. The rate is determined by adding a specific number of percentage points, known as “margin,” to a particular index. (Various indices employed as benchmarks include the six-month treasury bill rate, the various treasury securities rates, national average mortgage rates, prime rates and even the consumer price index). Monthly payments are adjusted when the interest is adjusted “so as to amortize the then-unpaid principal over the balance of the term of the loan.” The interest which may be charged on an ARM is usually capped at a maximum rate.

One new type of primary mortgage market product is the bi-weekly mortgage, in which payments are made twice, rather than once, a month. This accelerated payment schedule allows principal to be paid off more quickly, thereby reducing long-term interest payments. While most mortgage lenders allow borrowers to pay back their loans ahead of schedule, a prepayment penalty may be charged.

94. Additionally, a summary of primary mortgages is useful because many of the judicial opinions analyzed in this Comment concern hybrid transactions, or those in which the nature of the primary instrument helps determine the status of the secondary or tertiary instrument. See infra part III.


96. In October 1981, the FHLBB and the Comptroller of the Currency finalized regulations allowing national banks and federally chartered thrifts (S&Ls) to originate or purchase adjustable rate mortgages, in order to reduce lender risk and enhance lender flexibility. 12 C.F.R. pt. 29 (1981); 12 C.F.R. § 545.6-4a (1982). The use of ARMs, however, detracts from one of the goals of mortgage securitization, namely, uniformity of the instrument. See Lance, supra note 43, at 438-39.


98. Id.

99. Id.

100. Id.
2. Secondary Mortgage Market Instruments. The types of mortgage instruments available in the secondary market are manifold, defying strict categorization, and increasing in number with the increasing inventiveness of issuers. Typically,\(^{101}\) in the case of mortgage-backed securities, a pool of mortgages\(^{102}\) either originated by the issuer, or purchased from other lenders, is formed.\(^{103}\) The loans in the pool are then transferred to a trustee, who will issue certificates evidencing ownership in the pool.\(^{104}\) The certificates are sold by the pooling entity to investors.\(^{105}\) The originator frequently services the pool, collecting mortgage payments on behalf of the investors in the trust, and receiving a fee deducted from the interest payments collected from the borrowers.\(^{106}\)

The most common types of mortgage-related instruments are summarized as follows:

- **Whole Loans.** A whole loan is simply defined as the total outstanding principal balance on a mortgage.\(^{107}\) By selling whole loans, the lender may immediately recover the entire principal balance of a loan and use the recovered funds for relending. The lender avoids interest rate and default and refinancing risks inherent in mortgage loans, while sometimes retaining servicing responsibility, garnering servicing fees.\(^{108}\) On the downside, markets for whole loans are essentially limited to buyers such as other thrifts that are familiar

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101. Not all secondary mortgage market transactions consist of the sale of numerous pooled primary instruments. Often, developers and others sell mortgages (or participation interests in mortgages) to raise funds for development. See infra part III for a discussion of cases including these types of small, secondary market transactions.

102. A pool [of mortgages] is just a legal and tax structure. There is not much in the deal that is really separate from the legal structure, except the quality of the underlying mortgages, which are usually subject to well-established controls. It's a question of developing the most secure and efficient legal structure for the offering.

Masters, *supra* note 6, at 1-2. Nevertheless, says attorney John A. Quisenberry, "[t]hese deals are extremely complex, and there are lots of different ways to do them and innovations yet to be invented." *Id.*

103. Pittman, *supra* note 51, at 502 ("In order to hedge against changes in interest rates while the pools are being formed, the originator may enter into forward commitments, in which investors contract to purchase, at a fixed price, interests in the pool of mortgage loans that the originator expects to produce in the future.").

104. *Id.*


106. *Id.* Factors affecting prepayment rates of the pool as an aggregate include the age, size and location of the pool. See SEAN BECKETT & CHARLES MORRIS, THE PREPAYMENT EXPERIENCE OF FNMA MORTGAGE-BACKED SECURITIES 34-41 (1990).


108. *Id.*
with mortgage loans.\textsuperscript{109}

Whole loan purchases account for a large portion of secondary market sales.\textsuperscript{110} Thrift managers like to hold whole loan purchases of adjustable rate mortgages (ARMs) as a hedge on interest rates.\textsuperscript{111}

Drawbacks to the lender include: the preclusion of leverage of funds (as is available, for example, in participation sales),\textsuperscript{112} the requirement of extensive transaction documentation; and the transfer of all original loan documents to the buyer.\textsuperscript{113}

- \textit{Loan Participations.} In a loan participation, the holder of the primary mortgage sells a portion of it, that is, transfers an equitable interest in it.\textsuperscript{114} Two or more parties share the cash flow in proportion to their ownership interest in the mortgage. Investors generally receive a guaranteed yield, so that prepayments of the underlying mortgage pools do not affect the investor's yield.\textsuperscript{115} Advantages to the seller of a loan participation include: simplified documentation requirements; no immediate cash shortfall (because participation interests are sold at par); and the ability to leverage mortgage funds.

- \textit{Pass-Through Certificates.} Pass-Through Certificates vest the holder with an undivided ownership interest in the portfolio of mortgage loan pools and the right to receive pro rata shares of cash flows. All principal payments, interest payments, and prepaid principal are "passed through" to the certificate holder.\textsuperscript{116} Private issuers like this type of MBS because of its simplicity.\textsuperscript{117} (One commentator says that mortgage pass-throughs are so attractive to investors that they will accept a lower yield on them than on the underlying mortgages, because the pass-throughs are less risky, as they are guaranteed against default, are more liquid, and bring greater certainty to prepayment patterns).\textsuperscript{118}

- \textit{Mortgage-Backed Bonds and Pay-Through Bonds.} The holder of these types of bonds does not own any part of the underlying pool of mortgages but instead holds a debt instrument (similar to a cor-

\begin{itemize}
\item \textsuperscript{109} Mortgage-Backed Securities, \textit{supra} note 30, ¶ 13.
\item \textsuperscript{110} In 1987, whole loan purchases totaled $134 billion, compared with MBS purchases of $225 billion. \textit{Bartlett, supra} note 10, at 90.
\item \textsuperscript{111} Id. at 59, 90-91.
\item \textsuperscript{112} Leverage of mortgage funds is accomplished by selling a participation interest, receiving funds for the sale and using the funds to sell more participation interests. \textit{Id.}
\item \textsuperscript{113} Id.
\item \textsuperscript{114} Bradner, \textit{supra} note 18, at 974.
\item \textsuperscript{115} Silversmith, \textit{Securities in the Nineties, supra} note 107, at 3.
\item \textsuperscript{116} See Bradner, \textit{supra} note 18, at 962; Grobmeier & Garrett, \textit{supra} note 46, at 223.
\item \textsuperscript{117} Mortgage-Backed Securities, \textit{supra} note 30, ¶ 101.
\item \textsuperscript{118} However, mortgage pass-throughs are still more risky than traditional fixed income securities. \textit{See Beckett & Morris, supra} note 106, at 7-8.
\end{itemize}
MORTGAGE NOTES AS "SECURITIES"

The market value of the underlying mortgage pool as a whole secures mortgage-backed bonds, while pay-throughs are secured by the income stream from the monthly interest, principal payments and any prepayments by the mortgagors (borrowers). Unlike pass-through certificate holders (where principal and interest are passed to investors on a pro rata basis), mortgage-backed bond investors receive cash flows redirected on a priority basis to various classes of bondholders.

Mortgage Pay-Through Bonds are a hybrid of pass-through securities and mortgage-backed bonds. As with mortgage-backed bonds, the investor owns the bond while the issuer retains ownership of the collateral; unlike mortgage-backed bonds, however, pay-through bonds link the cash flow from the collateral to the cash flow on the bonds.

- **Collateralized Mortgage Obligations.** According to one trader in such bonds, the creation of the CMO was the beginning of the end for the huge profits being made in mortgage securities in the early 1980s. To create CMOs, one gathered hundreds of millions of dollars worth of ordinary mortgage bonds (Fannie Maes, Ginnie Maes, and Freddie Macs) and placed them in a trust, which paid a predictable rate of interest to its owners, through "tranches," or classes of payments. The owners of the first tranche received all of the prepayments first, while the lucky third tranche owner received prepayment (and thus, yield reducing) funds last. It became possible to predict with a fair degree of accuracy a time of maturity for each tranche, such as five years for the first tranche, ten years for the

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119. Bradner, supra note 18, at 93 ("The issuance of bonds rather than ownership interests in the pool allows the originator to amortize the loss on the discounted 'sale' instead of showing it all in one year."). Mortgage-backed bonds are similar to traditional corporate bonds. The only significant distinction is that mortgage-backed bonds use mortgage-related collateral. Federal Credit Union Investment in Mortgage Securities, 52 Fed. Reg. 27,994 (1987) (to be codified at 12 C.F.R. ch. VII) [hereinafter Federal Credit Union Investment].

120. Federal Credit Union Investment, supra note 119.

121. Id.

122. Id.


124. LEWIS, supra note 7, at 136.

125. Id.
second tranche, and fifteen years for the third and last tranche.126

This increased predictability made CMOs very popular. For example, in June 1983, the year the first CMO was issued by Freddie Mac, American pension funds controlled $600 billion in assets, and none of that was invested in home mortgages. By the middle of 1986, pension funds held about $30 billion in CMOs.127 International investors bought CMOs as well, looking for higher-yielding investments. The predictability of CMOs led to an increased number of buyers,128 which drove down the returns paid to the investor.129

• Real Estate Mortgage Investment Conduits (REMICs). The Tax Reform Act of 1986130 allowed issuers to avoid dual taxation through Real Estate Mortgage Investment Conduits (which operate so similarly to CMOs that the terms are almost interchangeable).131 REMICs have two broad classes of investors, regular interest holders and residual interest holders, with these classes being subdivided further in much the same manner as CMO tranches.132 Effective in 1992, REMICs became the preferred entity for issuances of multiple class (tranche) MBSs, as they allow income from a pool of mortgages placed in a trust or other entity to pass through to investors without tax consequences at the mortgage pool level.133

• Stripped Securities. A Stripped Security divides the cash flow from a pool of mortgages or from mortgage securities into Interest Only (IO) and Principal Only (PO) participation certificates. An IO investor receives all of the interest cash flows and none of the principal, whereas a PO investor receives all of the principal cash flows and none of the interest.134 IOs and POs have volatile price characteristics based on prepayment variability on the underlying mortgages and thus on the maturity of the stripped securities. IOs gen-

126. Id.
127. Id. at 137.
128. Wall Street investment banks sold $60 billion of CMOs between 1983 and 1988, channeling money into home mortgage finance. Id. at 138.
129. CMOs eventually were created with five, and even ten, tranches. The investment firms continually created new products that were outside the reach of regulators and not required to be listed on thrift balance sheets. This gave the S&Ls new ways to expand (or contract). Id.
131. Pittman, supra note 51, at 508.
133. Pearson & Schmidt, supra note 132, at 397.
Generally increase in value as interest rates rise, and POs decrease in value. When interest rates decline, the reverse happens.\textsuperscript{135}

- \textit{Planned Amortization Bonds (PACs) and Floating Rate Tranches}. "Floaters" generally hinge the rate of return received by investors to interest rate changes reflected in benchmark market indices, usually the London Interbank Offering Rate (LIBOR).\textsuperscript{136}

- \textit{Real Estate Securities}. Real Estate Securities may refer to transactions in either the primary or secondary market. They include common stock secured by commercial real estate and real estate municipal bonds, both investment grade and "high-yield," backed by physical property or mortgages. Real estate "high yield" bonds are analogous to corporate issues, carrying low or no rating and high risk, backed by second or higher order mortgages.\textsuperscript{137}

- \textit{Municipal Bonds}. Municipal bonds, along with real estate property taxes, compose the primary revenue source for municipal governments. They include Direct Loan Program Housing Bonds (DLHBs), which finance new construction, and Mortgage Purchase Bonds (MPBs), used to buy existing mortgage pools. The issuing agency sells housing revenue bonds, and purchases mortgages directly from thrifts (S&Ls), the bonds secured by mortgage payments.\textsuperscript{138}

II. What Is a "Security"?

A. \textit{Statutory and Regulatory Beginnings}

Thus far this Comment has referred for convenience and, in accordance with common practice, to various secondary mortgage market financial instruments as mortgage-backed, or mortgage-related, "securities." It is important to note, however, that the securities statutes and regulations promulgated thereunder contain specific definitions which the courts have struggled to parse even fur-
ther so that instruments commonly assumed to be "securities" are often found not to fit that technical definition.

As discussed earlier, the federal securities laws were enacted during the Great Depression of the 1930s in response to significant losses incurred by securities investors.\textsuperscript{139} The Securities Act of 1933 was designed to require disclosure to investors of material facts concerning securities publicly offered for sale, and to prevent fraud or deceit in the sale of securities generally.\textsuperscript{140} The security issuer is required to file a registration statement and prospectus containing financial information to the SEC, and sales cannot be made until the registration statement is made "effective."\textsuperscript{141} The SEC does not comment on the merits of the security, leaving that judgment to the investor after full and fair disclosure has been made.\textsuperscript{142}

The Securities Exchange Act of 1934 requires the registration and regulation of securities exchanges, the registration of securities listed on these exchanges, the registration of certain securities traded "over-the-counter" (OTC), registration of national securities associations, brokers and dealers, the prevention of fraud and deceit, and authorizes the Federal Reserve System to regulate the use of credit in securities transactions.\textsuperscript{143}

Companies wishing to have their securities listed and registered for public trading on an exchange must file a registration application with the SEC, so that interested persons can gain access to the information if desired.\textsuperscript{144} The Exchange Act has provisions regarding proxy solicitations, insider trading, credit, market surveillance, tender offers and corporate takeovers. The Act also allows for self-policing among OTC brokers and dealers such as the National Association of Securities Dealers.\textsuperscript{145}

\begin{flushright}
139. Kansas enacted the first comprehensive state securities law in 1911. BLOOMENTHAL & WING, supra note 79, § 1.23. State securities laws are colorfully referred to as "blue sky laws," after a Supreme Court decision characterized speculative investment schemes as having "no more basis than so many feet of blue sky." Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917). This Comment is concerned only with federal legislation.

140. BLOOMENTHAL & WING, supra note 79, § 1.02[1].

141. Id.

142. Id.

143. Id. at § 1.03[1].

144. Id.

145. Id. at §§ 1.03[2]-1.03[9]. A discussion of the many remaining federal securities statutes is beyond the scope of this Comment, which is concerned only with definitions under the Securities Act of 1933 and the Securities Exchange Act of 1934. "The Securities Act and the Exchange Act constitute virtually the entire body of general federal securities regulation. Most securities lawyers deal primarily with these two acts. There are, however, a number of other federal securities statutes, each of which deals with a specialized area." LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 3 (2d ed. 1990).

The other statutes include the Trust Indenture Act of 1939, which requires that
Section 2(1) of the Securities Act of 1933,146 and § 3(a)(10) of the Securities Exchange Act of 1934,147 contain definitions of a "security" so similar that the courts treat the two sections as virtually identical.148 Section 3(a)(10) of the Exchange Act provides that:

(a) When used in this chapter, unless the context otherwise requires—

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral loyalty or lease, any collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.149

The Securities and Exchange Commission, pursuant to its rule-making authority, has promulgated a rule against fraud in the purchase or sale of a security which has been the subject of much litigation:

Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5:

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,

bonds, notes, debentures and similar securities publicly offered for sale be offered under an indenture that meets SEC requirements; the Investment Company Act of 1940, which requires the registration and regulation of companies that are engaged primarily in the investing, owning, holding and trading of securities; the Investment Advisors Act of 1940, which regulates investment advisors under similar rules pursuant to the Exchange Act for broker-dealers; and the Public Utility Holding Company Act of 1935, which required that public utilities register and file periodic reports with the SEC, and the corporate simplification of utility holding companies. Id. at 3-4.

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a
material fact necessary in order to make the statements made, in the light
of the circumstances under which they were made, not misleading, or,

(3) 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 any security.\textsuperscript{150}

As one commentator has noted, Rule 10(b)-5 "probably provides
the most attractive remedy" for investors who allege fraud.\textsuperscript{151} If a
10(b)-5 cause of action does not lie, then the investor's alternative is
a common law fraud claim. For a 10(b)-5 action, whether or not the
instrument is a "security," if disputed, is the threshold question.

B. Judicial Construction Prior to Reves

1. The Supreme Court. Before Reves, a plaintiff contending that
the mortgage notes either sold fraudulently to or purchased fraudu-
lently from him met the federal securities law definition of "security"
had to persuade a court under judicially-created tests not designed
specifically for "notes." Supreme Court and lower federal court deci-
sions construing the word "security" have been categorized in a
number of ways. However, it is generally accepted that there are
three distinct tests for Securities Acts instruments which have been
denominated (1) "investment contracts," (2) "stock," and now, after-
Reves, (3) "notes."

- "Investment Contracts." The Supreme Court has had occasion
to construe the meaning of "security" as used in the federal securi-
ties statutes a number of times. In the first such case, SEC v. C.M.
Joiner Leasing Corporation,\textsuperscript{152} the Court considered whether the sale
of assignments of interests in oil and gas leases constituted securi-
ties. Specifically, the Court held that they met the definition of the
less specific "investment contracts."\textsuperscript{153} The Court reasoned that the
buyers of the assignments stood to profit by the increased value of
their interests if oil were to be discovered on adjacent property.

In its subsequent holdings, the Supreme Court expanded on the
investment contract approach in SEC v. W.J. Howey Company.\textsuperscript{154}

\textsuperscript{150} Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5
(1994).

\textsuperscript{151} Randall W. Quinn, After Reves v. Ernst & Young, When are Certificates of De-

\textsuperscript{152} 320 U.S. 344 (1943).

\textsuperscript{153} Id. at 348.

\textsuperscript{154} 328 U.S. 293 (1946).
Holding that the sale of units in a citrus grove and related service contracts for cultivating, harvesting and marketing the crops were securities, the Court stressed that the term “investment contract" represented a “flexible rather than a static principle,” meant to be broadly construed. Form was to be “disregarded for substance and emphasis... placed on economic reality.”

In Howey, the Court devised a test to determine the existence of an “investment contract." The Howey test consisted of three, four, or even five prongs, depending on one's interpretation. Howey considers an investment contract a transaction which entails: (1) an investment of money (2) in a common enterprise (3) with an expectation of profits (4) solely from the efforts of others.

Although meant to apply only to non-specific “investment contracts,” the Howey factors became, at times and with variations, the federal courts' test of choice for a variety of other instruments, including those specifically enumerated in the statute, such as stocks or notes. But the Court's decision offered ineffective guidance. Thus, one federal district court judge lamented: “[I]n the end one is left with the impression that he is dealing with an area of the law subject to wide variations, serious anomalies, and judicial disagreement, if not confusion. In short, the wealth of judicial writings on the subject has produced few discernible principles of decision.”

As Carl Schneider recently observed: “The constant heavy flow of litigation shows that much uncertainty remains in defining the term security... [T]here are many individual opinions that depart from [discernible] patterns, and, as in many areas of securities law, authority can be found for conflicting propositions. In general, the decisions are fact intensive.

• “Stock.” In United Housing Foundation, Inc. v. Forman, the
Supreme Court held that purchases of shares of stock in a nonprofit housing cooperative were not securities. The Court relied on the "economic reality" language in the Howey case, and rejected a literalist approach. The Court stated that although the shares sold were labeled "stock," they did not meet the statutory definition of a "security" as "stock" because they lacked the attributes of ordinary stock. However, in Landreth Timber Company v. Landreth, the Court moved closer to a literalist approach in recognizing that the Howey test was to be applied not to all instruments, but just to "unusual" ones:

Respondents... argue that our cases require us in every instance to look to the economic substance of the transaction to determine whether the Howey test has been met. . . .

. . . [I]t is important to understand the contexts within which these cases were decided. All of the cases upon which respondents rely involved unusual instruments not easily characterized as "securities." . . . Thus, if the Acts were to apply in those cases at all, it would have to have been because the economic reality underlying the transactions indicated that the instruments were actually of a type that falls within the usual concept of a security. In the case at bar, in contrast, the instrument involved is traditional stock, plainly within the statutory definition. There is no need here, as there was in the prior cases, to look beyond the characteristics of the instrument to determine whether the Acts apply.

The Supreme Court added another twist to the various tests for what constitutes a "security" in the widely criticized decision, Marine Bank v. Weaver. The Court held that a certificate of deposit issued by a federally regulated bank was not a security, primarily because securities law protection was not needed in the presence of another risk-reducing scheme that centered around the federal banking laws. The Court found authority for its position in prefatory language to the Exchange Act's § 3(a)(10), i.e., that unless "the

165. The Supreme Court in Forman re-formulated the familiar Howey test: "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." Forman, 421 U.S. at 852.
166. 471 U.S. 681, 697 (1985) (concerning the sale of all the stock of a company, and holding that sale did indeed encompass sale of "securities" within definition of federal statutes).
167. Id. at 689-90.
168. 455 U.S. 551 (1982). See Steinberg, Contemporary Issues, supra note 79, at 12-45 (discussing extensively Weaver's errors, especially its misplaced reliance on the "context clause").
169. 455 U.S. at 558.
context otherwise requires,” an instrument will be deemed a security. In *Marine Bank*, the Court held that the context did indeed “otherwise require.”

- “Notes.” In 1990, the Supreme Court handed down its decision in *Reves v. Ernst & Young*. The Court held that yet another test was required when considering a class of instruments falling under the category of “notes.” Thus, to date, the Court has presented securities practitioners with three distinct tests, one for investment contracts, one for stock and one for notes. Each test has various permutations, including the economic realities underlying the transaction, the context clause and the existence of an alternative regulatory scheme.

2. *Circuit Courts.* The lower federal courts also have added permutations to all these tests. Although these permutations are legion, they will not be discussed here. This Comment focuses on notes alone or, more specifically, the application of the *Reves* analysis to mortgage notes. Since the Supreme Court previously had stated that each decision might be fact specific, perhaps it is no surprise that the *Reves* Court borrowed a little from *Forman*, *Joiner*, *Howey*, *Marine Bank*, and the Second Circuit’s “family resemblance” test. Like the rest of securities law, the *Reves* “note” decision appears to be a patchwork.

   It does not follow that a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a “security” as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

*Id.*

The *Reves* Court moved away from this notion, stating: “A commitment to an examination of the economic realities of a transaction does not necessarily entail a case-by-case analysis of every instrument. . . .” *Reves*, 494 U.S. at 62 (emphasis added).

173. 494 U.S. at 66 (comparing *Forman’s* “inducement to purchase” with *Reves*’ “motivation” of buyer and seller).
174. *Id.* (adopting *Joiner’s* examination of the “plan of distribution” of the instrument, and whether it is an instrument in “common trading for speculation or investment”).
175. *Id.* at 68 (comparing *Howey’s* “plan of distribution” to the *Reves*’ co-op).
176. *Id.* at 67 (adopting *Marine Bank’s* “existence of another regulatory scheme” as the fourth prong in the new *Reves*’ “family resemblance” test for notes).
177. *Id.* at 65 (adopting in its entirety and expanding the Second Circuit’s distinctive “family resemblance” test for the presence of a “note,” first enunciated in *Exchange Nat’l Bank v. Touche Ross & Co.* , 544 F.2d 1126 (2d Cir. 1976)).
Section 3(a)(10) of the Securities Exchange Act provides that: "The term 'security' means any note, stock, treasury stock, bond, debenture..." "Note" is not defined in the Exchange Act, but generally is understood to be "an instrument containing an express and absolute promise of a signer to pay to a specified person or order, or bearer, a definite sum of money at a specified time." A "mortgage note" is a note "evidencing a loan for which real estate has been offered as security."

Three tests emerged for separating those notes deemed to be "securities" for securities acts purposes and notes that were nonsecurities. The most widely adopted test was the "commercial/investment" test which was adopted by the First, Third, Fifth, Seventh, Tenth and Eleventh Circuits. The "risk capital" test was espoused by the Sixth and Ninth Circuits and in Exchange National Bank of Chicago v. Touche Ross & Co., the Second Circuit adopted the "strong family resemblance" test.

- The Commercial/Investment Test. Through this test, the economic realities of an underlying transaction are analyzed in order to determine whether the transaction represents an investment or a commercial transaction. Essentially, the test examines "whether the note is collateralized, how the proceeds are used, whether repayment is dependent on the borrower's income, whether the note is speculative, whether the borrower or the lender initiated the loan, and whether the note is one of many notes issued to many lenders."

The circuit courts employing this test developed their own criteria for determining what type of transaction was involved. In McClure v. First National Bank of Lubbock, the Fifth Circuit decided that investment transaction notes shared at least three qualities: (1) they were offered to "some class of investors," (2) they were "acquired... for speculation or investment," and (3) their proceeds...
MORTGAGE NOTES AS "SECURITIES" were used to "obtain investment assets, directly or indirectly." In C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., the Seventh Circuit cited six criteria for determining whether notes were commercial in nature or investments: (1) the community's characterization of the instrument; (2) the use of the proceeds; (3) the reliance on the efforts of others; (4) the number of notes issued, the number of payees and dollar amount of the transaction; (5) the note's term length, and (6) the characterization of the instruments in financial statements.

"Risk Capital." "Risk capital" analysis is a hybrid of both the investment/commercial test, and the Howey and Forman tests. It differentiates between note transactions involving "risk capital," which are likely to be investment securities, and those evidencing "risky loans," which are commercial. It further requires that "risk capital" be subject to the entrepreneurial or managerial efforts of others. "[Risk capital'] requires the weighing of a number of factors, such as the maturity length of the note, the collateralization of the note, the form of the obligation, the issuance of the note to either a single party or a large class of investors, the relationship between the amount involved and the size of the [borrower]'s business, and the contemplated use of the proceeds.

III. REVES V. ERNST & YOUNG: THE "FAMILY RESEMBLANCE" TEST

A. The Supreme Court's 1990 Decision

In Reves, the Court unanimously adopted a modified version of the Second Circuit's "family resemblance" test for notes, but split 5-4 over whether the 1934 Securities Exchange Act's exclusion of notes with a maturity of less than nine months at the time of issuance applied to demand notes.
Originally farmers' cooperatives were formed as a turn-of-the-century Populist initiative meant to avoid deflationary produce prices and usurious interest rates for borrowing. The cooperatives would buy farm produce, store it in cooperative warehouses, sell the produce at optimum prices and thereby protect farmers from low prices. The cooperatives also bought supplies wholesale and sold them to farmers at reduced interest rates. The largest such co-op, the statewide Texas Exchange, was also the first to fail. In order to raise capital, the co-op sold stock shares to farmers and tried to raise additional funds by selling notes that pledged members' farms as collateral. The co-op ordered supplies only to discover that the banks would not lend it money. The co-op failed in 1889 after only one year.\(^{193}\)

In \textit{Reves}, the Farmer's Cooperative of Arkansas and Oklahoma, Inc. raised much of its capital through the sale of uncollateralized, uninsured notes payable on the noteholder's demand ("demand notes") that paid higher interest rates than those offered by local financial institutions. The co-op offered notes to both members and nonmembers, advertising their purchase "Investment Program." Over 1,600 people bought notes that were worth, in aggregate, approximately $10 million.\(^{194}\)

The co-op had hired the accounting firm of Arthur Young & Co., defendant Ernst & Young's predecessor in interest, to audit its financial statements. After the co-op filed for bankruptcy, the plaintiff noteholders brought suit, alleging that Arthur Young had intentionally failed to follow generally accepted accounting principles (GAAP) in its valuation of one of the co-op's major assets, a gasohol plant. The plaintiffs claimed that Arthur Young had violated prohibitions on fraud under both state and federal securities laws. They maintained that if Arthur Young had audited the co-op properly, its insolvency would have been apparent and the plaintiffs would not have invested in it. Arthur Young, in turn, argued that the demand notes in question were not "securities."\(^{195}\)

The plaintiffs prevailed in the district court, and won a $6.1 million judgment. The Eighth Circuit reversed, and the Supreme Court granted certiorari to consider the federal securities law claims. The Court reversed the Eighth Circuit's decision, holding

\(^{193}\) \textsc{Gredler}, supra note 39, at 251-53.
\(^{194}\) \textit{Reves}, 494 U.S. at 58-59.
\(^{195}\) \textit{Id.}
that the demand notes in question were indeed "securities" and that an action could lie under federal securities laws.\textsuperscript{196}

In so doing, the Supreme Court rejected the \textit{Howey} investment contract test, holding that it was not applicable to instruments that were deemed "notes," but only to investment contracts. The Court also rejected its \textit{Landreth Timber}\textsuperscript{197} analysis of "stock" as one of the enumerated categories under the definition of "security" in the securities laws,\textsuperscript{198} holding that "note," although similarly enumerated, is a "relatively broad term that encompasses instruments with widely varying characteristics," both investment and commercial.\textsuperscript{199}

The Court rejected the "risk capital" approach. While the Court also rejected the investment/commercial test, it found that test sufficiently similar to the "family resemblance test" to require incorporation into the latter's analytical framework.\textsuperscript{200} The Court stated that a "note"/"security" analysis must start with the rebuttable presumption that every note is a security, with the possible exception of short-term commercial paper.\textsuperscript{201} It then adopted the Second Circuit's list of exceptions for notes that fall outside the definition of "security." These include

the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized) . . . [and] notes evidencing loans by commercial banks for current operations.\textsuperscript{202}

Notes which do not bear a "strong family resemblance" to those on the enumerated list are presumed to be "securities" and thus subject to the federal securities statutory and regulatory prohibitions

\begin{flushleft}
\textsuperscript{196} \textit{Id.}
\textsuperscript{197} 471 U.S. 681 (1985).
\textsuperscript{199} 494 U.S. at 62.
\textsuperscript{200} \textit{Id.} at 64-65. Indeed, the Court on more than one occasion stressed its approval of the distinction between commercial transactions and investments. \textit{See}, \textit{e.g.}, \textit{id.} at 61 ("Congress' purpose in enacting the securities laws was to regulate \textit{investments}, in whatever form they are made and by whatever name they are called" (emphasis in original)); \textit{id.} at 68 ("the transaction is most naturally conceived as an investment in a business enterprise rather than as a purely commercial or consumer transaction"). \textit{Cf.} Futura Dev. Corp. v. Centex Corp., 761 F.2d 33, 40 (1st Cir. 1985) (holding that the conceptual basis of the commercial/investment, risk capital and family resemblance tests, "and the considerations examined by the courts in applying the tests[,] tend to be very similar although the focus is slightly different").
\textsuperscript{201} 494 U.S. at 65.
\textsuperscript{202} \textit{Id.}
\end{flushleft}
against fraud in the purchase or sale of securities. The Supreme Court expanded on the Second Circuit's "family resemblance" list by identifying four factors to assess in determining whether a transaction bears that resemblance. These factors are:

1. the motivations that would prompt a reasonable seller and buyer to enter into the transaction;

2. the plan of distribution of the instrument, to determine whether it is an instrument in which there is common trading for speculation or investment;

3. the reasonable expectations of the investing public; and

4. the existence of another regulatory scheme that significantly reduces the risk of the instrument.

Although the Court intends this modified family resemblance test to apply only to "notes," a comparison of the four factors in the Reves test to the Howey, Marine Bank, investment/commercial and "risk capital" tests reveals similarities. Legal commentators in the wake of Reves have made such comparisons.

B. The Legal Community's Reaction to Reves

1. Approval of the Reves "Family Resemblance" Test. Despite the Court's rejection of the majority approach and its adoption of a patchwork version of the Second Circuit's minority "family resemblance" test, legal commentators have overwhelmingly approved the Reves decision. It remains to be seen whether this approval will continue in light of the inconsistent application of Reves.

Most commentators who praise the Reves decision approve of its resolution of the inherent ambiguities in the circuit courts' different tests for determining whether notes are "securities." These commentators suggest that the uniformity imposed by Reves will make practitioners' jobs easier by increasing outcome predictability. Other commentators approve of Reves on its merits, arguing

203. These prohibitions include the anti-fraud provisions of Rule 10b-5: Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (1994).

204. Reves, 494 U.S. at 66.

205. See B. Joseph Krabacher, Promissory Notes as Securities, 19 COLO. L. REV. 1585, 1587-88 (1990); The Supreme Court has eliminated the split among the courts of appeal as to the conceptual framework for analyzing notes as securities . . . . Reves answered some questions that have long needed to be addressed. There are uncertainties, however, left by the Reves decision that will have to be resolved by the courts in the future.

Id.; Scott D. Museles, To Be or Note to Be a Security: Reves v. Ernst & Young, 40 CATH. U. L. REV. 711, 743, 751 (1991):
that the decision strikes the proper balance between various extremes. Two commentators suggest that *Reves* accords with the spirit of the securities acts, while another approves of *Reves*' burden shifting, which requires that a party using another's funds prove a note's non-security status.

2. Criticism of the *Reves* "Family Resemblance" Test. One consistent complaint regarding *Reves* concerns the Supreme Court's

*Reves* ... provides lower courts with additional guidance to determine when a note is a security. ... Adopting a separate test for notes wisely and accurately reflects the inadequacy of attempting to apply uniformly one test to a multitude of distinct instruments. ... *Reves* ... strengthens the ability to predict whether a note will fall within the Securities Acts' prohibitions.


206. See Maura A. Folan, *Comment, Supreme Court Adopts Family Resemblance Test to Determine When a Note is a Security*, 25 SUFFOLK L. REV. 895, 903 (1991) ("The Court correctly attempted to balance the purpose of federal securities regulations and the need to avoid litigation over instruments clearly not within the purview of the 1934 Act"); Michael A. Lueder, *Note, Presuming Notes are Securities, the Supreme Court Adopts its Own Version of the "Family Resemblance" Test*, 26 WAKE FOREST L. REV. 503, 505, 539 (1991) ("*Reves* is a substantial improvement over the circuit courts' previous tests. .... [and] has resulted in a practical approach to the analysis of note transactions, while still providing a degree of flexibility."); Kenneth Schrupp, *Comment, The Status of Notes Under the Securities Acts: An Analysis of the Family Resemblance Test*, 21 MEM. ST. U. L. REV. 387, 400 (1991) ("*Reves* strikes a workable balance between effectuating the legislative intent of the Acts and providing notice to practitioners of the forms of transactions that are subject to the Acts").


208. See *Note, When is a Note a Security? A Historical Perspective on the Supreme Court's Adoption of the Family Resemblance Test*, 24 CREIGHTON L. REV. 371, 395 (1990) ("Placing the burden of showing a non-security on the person seeking to use other persons' money also serves [the Acts'] policies and purposes."). This author speculates about why the Supreme Court adopted the "family resemblance" test, and concludes that a presumption that a note is a security better effectuates the Acts' purpose of providing broad coverage for the protection of investors, and that a checklist, such as the one that the Second Circuit crafted, helps to focus judicial analysis. *Id.* at 391-92.
failure to provide sufficient guidance as to the amount of weight to ascribe to the four factors of the "family resemblance" test.\textsuperscript{209} Do any prongs hold greater weight than the others? Must all factors be met to find a resemblance, or should lower courts weigh the factors using a balancing test?

Two commentators criticize \textit{Reves} for adopting the Second Circuit's "judicially crafted list of exceptions."\textsuperscript{210} One criticizes the list as "finite" and recommends that courts applying \textit{Reves} ignore the list and focus instead on the four-factor analysis.\textsuperscript{211} The other argues that Congress, in enacting the Securities and Securities Exchange Acts, erred in adopting an unworkable denotative list of \textit{examples} of securities, which the \textit{Howey} Court corrected by providing a connotative \textit{definition} to apply. Now \textit{Reves}, according to this commentator, is mixing "oil and water" by adopting both denotative and connotative tests. Rather than suggesting that jurists focus solely on the four factor analysis, this commentator suggests a return to a modified \textit{Howey} analysis.\textsuperscript{212}

Another commentator complains that the \textit{Reves} four-factor analysis is just a disguised re-hash of the \textit{Howey} test, and criticizes the decision as having to have "come from another planet."\textsuperscript{213} A similarly harsh article contains all manners of criticism: that (1) the "family resemblance" test "judicially crafts" a list of exceptions not based on prior precedent; (2) questioning the seller's motivations under the four-factor test is inappropriate and may lead to bizarre results; (3) although the fourth factor of the test, which is supposed to be used to determine a note's family resemblance, contemplates an alternative risk-reducing scheme, none of the items on the judicially crafted list of exceptions has an alternative risk-reducing


\textsuperscript{210} \textit{Reves}, 494 U.S. at 63.


\textsuperscript{212} Lawrence Page, Note, \textit{Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of A Security}, 1992 U. ILL. L. REV. 249, 251, 291-93 (1992). The author faults denotative lists of examples for failing to provide guidance in all situations, and while admitting that connotative definitions are difficult to craft sufficiently and precisely, avers that they provide better guidance without the drawing of inconsistent analogies. \textit{Id.} at 293.

\textsuperscript{213} Gordon, \textit{supra} note 157, at 404.
scheme; (4) notwithstanding the Marine Bank\textsuperscript{214} decision, the Supreme Court neglected to add certificates of deposit to its list of exceptions; and (5) although the majority of notes issued are not securities, the Reves test incorrectly imposes a bias toward finding one.\textsuperscript{215}

3. Predictions Regarding Reves' Impact.\textsuperscript{216} Those commentators who proffer a prediction are unanimous in their belief that a greater number of notes will be held to be "securities" after the Reves decision.\textsuperscript{217} Commentators disagree about whether the Reves Court's footnote, regarding the consideration of interest payments in any calculation of profit, will have a significant effect.\textsuperscript{218} Marc Steinberg argues that the Reves Court's definition of profit is "vitally important," and will be interpreted such that in order for a note to have a "valuable" return, it must pay the holder interest above the prevailing rate.\textsuperscript{219} Carl Schneider and Joshua Cohen suggest that:

Virtually every buyer of a note will be motivated by the potential interest return, which, according to the Court, suggests the existence of a security.

\begin{flushleft}
\textsuperscript{214} Marine Bank v. Weaver, 455 U.S. 551 (1982).
\textsuperscript{215} Schneider & Cohen, supra note 209, at 191.
\textsuperscript{217} Schneider and Cohen give this notion only qualified endorsement. Schneider & Cohen, supra note 209, at 200-02. The cynical commentators predict that:

\begin{quote}
Notwithstanding the language of Reves, we suspect that, conforming to past practice, a security almost never will be found when a note (or participation) is acquired by a bank or other commercial lender in the ordinary course of its business, or when a natural person issues a note for a non-commercial purpose. . . .
\end{quote}

\begin{quote}
Id. They also point out that "[i]n almost all cases where the purchasers and offerees are members of the general public, the transaction does involve the sale of a security. . . ." Id. See also Stephen J. Greenberg & Stephen L. Kibblehouse, Securitization of the Banking Business: Prime Funds and Asset-Backed Notes, 11 BANKING & COM. LENDING L. 3, 35 (1990); Krabacher, supra note 205, at 1587; Quinn, supra note 151, at 188; Steinberg, supra note 205, at 684-86.
\end{quote}

\textsuperscript{218} The Court's footnote stated:

\begin{quote}
We emphasize that by "profit" in the context of notes, we mean "a valuable return on an investment," which undoubtedly includes interest. We have, of course, defined "profit" more restrictively in applying the Howey test to what are claimed to be "investment contracts." . . . To apply this restrictive definition to the determination whether an instrument is a "note" would be to suggest that notes paying a rate of interest not keyed to the earning of the enterprise are not "notes" within the meaning of the Securities Acts. Because the Howey test is irrelevant to the issue before us today . . . we decline to extend its definition of "profit" beyond the realm in which that definition applies.
\end{quote}


\textsuperscript{219} Steinberg, Notes, supra note 205, at 681.
We doubt that the buyer's purpose in earning interest will be given the
degree of significance suggested by the *Reves* opinion in cases where no
security is found, although it probably will be treated as significant when-
ever a security is found.\(^\text{220}\)

In a similarly cynical vein, these commentators go on to predict
that, "[a]s in many other areas of securities law, courts probably will
determine for other reasons what the outcomes should be, and then
the various factors relating to the buyers' state of mind will be re-
cited appropriately in a manner consistent with the result reached.\(^\text{221}\)

For this Comment's purposes, the important question is what
effect *Reves* will have on mortgage notes. Only four commentators\(^\text{222}\)
speak even minimally to this question.\(^\text{223}\) The first commentator
predicts in a two sentence summary that, after *Reves*, the note se-
cured by a mortgage on a principal residence probably will not be
considered a security and, although a fractional interest in the note
may be a security, the note securing the purchase of an investment
property may not be a security.\(^\text{224}\)

In their short analysis of *Reves* application to mortgage notes,
Carl Schneider and Joshua Cohen conclude that in pre-*Reves* cases,
the *identity of the purchaser* in a secondary market transaction was
the crucial factor for identification of the underlying notes as secu-
rities. If the purchaser was a commercial lender, then the instru-
ment generally was not a security; if the purchaser was a member of
the general public, then the transaction was a security sale. These
commentators predict that this trend will continue after *Reves*.\(^\text{225}\)

\(^\text{220}\) Schneider & Cohen, *supra* note 209, at 199.

\(^\text{221}\) *Id.*

\(^\text{222}\) For a comprehensive discussion of whether "mortgage-backed securities" were
properly characterized as "securities" for Securities Acts purposes, see Paula C. Murray &
Beverly L. Hadaway, *Mortgage-Backed Securities: An Investigation of Legal and Finan-
cial Issues*, 11 J. CORP. L. 203, 220-34 (1986). Since their article preceded the Supreme
Court's *Reves* decision, they did not employ a *Reves* "notes" analysis in comparing mort-
gage notes and the definition of "security."

\(^\text{223}\) The only commentator to ask the specific question of when real estate interests
are securities, takes no account of the *Reves* decision. Instead, the author focuses on the
*Howey* investment/contract analysis, which the *Reves* Court discredited as it applied to
notes. *See* James B. Aronoff, *When Are Real Estate Interests Securities?*, 8 PRAC. REAL
EST. LAW. 77 (1992). It is unknown whether the author deemed the *Reves* decision of such
little import in the real estate context, and assumed that the *Howey* analysis would con-
tinue to prevail, or perhaps felt that *Reves* had not been construed sufficiently for him to
comment upon its implications. The author concludes that "the application of securities
laws depends on the facts of each case and admits of no hard and fast rules." *Id.* at 85.
Whether this continues to hold true after the *Reves* decision remains to be seen.

\(^\text{224}\) Krabacher, *supra* note 205, at 1586.

\(^\text{225}\) Schneider & Cohen, *supra* note 209, at 200-02. They argue:
There are many circumstances in which a whole note or a participation in a
Park McGinty warns that Reves' rebuttable presumption that all notes are securities is over-inclusive and economically dangerous. Using collateralized mortgage obligations as an example, McGinty distinguishes between investment notes and commercial/consumer notes, and suggests that the Reves presumption should apply only to pooled, "securitized" mortgage notes, and not the underlying mortgages.\(^\text{226}\)

John Scribner cites three post-Reves mortgage/security cases, one with approval, the other two only in passing.\(^\text{227}\) Perhaps it was too soon after Reves for Scribner to discern that which is becoming more apparent with time: that Reves is being applied inconsistently, not just to mortgage/security cases, but to other note/security cases as well.\(^\text{228}\) A discussion of Reves' application to mortgage/security cases demonstrates this trend.

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note is resold by one holder to another. In almost all cases, the underlying notes were issued in the ordinary course of business to banks, financial institutions, or other commercial lenders by business borrowers or consumers (the consumer notes often being secured by a mortgage on residential real estate). The underlying notes typically would not be a security in the context of their original issuance. When the notes are resold, the seller typically offers services to the buyer in collecting and enforcing the notes. Another benefit offered by the seller to enhance the value of the notes may be the creation of liquidity through a secondary market. For many thrift institutions, banks, and other commercial lenders, fees from servicing notes that they originate and sell to others constitute a significant source of income.

In almost every relatively recent case where the purchaser is itself a commercial lender, the note or participation (in a note or a pool of notes) involved in the resale transaction is not a security, even if the retention of servicing by the seller is a required term of the transaction (and even though "participations" in other named classes are a named class included in the definition of "security"). In almost all cases where the purchasers and offerees are members of the general public, the transaction does involve the sale of a security, even if the servicing package is optional and the investor is given a substantial amount of information with which to evaluate the underlying credit and select a particular note to purchase. These cases well illustrate the general principle that in determining whether a particular note is a security, the identity and characteristics of the purchaser may be far more significant than the terms of the note or other formal characteristics of the transaction.

\(\text{Id. (emphasis added) (citations omitted).}\)


\(\text{228. See, e.g., Kerr & Eisenhauer, supra note 216, at 1123; Murray & Vittone, supra note 216, at 388.}\)
IV. APPLYING REVES: ARE MORTGAGE NOTES "SECURITIES"?\textsuperscript{229}

A. Mortgage/Security Case Law Before and After Reves

Analysis of the reasoning in mortgage/security case law over the past twenty years offers an idea about how the courts will decide future cases, especially those pending or expected in the wake of the savings and loan crisis.\textsuperscript{230}

1. Decisional Patterns Demonstrate Only Muted Changes. Federal mortgage-security decisions may be analyzed in any number of ways. They may be characterized as pre- or post-Reves cases or by the type of instrument or transaction involved. The cases also may be characterized by decisional patterns, i.e., date decided, court test(s) employed or the ultimate decision in each case.\textsuperscript{231} Such analysis assumes that all of the transactions involve "mortgage-related instruments." Other commentators might divide the cases between primary and secondary market transactions. Thus, this Comment only claims that its categorization process yields a semi-representative sample,\textsuperscript{232} and that the conclusions reached are tentative ones.\textsuperscript{233}

\textsuperscript{229} The Supreme Court has not had occasion to construe the term "security" under the federal securities laws in a mortgage note-related context. Its decision in Reves was, of course, the first time the Court handed down a securities decision concerning a test for notes at all, much less in the mortgage context.

In one pre-Reves decision, Dinjian v. Dinjian, 495 N.E.2d 882, 22 Mass. App. Ct. 589 (Mass. App. Ct. 1986), Deran Dinjian sued his brother (Karnig) and cousin (Nubar) for, \textit{inter alia}, the fraudulent sale of securities, relating to his investment/lending of funds to his relatives, who were in the habit of lending money to real estate developers, the loans secured by second mortgages on the subject properties. Thus, this case concerned not the secondary mortgage market, but rather second mortgages in the primary market. The court held, reasonably enough, that the notes involved were indicative of simple commercial loan transactions, not sales of securities.

The Arizona Supreme Court in a post-Reves decision rejected the argument that the Reves test was unconstitutionally vague as it decided that Reves was inapplicable to Arizona criminal securities fraud statutes. A developer had borrowed money for a failed country club development, selling promissory notes to a number of investors. State v. Tober, 841 P.2d 206 (Ariz. 1992).


\textsuperscript{230} Although the Resolution Trust Corporation (RTC) apparently does not track internally its litigation by the specific issues therein (such as whether the question of an instrument meeting the definition of security is implicated in the case), an informal examination of the general issues involved in its civil litigation revealed that approximately 10-15% concerned securities law issues. Telephone Interview with Roberta Babbitt, RTC Reading Room, Resolution Trust Corporation in Washington, D.C. (Mar. 3, 1994).

\textsuperscript{231} \textit{See infra} notes 234-52 and accompanying text.

\textsuperscript{232} Because these cases cut across so many different types of transactions, it seems fair to characterize them as representative of the general class, "mortgage-related."

\textsuperscript{233} Also, some breakdowns would be unpersuasive no matter how they were sliced.
Nevertheless, the striking patterns and trends that emerge suggest the likely direction of post-Reves decisionmaking.

2. Classification By Decision Reached. Can any consistent principles be derived from the case results? While offering some suggestions, this Comment leaves that decision to the reader. Of the twenty-three mortgage-security decisions before Reves, eight courts found securities, twenty-four did not, and one court did not decide.

For example, it is difficult to argue that there is any significance to the fact that the single mortgage-security case decided in the District of Columbia Circuit held the presence of a security. See SEC v. Diversified Indust., Inc., 465 F. Supp. 104 (D.D.C. 1979).


235. First Fin. Fed. Sav. & Loan Ass'n v. E.F. Hutton Mortgage Corp., 834 F.2d 685 (8th Cir. 1987) (holding that re-sold whole mortgages were not securities); McVay v. Western Plains Serv. Corp., 823 F.2d 1395 (10th Cir. 1987) (holding that participation notes were not securities); Futura Dev. Corp. v. Centex Corp., 761 F.2d 33 (1st Cir. 1985), cert. denied, 474 U.S. 850 (1985) (holding that promissory note secured by property being developed was not security); Williamson v. Tucker, 645 F.2d 404 (5th Cir. May 1981), cert. denied, 454 U.S. 897 (1981) (holding that real estate purchase money notes not securities); AMFAC Mortgage Corp. v. Arizona Mall, 583 F.2d 426 (9th Cir. 1978) (holding that promissory notes secured by shopping center were not securities); In re Nat'l Mortgage Equity Corp. Mortgage Pool Cert. Sec. Litig., 728 F. Supp. 497 (C.D. Cal. 1989) (holding that pass-through certificates were not securities); Developer's Mortgage Co. v. TransOhio Sav. Bank, 706 F. Supp. 570 (S.D. Ohio 1989) (holding that participation notes were not securities); In re EPIC Mortgage Ins. Litig., 701 F. Supp. 1192 (E.D. Va. 1988), aff'd in part and rev'd in part, Foremost Guar. Corp. v. Meritor Sav. Bank, 910 F.2d 118 (4th Cir. 1990) (holding that both whole mortgage loans and pass-through certificates were not securities); Home Guar. Ins. Corp. v. Third Fin. Servs., Inc., 667 F. Supp. 577 (M.D. Tenn. 1987) (holding that re-sold whole mortgages were not securities); Deauville Sav. & Loan Ass'n v. Westwood Sav. & Loan Ass'n, 648 F. Supp. 513 (C.D. Cal. 1986) (holding that participation notes were not securities); Bank of America Nat'l Trust & Sav. Ass'n v. Hotel Rittenhouse Assocs., 595 F. Supp. 800 (E.D. Pa. 1984) (holding that promissory note secured by collateral was not security); Home Sav. & Loan Ass'n v. Samuel T. Issac & Assoc's., Inc., 496 F. Supp. 831 (N.D. Ill. 1980) (holding that loan participation notes were not securities); Old Sec. Life Ins. Co. v. Waugnueux, 484 F. Supp. 1302 (S.D. Fla. 1980) (holding that notes and mortgages assigned as part of required reserves were not securities); United Sportfishers v. Buffo, 396 F. Supp. 310 (S.D. Cal. 1975), aff'd, 597 F.2d 658 (9th Cir. 1978) (holding that promissory notes in boat-real property exchange
Of the ten decisions after *Reves* to date, four courts found securities, 237 five did not, 238 and one court left the question to the jury. 239 This may be indicative of a trend for more courts to find mortgage notes to be securities, given *Reves’* switch to a rebuttable positive presumption.

3. Classification By Date of Decision. A date classification yields more striking evidence for this trend. In the 1970s, seven courts deciding mortgage-security cases found securities, 240 while only two courts did not. 241 In a strong 1980s reversal, only one court found a security, 242 while twelve courts did not. 243 Thus far in the 1990s, four

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237. Wright v. Downs, No. 91-2050, 1992 WL 166104 (6th Cir. July 17, 1992) (holding that promissory notes secured by second mortgage on property were securities); Deal v. Asset Management Group, 1992 Fed. Sec. L. Rep. (CCH) ¶ 97,244 (N.D. Ill. Aug. 23, 1992) (holding that notes representing investment in renovation of home were securities); Mercer v. Jaffe, Snider, Raitt & Heuer, P.C., 736 F. Supp. 764 (W.D. Mich. 1990), aff’d, 933 F.2d 1008 (6th Cir. 1991) (holding REIT notes and mortgages were securities); Vicente v. Obenauer, 736 F. Supp. 679 (E.D. Va. 1990) (holding that participation notes were securities).

238. First Citizens Fed. Sav. & Loan Ass’n v. Worthen Bank & Trust Co., 919 F.2d 510 (9th Cir. 1990) (holding that participation note was not a security); Rolo v. City Investing Co. Liquidating Trust, 845 F. Supp. 182 (D. N.J. 1993) (holding that mortgage notes issued in housing development fraud were not securities); Pollack v. Laidlaw Holdings, Inc., No. 90 CIV. 5788, 1993 WL 17302 (S.D.N.Y. Jan. 21, 1993), rev’d, 27 F.3d 808 (2d Cir. 1994) (holding that participations and mortgages were not securities); Ford v. Spartin, No. CIV.A. No.92-696, 1992 WL 297432 (D. Md. July 23, 1992) (mem.) (holding that uncollateralized promissory note for housing developer was not security); Singer v. Livoti, 741 F. Supp. 1040 (S.D.N.Y. 1990) (holding that promissory note secured by property being developed was not a security).

239. Zolfaghari v. Sheikholeslami, 943 F.2d 451 (4th Cir. 1991) (explaining that issue of whether sale of mortgages and interests in mortgage pools were securities was jury question).


courts have found a security, five have not, and one has held "maybe." There is evidence that the Reves decision already has led to a greater number of mortgage decisions holding that notes are indeed securities.

4. Classification By Court. This Comment will not undertake a comparison among specific circuits, or among the circuit and district courts. At the federal appellate level, all seven pre-Reves decisions let stand district court decisions finding no security.\textsuperscript{244} After Reves, the results essentially are reversed: three post-Reves mortgage-security appellate decisions have found a security,\textsuperscript{245} and one does not.\textsuperscript{246} This may be where Reves is having its greatest effect.

Some might argue that there is little value to this type of statistical analysis because "apples and oranges" are being compared. But to the extent that judicial decisions have mimicked commentators' predicted outcomes, they are at least worthy of consideration.\textsuperscript{247}

5. Classification By Test Employed. No mortgage note has ever been held to constitute a security under the "risk capital" test. Before Reves, all six courts using that test in the mortgage context said "no."\textsuperscript{248} After Reves, the test has not been used. Under the Howey in-
vestment contract or investment/commercial tests, almost a third of the cases before Reves found a security.249 Interestingly, courts employing the “family resemblance” test before Reves found a security by a ratio of three-to-one.250 After Reves, this ratio is one-to-one.251

6. Classification By Type of Instrument. The above analysis suggests that after the Supreme Court adopted the “family resemblance” test in 1990, courts interpreting the securities laws in the mortgage-security context have been persuaded to move away from


their leniency of the 1980s—though they have not fully returned to their strictness of the 1970s—and after Reves, at least when the case involves mortgages, are just as likely to find a security as not.

As to whether this conclusion holds true for those cases concerning instruments and transactions historically associated with the secondary mortgage market, all three pre-Reves courts considering whether sales of whole mortgage loans constituted sales of "securities" held that they did not.252 No court after Reves has reached the issue. Regarding loan participations and mortgages, one court before Reves may have held that a loan participation was a security.253 Four courts before Reves254 have held that a mortgage loan participation is not a security. After Reves, courts have split on the issue.255

Thus, the EPIC court's 1988 pronouncement, that courts "uniformly hold that the purchase and sale of whole loans and loan participations... do not involve securities,"256 is no longer true. Nevertheless, after Reves, courts still are sympathetic to the idea that these instruments are not securities.257

Concerning those instruments most commonly known as "mortgage-backed securities," only one pre-Reves court has decided


257. Although the Second Circuit recently overturned a lower court decision that held mortgage loan participations were not securities, this Circuit's Reves analysis is fact specific and easily might go the other way with a few factual differences. See Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808 (2d Cir. 1994), rev'd No. 90 CIV. 5788, 1993 WL 17302 (S.D.N.Y. Jan. 21, 1993).
the issue:258 In Re National Mortgage259 held that mortgage-backed pass-through certificates260 were not "securities" under federal securities laws. After Reves, the district court in Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.261 held that REIT shares claimed to have been sold fraudulently were securities. In Zolfaghari v. Sheikholeslami,262 the Fourth Circuit left the issue up to the jury.

7. Classification By Plaintiff. Before Reves, when the plaintiff was, or represented, a financial institution, only three courts held that the instruments were securities,263 and eleven did not.264 When the suit was brought on behalf of individuals or small developers, five pre-Reves courts found securities,265 and three did not.266 After Reves, only one court has decided a mortgage/security case where the plaintiff was a financial institution. This court did not find a security.267 Where the plaintiff note buyers were indi-

258. Another pre-Reves court did not decide the question of whether CMOs and POs were securities. See Elysian v. First Interregional, 713 F.Supp. 737 (D.N.J. 1989).
260. Mortgage-backed, pass-through certificates are one of the quintessential secondary market "securities."
262. 943 F.2d 451 (4th Cir. 1991).
viduals, the post-Reves decisions are split five-to-four,\textsuperscript{268} with one decision leaving the issue to the jury.\textsuperscript{269}

If there is a conclusion to be drawn from this, it seems that a financial institution bears a more significant burden than the "little guy" in persuading a court that the mortgage note it purchased was a security under the securities laws.

B. Judicial Quixotism and Inconsistent Application Mute Reves' Impact

Generally, the post-Reves cases have been consistent in their selection of the proper test for evaluating mortgage-related note transactions, namely, the Reves note analysis.\textsuperscript{270} Nevertheless, the cases have yet to demonstrate consistency in their application of the Reves formula. After Reves, the crucial question for mortgage-related notes in the securities fraud context is whether they will be found to bear a strong family resemblance to a particular exception adopted from the Second Circuit and carved out in Reves: What is the meaning of the phrase, "the note secured by a mortgage on a home"?\textsuperscript{271}

1. Inconsistencies Abound In Application of Any of the Tests For a "Security," Including the Reves Test. Schneider and Cohen predicted that, "[a]s in many other areas of securities law, courts probably will determine for other reasons what the outcomes should be, and then the various factors relating to the buyers' state of mind will be recited appropriately in a manner consistent with the result reached."\textsuperscript{272} Even though the majority of the cases discussed in this Comment contain internally consistent reasoning, the many inconsistencies among decisions before and after Reves render such a cynical prediction accurate.

On virtually all the cases' decisional sub-issues, one can find


\textsuperscript{269} Zolfaghari v. Sheikholeslami, 943 F.2d 451 (4th Cir. 1991).

\textsuperscript{270} See id.

\textsuperscript{271} Reves, 494 U.S. 56, 65 (1990).

\textsuperscript{272} Schneider & Cohen, supra note 209, at 199.
authority for opposing positions.

- **Loan Administration:** Does the seller’s servicing of the loan represent a managerial function, leading to the conclusion that the transaction instrument was a security? Or are such after-purchase servicings purely administrative in nature, leading to a negative conclusion?\(^{273}\)

According to the pre-Reves, *First Federal*\(^{274}\) court, a “servicing agreement” whereby the seller collected payments and handled administrative matters indicated the presence of a security. But according to the pre-Reves, *In Re National Mortgage*,\(^{275}\) *First Financial*\(^{276}\) and *EPIC*\(^{277}\) courts, such servicing agreements represent only administrative functions, not entrepreneurial or managerial ones, and there was no security. The post-Reves courts have not yet reached this issue.

- **Risk Reduction:** Do collateral, mortgage insurance, seller guarantees or state and local mortgage statutes provide sufficient risk reduction so that the protection of the securities laws is unnecessary? Or must the protective scheme consist of other federal legislation?\(^{278}\)

Before Reves, only two cases, *Home Savings*\(^{279}\) and *In Re National Mortgage*,\(^{280}\) addressed this issue. Both decided that collateral, seller guarantees and insurance provided sufficient protection. After Reves, seven courts discussed this issue. *Mercer*,\(^{281}\) stated in *dicta* that collateralization might be sufficient, while *Singer*\(^{282}\) and *Pollock*\(^{283}\) held that state and local mortgage statutes were sufficient. However, the *Wright*\(^{284}\) and *Deal*\(^{285}\) courts disagreed, cautioning that

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273. Fees for servicing loans, set by the servicer and often taxed separately from the mortgage loan sale, can be quite lucrative for the loan administrators. Therefore, many thrifts buy and sell mortgage loans less not only to realize a profit from the sale, but also to gain a profit from the fees for servicing the loans. Lee A. Sheppard, *Tax Questions Raised By Mortgage-Backed Securities*, 47 *Tax Notes*, May 28, 1990, at 1041-42.


276. 834 F.2d 685 (6th Cir. 1987).


279. 496 F. Supp. 831 (N.D. Ill. 1980).


state laws were not what the Supreme Court had in mind when it spoke of an alternative risk-reduction scheme in Reves. Finally, Vicente simply found no risk-reducing factors.286

- Fixed Return of Interest: Does a fixed interest return represent profit, thus indicating a security? The pre-Reves mortgage-security cases overwhelmingly held that it did not.287 One early pre-Reves decision, SEC v. Havasu,288 held that fixed interest was profit.

After Reves the balance has shifted, probably due to a Reves footnote, the importance of which the commentators have disputed.289 Five post-Reves courts, Mercer,290 Wright,291 Deal,292 Vicente293 and Pollack on appeal294 have held that a fixed rate of interest is profit indicating a security. Only one post-Reves mortgage note decision, the district court's decision in Pollack,295 holds otherwise.

- Concerns About Securities Law Subsuming Real Estate Law: Three pre-Reves courts and one post-Reves court make this argument against defining real estate notes as "securities."296 Another

289. In footnote four, the Court stated:
We emphasize that by "profit" in the context of notes, we mean "a valuable return on an investment," which undoubtedly includes interest. We have, of course, defined "profit" more restrictively in applying the Howey test to what are claimed to be "investment contracts."... To apply this restrictive definition to the determination whether an instrument is a "note" would be to suggest that notes paying a rate of interest not keyed to the earning of the enterprise are not "notes" within the meaning of the Securities Acts. Because the Howey test is irrelevant to the issue before us today... we decline to extend its definition of "profit" beyond the realm in which that definition applies.
Reves v. Ernst & Young, 494 U.S. 56, 67 n.4 (1990); see discussion supra Part II.D.
pre-Reves court simply rejects the argument as unworthy of concern.297

- Does a Specific Reference, or Omission of One, to the Sale of "Securities" By the Seller Indicate the Presence of a "Security" Under the Statutes?: One pre-Reves case, AMFAC Mortgage Corporation,298 and two post-Reves cases, Mercer299 and Deal,300 held that it did. Nevertheless, one of the pre-Reves decisions held differently. In Re National Mortgage301 held that even though the purchased, mortgage-backed pass-through certificates were labeled "securities," the buyers were sophisticated enough to have been able to look beyond the labeling and determine the truth themselves.302

- Did the Buyer's Opportunity to Negotiate Aspects of the Sale Indicate the Presence of a "Security"?: After Reves, one court has reached this question.303 There are inconsistent decisions at the pre-Reves level. In accordance with Marine Bank304 and Great Western Bank & Trust v. Kotz,305 most of the courts considering this issue before Reves have viewed the opportunity to negotiate as indicative of a commercial transaction that represents no sale of security. One pre-Reves decision, First Federal,306 held that the opportunity to negotiate meant an interest in assuring eventual profit, thus indicating the presence of a security.

- Does the Family Resemblance Exception, "Note Secured By A Mortgage On A Home," Mean Just A Primary Market Loan For An Individual Residence, Or May Its Meaning Be Stretched Further?: Both the pre- and post-Reves cases are split on this issue. Before Reves, three decisions, Diversified,307 Shults,308 and Garfinkle,309 held to a strict, literal interpretation of this phrase. The Home Guaranty court310 stated that "note secured by a mortgage on a home" could encompass notes secured by multiple townhouse units.311

After Reves, the courts are also split. Mercer,312 Ford,313 and

298. 583 F.2d 426 (9th Cir. 1978).
302. Id. at 503.
305. 532 F.2d 1252, 1260-62 (9th Cir. 1976).
311. Id. at 581-82.
Wright\textsuperscript{314} call for a strict interpretation, while Singer,\textsuperscript{315} Pollack,\textsuperscript{316} and Rolo\textsuperscript{317} allow that "a home" could encompass a note secured by a number of homes, or even small commercial properties. The Deal\textsuperscript{318} court also seems willing to entertain this suggestion.

- **Does a Loan of Short Duration Indicate a Commercial, Non-"Security" Loan, While a Longer Duration Loan Indicates a Security Investment?:** The majority of the courts that have considered this question in the mortgage-security context reach the traditional conclusion, namely, that short-term loans are commercial and long-term loans are investments.\textsuperscript{319} However, two pre-Reves courts, Deauville\textsuperscript{320} and In re National Mortgage,\textsuperscript{321} held that the duration of the loan was of little significance.

- **Does the Buyer's Sophistication Matter?:** The relevant pre-Reves decisions hold unanimously that it does, and that the purchase of mortgage-backed instruments by sophisticated financial institutions militates against finding a security.\textsuperscript{322} The only post-Reves decision discussing the issue, the district court's decision in Pollack,\textsuperscript{323} held by negative implication that where unsophisticated purchasers were affected, the instruments in question likely were securities. Nevertheless, the district court in Pollack gave this factor little weight, finding that where the other three Reves factors suggested that the instruments were securities, the "harm to an unsophisticated purchaser" factor would give way.\textsuperscript{324}
2. Proper Test Application. Of course, the pre-Reves cases applied a number of different tests to the issue of whether a note is a security. The Reves Court attempted to impose uniformity in the test to be applied. Unfortunately, the post-Reves, Zolfaghari court, in concluding that the instruments in question may not have been notes, declined to apply a Reves analysis and thereby departed from this uniformity goal.\(^{325}\)

The pre-Reves courts were extraordinarily inconsistent in their application of the securities statutes to mortgage-related note transactions. This inconsistency is to be expected, since before Reves the courts employed at least three different tests, as well as hybrids. What is surprising, and troubling, is that inconsistency still characterizes judicial reasoning in this area, even though the majority of post-Reves courts are uniformly applying the proper Reves four-factor analysis.

It would be simplistic to explain away the post-Reves inconsistencies by declaring that the cases are fact-specific and thus decided differently on their facts. The truth is that even where similar facts are involved, the test itself is being applied inconsistently. This has troubling implications for those who oversee the securities laws or practice in the securities area. Assuming that this state of affairs is likely to continue, the Supreme Court soon may wish to consider tightening its Reves four-factor test, and address those issues that continually are decided differently.\(^{326}\) The SEC or Congress also may wish to act in order to ensure more consistency in these decisions.

3. The Second Circuit May Be Applying Its Own Test Less Rigorously. Before Reves, those courts applying the “family resemblance” test found securities by a margin of three-to-one. Both Second Circuit decisions before Reves held that mortgage notes were securities, and two other circuit courts trying out the “family resemblance” test split.\(^{327}\)

Of the ten courts applying the “family resemblance” test to

\(^{325}\) 943 F.2d 451, 455 (4th Cir. 1991).

\(^{326}\) These factors include: loan administration, types of risk reduction, interest as profit, concern about securities law’s subsumption of real estate law, instrument labeling, opportunities to negotiate, boundaries of the phrase “note secured by a mortgage on a home,” loan duration and the buyer’s sophistication. Though the courts rely on and find dispositive these subfactors underlying the Reves four-factor analysis, courts often analyze these factors differently.

mortgage note-security cases after Reves, five have found securities and five have not. Two of the five post-Reves decisions that did not find a security came out of district courts in the Second Circuit, namely, Singer and Pollack. If one accepts the premise that the circuit that (1) created the “family resemblance” test, and (2) applied it more often than any other circuit, may be looked to for guidance in determining how the test is to be applied; then one must conclude that trends within that circuit may have some bearing on whether mortgage-related instruments are deemed “securities” in the future.

After Reves, at the Second Circuit’s district court level, both mortgage-related securities cases used the Reves “family resemblance” test to hold that no security existed. Only one such case has been decided at the Second Circuit’s appellate level. There are indications from related cases decided there that the Second Circuit may hesitate to find “securities” under the “family resemblance” test for mortgage-backed instruments, unless a dispositive subfactor, such as buyer sophistication, points overwhelmingly in that direction. An interlocutory appeal was certified in Pollack, because the court found that the question of whether mortgage participations are securities is an issue “on the fringe of the law.” This dicta in other cases highlight situations in which the Second Circuit may not find the presence of a security.

4. Securities Industry Association v. Clarke. The Securities Industry Association, a national trade association representing investment bankers and securities brokers, asked the Comptroller of the Currency to review for banking improprieties the Security

330. Shortly before this Comment was published, the Second Circuit reversed Pollack, holding that the mortgage participations at issue were securities. Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808, 813 (1994). The decision is fact-specific, and its influence might be limited to situations involving the particular types of mortgage instruments and their sales context. However, the case is more interesting, and likely to be more influential, for its analysis of the nine subfactors, identified in this Comment, that the courts employing the Reves test continue to analyze inconsistently. Pollack discusses seven of the nine subfactors. See supra note 326. Only two of the subfactors, loan duration and instrument labeling, are inapparent.

If the losing appellees should seek certification of the issue to the Supreme Court, the Court would have an ideal opportunity to clarify its Reves decision, in terms of both the weighing of the Reves factors and the ambiguities inherent in the mortgage note context.

Pacific National Bank's issuance of $194 million worth of mortgage pass-through certificates. The SPN Bank, upon issuing the mortgage-backed securities, had issued a prospectus and registered the issue with the SEC, thus accepting that the instruments in question did constitute "securities" under the federal laws at the time they were issued.\(^3\)

The Comptroller of the Currency, responding to the SIA, wrote as follows:

The Bank's program, as described in the Prospectus and Prospectus Supplement dated January 23, 1987, is squarely based on long-standing precedent that is fully supported by applicable law and subsequent court decisions interpreting these laws. In pooling its mortgage loans and selling interests therein, the Bank is merely engaging in a permitted sale of its mortgage assets. We cannot conclude that the Glass-Steagall Act is intended to preclude banks from conducting this activity.\(^3\)

The SIA brought suit in federal court, seeking to overturn the Comptroller's decision. The district court granted summary judgment for SIA,\(^3\) and the Comptroller and the SPN Bank appealed.

Although this case concerns mortgage-backed security sales and the banking law, the decision has security law resonance due to the appellate court's *dicta*. In ruling for SPN Bank and the Comptroller of the Currency, the Second Circuit criticized the district court's reasoning as flawed because it analyzed the question of whether the pass-through certificates were "securities" under the Glass-Steagall banking laws by employing tests for the definition of "security" under the securities laws. The Second Circuit criticized the lower court's reasoning:

[The district court appeared to give determinative significance to the sale of the mortgage loans under SPN Bank's plan, by means of the pool instead of individually [citation omitted]. The mere fact that the certificate mechanism was used to sell otherwise salable mortgage loans transformed the transaction, in the district court's view, into the unlawful "underwriting of securities." The district court erred in attributing such significance to SPN Bank's pooling of the mortgages and sale of certificates.\(^3\)]

The Second Circuit overturned the district court's conclusion that a

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\(^3\) Clarke, 885 F.2d at 1032.

\(^3\) Id. at 1038.

\(^3\) Clarke, 885 F.2d at 1050.
banking securities claim would lie. Although admittedly this decision is under banking and not securities law, the court's dicta that pooled, mortgage pass-through certificates may not be securities, even under a securities law analysis, may be telling.

5. Banco Espanol de Credito v. Security Pacific National Bank. Loan participation mortgage note decisions are one of the few areas of mortgage note law where decisions are nearly unanimous, because the courts have been nearly unanimous on the larger issue, i.e., whether loan participations that one bank or financial institution sells to another are securities. Generally, they are not.

Banco Espanol has been widely criticized, and when called upon to ascertain the security status of mortgage loan participations, the Second Circuit took pains to distinguish the cases on the basis of the relative sophistication of the investors involved.

In 1988, SPN Bank extended a line of credit to Integrated Resources, Inc., so that Integrated was able to borrow short-term unsecured loans from SPN. Security Pacific sold these loans, in whole or in part, to various institutional investors at varying interest rates; that is, they sold loan participations.

Later that year, Integrated began experiencing financial problems. SPN Bank soon refused to extend Integrated any more credit. Nevertheless, SPN continued to sell loan participations on Integrated's debt. Integrated began defaulting on its loans and eventually declared bankruptcy.

Two sets of investors who had purchased loan participations brought suit against SPN, contending that the loan participations were "securities" under the Securities Acts. The district court ruled that the participations were not securities, and granted summary judgment to SPN Bank. The plaintiffs appealed.

The Second Circuit applied the Reves four-factor analysis, agreeing with the district court's conclusions:

(1) Motivation—the court held that SPN was motivated by a desire to increase lines of credit to Integrated while diversifying its own risk, and that Integrated was motivated by the need to acquire short-term credit to

finance its current operations. Thus, the transaction was a commercial one.

(2) *Plan of Distribution*—there was no common trading, just a “limited solicitation to sophisticated financial or commercial institutions and not to the general public.”\(^3\) Additionally, resales of the loan participations were prohibited, thus limiting eligible buyers to the non-general public.

(3) *Public Expectations*—the sophisticated purchasers had ample notice that they were buying participations in loans, not investments in a business enterprise.

(4) *Alternative Regulatory Scheme*—the Comptroller of the Currency had issued specific policy guidelines regarding the sale of loan participations; thus, application of the securities laws was unnecessary.

Thus the court held that under the *Reves* analysis, the loan participations at issue had a strong family resemblance to “the enumerated category of loans issued by banks for commercial purposes” and were not “securities.”\(^3\)

Judge Oakes dissented, declaring that “the majority opinion misreads the facts, makes bad banking law and bad securities law, and stands on its head the law of this circuit and of the Supreme Court in *[Reves v. Ernst & Young]*.”\(^3\) Judge Oakes pointed out that the SEC had submitted an *amicus curiae* brief, which the majority had not mentioned, supporting a designation of the loan participations as “securities.” These loan notes differed from traditional loan participations in that traditionally, participations are negotiated one-to-one by the parties, while in *Banco Espanol*, the participants were not supplied sufficient information.

Additionally, the dissent stated that the SPN-issued participations resembled investments in their promotion. As to the investors being “sophisticated,” Judge Oakes declared that “[t]he fact that the purchasers here were sophisticated entities does not exclude them from being considered a ‘broad segment of the public’.”

Given its reliance in both *Banco Espanol* and *Pollack* on buyer sophistication as a largely dispositive issue, the Second Circuit effectively may supplant the *Reves* analysis, which was adapted from its own “family resemblance” test, with a new note analysis that hinges on only one of the *Reves* factors. If decided, a case now pending in the Western District of New York also may hinge on the

\(^3\) *Banco Espanol*, 973 F.2d at 55.

\(^3\) *Id.* at 56. Note that another circuit court after *Reves* has used this *Reves* exception in the mortgage/security realm. In *First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co.*, 919 F.2d 510 (9th Cir. 1990), the court found that a note underlying a loan to a developer for improvement of real property met the *Reves* exception for a loan by a commercial bank to finance business development. *Id.* at 515.

\(^3\) *Banco Espanol*, 973 F.2d at 56.
buyer's sophistication issue.

6. Permanent Savings Bank v. Merrill Lynch Pierce Fenner & Smith, Inc.\(^{345}\) In the mid-1980s, Permanent Savings Bank, through intermediary Merrill Lynch, purchased from Landbank Equity Corporation $8 million worth of two pools of high-yield mortgage pass-through notes.\(^{346}\) The notes were insured by Lloyd's of London, but the insurance later proved illusory as a result of an indemnification agreement between Lloyd's and Landbank. After Landbank went into bankruptcy, and Permanent became insolvent, the Federal Deposit Insurance Corporation (FDIC) was substituted as the named plaintiff. Permanent (now FDIC) brought suit against Merrill Lynch, alleging misrepresentation under the securities laws in the brokering of a sale of "securities." Merrill Lynch responded that the mortgage notes do not meet the securities law definition of "securities." Both sides have filed cross-motions for summary judgment on this issue, upon which the court has not ruled.\(^{347}\)

**Plaintiff's Arguments.** The plaintiff relies heavily on *Mercer*\(^{348}\) throughout its argument, contending that the *context* in which the purchase was made, i.e., the secondary mortgage market, "completely alters the analysis of all four *Reves* factors."\(^{349}\) Additionally, the plaintiff also argues as a policy matter that the federal securities laws are well designed to regulate the secondary mortgage market and traditionally have been applied to such transactions.\(^{350}\)

Regarding the *Reves* four-factor analysis, the plaintiff claims:

1. **Motivation**—that its motive was to gain profit in the form of interest, and the seller's motivation concerned receiving pool servicing fees to use in its general business operations.

345. No. 86-0713C (W.D.N.Y. argued Dec. 15, 1991). As of this writing, this case is on hold due to discussions regarding a broader settlement between Merrill Lynch and the FDIC.

346. The plaintiff describes these notes as providing a blended interest rate, and as pass-through certificates. Plaintiff's Supplemental Memorandum of Law In Support of Motion For Summary Judgment at 9, 11, *Permanent Sav. Bank* (No. 86-0713C).

347. The plaintiff also alleges RICO violations. The defendants have responded with a statute of limitations defense, which will not be discussed here. The threshold issue in the case is whether the mortgage instruments in question represent "securities."


350. The plaintiff offers no authority in support of this strong assertion. Interestingly, rather than being concerned that real estate law is at risk of being subsumed by securities law, about which some courts and commentators worry, see, e.g., Singer v. Livoti, 714 F. Supp. 1040 (S.D.N.Y. 1990) and Bradner, *supra* note 18, at 977, the plaintiff is concerned that *Reves* not supplant securities law. Plaintiff's Supplemental Memorandum of Law at 9, *Permanent Sav. Bank* (No. 86-0713C).
(2) **Plan of Distribution**—that there was a moderately sized private placement with sales to ten institutional investors.

(3) **Public Expectations**—that it made two investments in two pools of loans, not a series of purchases of hundreds of individual mortgages. Plaintiff also claims that the reasonable expectation of sophisticated institutional investors in making purchases in the secondary mortgage market is that they are buying securities.

(4) **Alternative Regulatory Scheme**—that the available risk reduction schemes were insufficient, given that the insurance proved to be illusory, and state mortgage regulation does not constitute adequate protection.

The plaintiff also argues that while it may have had some control over the acceptance or rejection of individual mortgages in the pool, the pools it purchased were subject to servicing agreements that afforded Permanent no managerial discretion. But the plaintiff next contends that it relied on Landbank to do its investigating, leading to speculation that its losses on the transactions derived not from misrepresentation in the sale, but from neglect on the part of Permanent to effectively use its power of review over the individual mortgages.

**Defendant's Responses.** The defendant argues that **Mercer** is distinguishable since the case at bar involves no offering of "securities" by prospectus and no offering to the general public. Instead, a sophisticated bank in the mortgage loan business purchased a quantity of individual mortgages, each of which was individually reviewed and accepted by the plaintiff on terms individually negotiated by the plaintiff and Landbank.

The defendant also contends that **Singer v. Livoti** supports its position, since the extensive negotiation that took place characterizes the transaction as a traditional, private commercial one. Concerning the fourth **Reves** factor, the defendant points to **Singer**'s acceptance of professional licensing as a risk reduction factor which was in effect during the transaction in the case at bar, and argues that the failure of the insurance does not render the insurance a non-risk reducer. Concerning the first **Reves** factor, i.e., motivation, the defendant relies on **Banco Espanol** for the proposition that a

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352. *Id.* at 27-28.
fixed rate of interest is the likely motivation for a commercial, not investment, transaction.

The defendant’s strongest argument concerns the second and third Reves factors, plan of distribution and public expectations. Permanent purchased loans and mortgages after negotiation and individual review.\(^3\) Although the defendant concedes that Landbank did sell mortgages to other banks, the transaction in the case at bar was “an individually negotiated agreement to purchase individual mortgages.”\(^4\) Permanent became the owner of record on each note and mortgage, which lends further support to the conclusion that this was not a public investment offering of securities. The defendant claims that “every single mortgage sent to Permanent was subject to a right of rejection,” and that Permanent rejected a significant number of mortgages.\(^5\)

The defendant adds an interesting twist to this argument in a letter appended to its Reply Memorandum, which states that Permanent’s public expectation was that it was purchasing individual whole loans, because it treated them that way by individually negotiating them.

- **Decision.** The parties in Permanent Savings don’t disagree substantially on the facts. Rather, they disagree on whether to categorize the sale as one of securities backed by mortgage pools, or one of many individual mortgages. An analysis of the Reves sub-issues involved shows where the real disputes are: (1) whether the loan administration constituted management or just administration; (2) whether insurance and state and local regulation render sufficient risk reduction; (3) whether fixed interest constitutes profit; (4) whether one-to-one negotiation holds sway in the interpretation of the Reves factors; (5) whether the sophistication of the buyer affects the outcome; and (6) whether there is a concern about securities law subsuming real estate law, or vice-versa.

Until the Supreme Court clarifies Reves, these persistent sub-issues will continue to produce widely inconsistent decisions.\(^6\) But based on its facts and some of the trends predicted earlier, Perma-

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357. Defendant’s Reply Memorandum of Law To Plaintiff’s Supplemental Memorandum of Law at 8, Permanent Sav. Bank (No. 86-0713C).

358. Id. at 10.


nent should be decided for the defendant. In re National Mortgage,\textsuperscript{361} a case before \textit{Reves} concerning similar mortgage notes, held that no securities were involved because the buyer had an opportunity to negotiate the origination criteria for the underlying pool. Here, where the facts indicate that Permanent had an opportunity to and did negotiate not only the origination criteria but also which individual mortgages that it would select, a reliance upon the In re \textit{National Mortgage} holding leads one to the conclusion that these were individually negotiated whole mortgages and not investment securities.

Also, because the secondary market instruments involved in \textit{Permanent} are whole loans and/or pass-throughs, as opposed to more exotic, broken down and re-packaged instruments such as collateralized mortgage obligations or stripped securities, there is ample precedent for not finding them to constitute securities.\textsuperscript{362} Finally, the federal courts usually decide not to hold the instruments to be securities when institutions are the buyers, since financial institutions, even thrifts, generally are deemed sophisticated purchasers. This is especially true of the Second Circuit, given its recent application of \textit{Reves} to the loan participations in \textit{Banco Espanol} and \textit{Pollack}.

V. ANALYSIS: THE DYSFUNCTIONAL “FAMILY RESEMBLANCE” TEST

A. The Boundary Between Mortgage and Securities Law

\textit{Reves} offers insufficient guidance as to when real estate transactions should fall under the ambit of the securities laws. Unless and until the Supreme Court clarifies its \textit{Reves} decision, either in the mortgage/security context or elsewhere, it is certain that mortgage/security cases will be decided inconsistently. This lack of judicial consistency derives in part from the courts' hesitancy to bring largely local real estate laws under the ambit of the federal securities scheme. Both courts and commentators have expressed concern about this hesitancy.

Courts also may be hesitant to find that mortgage instruments are "securities" due to the mortgage note's versatility. A mortgage note's use can range from a minor, single-family acquisition to a complex development or investment scheme. One commentator has threatened that if \textit{Reves}' rebuttable presumption, that all notes are

\textsuperscript{361} 723 F. Supp. 497 (C.D. Cal. 1989).

securities, were strictly followed, "serious economic dislocation" would occur.\textsuperscript{633}

However, the SEC and Congress already have given some indication that they would prefer greater federal security law protection for real estate transactions. Specifically, Congress has enacted the Secondary Mortgage Market Enhancement Act of 1984, which exempts certain private issues of mortgage-backed securities from securities law registration requirements, but not from securities law fraud remedies. The SEC has urged enhanced security law protection in various releases and \textit{amicus curiae} briefs filed in several mortgage-security related cases. In order to overcome judicial resistance to such enhanced protection, it may be necessary for Congress and the SEC to tighten the securities statutes and regulations to provide a stronger framework for the courts.

\textbf{B. Whom Is Federal Security Law Designed to Protect?}

1. \textbf{A Federal Security Fraud Remedy.} The boundary between mortgages and "securities" cannot be overlooked. Besides its economic implications—considering the enormous growth of the secondary mortgage market and the potential for voluminous litigation over losses in that market—a basic question of access to federal court remedies also is implicated.

Plaintiffs decrying fraud perpetrated upon them in the sale of notes conceivably might bring state common law or statutory securities fraud claims.\textsuperscript{364} But commentators have noted the general advantages to bringing federal court actions: "better" judges;\textsuperscript{365} "fairer" courts;\textsuperscript{366} and procedural advantages, including wider choice of venue, world-wide service of process, more liberal joinder, pleading and discovery, and possibly longer statutes of limitation.\textsuperscript{367} Commentators also have noted specific advantages to federal causes of action in the securities context: easier elements of proof and relaxed

\begin{footnotesize}
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\item\textsuperscript{633} McGinty, supra note 226, at 1033.
\item\textsuperscript{364} Perhaps because access to federal courts remains difficult even under Reves' rebuttable presumption, Congress recently expanded self-regulating agency NASD's authority to censure dealers of mortgage-backed securities, irrespective of federal fraud remedies. "The new law enables us to bring an action where misconduct has occurred and not have to prove fraud," stated John Pinto, VP for Regulation at NASD. See NASD Prepares Fair Practice Rules, MORTGAGE-BACKED SEC. LETTER, Jan. 31, 1994.
\item\textsuperscript{365} RICHARD A. POSNER, THE FEDERAL COURTS: CRISIS AND REFORM 135 (1985).
\end{enumerate}
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sciente,\textsuperscript{368} wider standing to pursue private actions\textsuperscript{369} and greater receptivity to allowing recovery in cases of first impression.\textsuperscript{370}

2. What Makes An Unsophisticated Investor? At issue is whom Congress and the courts want to protect. This Comment demonstrated earlier that in the mortgage/security context, "sophisticated" financial institutions generally are not being extended federal fraud protection. Courts rarely find mortgage notes to be securities in such a context.\textsuperscript{371}

As also discussed earlier, Congress, in passing the Secondary Mortgage Market Enhancement Act of 1984, defined small banks, thrifts, and credit unions as \textit{unsophisticated} financial institutions:

\ldots [T]he Committee was of the view that small banks, thrifts and credit unions lacking in financial expertise should be provided additional protection against risky purchases. Accordingly, \ldots the bill requires the appropriate regulators to consider this question and provide regulations where necessary governing the size and determination of the purchases that are authorized. In this way, the bill endeavors to protect the liquidity of less financially sophisticated institutions on whom many of our citizens rely for the protection of their savings.\textsuperscript{372}

This view is in accordance with that of SEC and state securities regulators, as well as various self-regulating organizations.\textsuperscript{373} However, the courts rarely see it that way. At least in the mortgage/security context, the securities laws rarely are held to apply when the note purchaser is a financial institution.\textsuperscript{374}

The courts might be concerned about the chilling effect of coverage of these transactions under securities fraud statutes. After all, allowing widespread civil litigation for securities fraud could well dampen Wall Street's enthusiasm for the secondary mortgage market. Congressional and SEC inaction in expanding the definition of "security" also might be explained in this manner. If significant liti-
gation losses deterred dealers from selling these notes, the desire to achieve investor protection would run counter to the concurrent desire to expand the secondary mortgage and asset-backed markets.

The courts may also be concerned that pro-purchaser decisions will stand tort law on its head. If the unsophisticated investor is identified by losses sustained in market purchases, then misrepresentation torts soon might drift over into the strict liability or ultra-hazardous activity categories. The courts might be thinking that it is better to allow note-purchasing financial institutions to take whatever losses they are capable of sustaining than to provide recovery whenever there is a loss.

In any event, if Congress and the SEC find themselves agreeing more with Michael Lewis' definition of the sophisticated investor than the federal judiciary's definition, then they will need to make clearer their collective interpretation, and provide greater federal securities law protection to institutional note purchasers.

The Second Circuit recently, and the federal courts generally, have little difficulty holding the "little guy" as a protected, unsophisticated investor. However, when applied to thrifts, that characterization is troubling because thrifts are popularly characterized as criminal. Real estate developers, for example, have owned S&Ls and siphoned off funds. Indeed, a 1988 House Government Operations Committee report found that fraud and misconduct played a role in three-quarters of all S&L failures.

Nevertheless, it is clear that Congress and the SEC often see large financial institutions as unsophisticated investors, while courts in the mortgage/security context rarely do. Perhaps it is time for the courts to begin extending federal securities law fraud protection to unsophisticated thrifts.

375. In the 1980s, the S&L executive trading in mortgage-securities was an unsophisticated investor, the "fool in the market." LEWIS, supra note 7, at 114. However, even Lewis points out that these transactions were between consenting adults, "the thrift managers forgetting that age-old caveat, 'buyer beware.'" Id. at 105.

376. See MAYER, BANK ROBBERY, supra note 22, at 171.

377. ROBINSON, supra note 89, at 184.

378. See, e.g., House Seeks Fair Practice Rules For Government Mortgage-Backed Securities, MORTGAGE-BACKED SEC. LETTER, Oct. 19, 1992; RTC Chronicles Widespread Securities Speculation By Thrifts in Congressional Report, RTC WATCH, Mar. 30, 1992, at 3 (reporting statement of House Finance Subcommittee Senior Policy Analyst that an S&L executive "might manage a lot of money, but still not be a sophisticated investor"). Congress also sought to protect municipalities after West Virginia, San Jose and various Ohio cities lost millions of dollars in government securities, including mortgage-backed securities such as IOs. Id.; see also Government Sponsored Enterprises Respond To Derivatives Crash, INT'L BANK ACCT., Nov. 15, 1993, at 3.
C. **Intent to Protect Unsophisticated Investors is Clear, But Execution is Ineffective**

1. **Clear Intent.** Congress, the SEC and the Supreme Court agree in their mutual desire to protect the unsophisticated investor *however* such an entity is defined. In 1990 the SEC adopted Rule 144A, which allows large, sophisticated Qualified Institutional Buyers, or QIBs, to trade private placements among themselves.379 Similarly, the Supreme Court has indicated that the 1933 Securities Act was designed to protect individual investors, not sophisticated institutions.380

2. **Healing the Dysfunctional “Family Resemblance” Test.** In *Reves*, the Supreme Court expressed its clear intention in note cases: to allow plaintiffs a rebuttable presumption that the note in question is a security. While the Court’s expressed intent is crystal clear, the “family resemblance” test to be employed in effecting this intent is muddy. In a word, the “family resemblance” test is dysfunctional.

This Comment urges the Supreme Court to clear the waters and heal this dysfunctional test by accepting another note case, preferably a mortgage note case, and doing the following:

1) **Answer the commentators**, and the courts below, as to how the *Reves* four-factor analysis is to be applied. Must all four factors be met, is a balancing required, or do some factors have greater weight than others?

2) **Resolve the inconsistencies** among the *Reves* sub-issues implicated in the note cases. Provide guidance on “note as security” questions of: loan administration; available types of risk reduction (are state/local mortgage law remedies sufficient?); interest as profit; concerns regarding real estate law’s subsumption; instrument labeling (does it matter that the instrument says “security”?); opportunities to negotiate; the scope of the exceptions for “note secured by a mortgage on a home” and “commercial loans”; duration of the loan; buyer’s sophistication, or lack thereof; and when financial institutions are entitled to federal securities law fraud protection.

**CONCLUSION**

It is by no means certain that *Reves* will sweep the secondary mortgage market further under the ambit of the federal securities laws; in fact, there are indications that *Reves*’ ultimate effect may be just the opposite. The application of inconsistent tests to determine whether mortgage-related instruments constitute securities under the federal laws, both before and after the Supreme Court’s *Reves*


decision; an ongoing pattern of dilution of the “family resemblance” test, particularly in the Second Circuit, where it was originally created but now hinges on the sub-issue of buyer sophistication; and, the significant differences in outlook between the courts and the administrative and legislative branches as to who is an unsophisticated investor; all lead to the conclusion that mortgage/securities law will continue to be business as usual, decided by whim rather than reason.

However, agreement between the Supreme Court, Congress and the SEC about the intent to maintain availability of a federal remedy for fraud in the sale and/or purchase of securities leads to the hope that mortgage/security law will not be business as usual. Rather, one can hope that the law will evolve as the Supreme Court comes to recognize deficiencies in the “family resemblance” test and seeks to heal them.

Unless the Supreme Court revises its dysfunctional “family resemblance” test, mortgage-related instruments will more consistently be held to be under the federal securities laws’ umbrella of protection only if Congress and the SEC act to make it so. Family law requires specific, predictable tests to determine “family resemblance,” i.e., parentage. There is no reason why tests for family resemblance in securities law cannot be as exactly and consistently applied.
