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HIGHLIGHTS

SEC Provides Relief Under IAA for Principal Trades in Certain Accounts
The Securities and Exchange Commission votes to provide temporary relief from 1940 Investment Advisers Act principal trading restrictions for certain non-discretionary advisory accounts, including those that previously functioned as fee-based brokerage accounts. The action was prompted by a recent federal appeals court ruling. **Page 1429**

NASD Not Immune From Suit Over WorldCom Ads, 11th Cir. Holds
A divided U.S. Court of Appeals for the Eleventh Circuit, sitting en banc, affirms that NASD and the Nasdaq Stock Market are not immune from being sued under Florida law by an investor who allegedly relied on their advertisements implying that WorldCom Inc. was a good investment. **Page 1434**

Complex Nasdaq, Dubai, OMX Deals Facing Scrutiny by Lawmakers, CFIUS
A series of complex transactions that would establish a global financial network among capital market exchanges in the United States, Europe, and the Middle East faces Capitol Hill and regulatory scrutiny before it can be approved, financial specialists and company officials involved with the deal say. **Page 1430**

Milberg Weiss Founder Indicted in Widening Kickback Probe
A grand jury in the U.S. District Court for the Central District of California indicts Melvyn Weiss, co-founder of the class action law firm now known as Milberg Weiss LLP, for his role in an alleged scheme that allowed the firm to earn hundreds of millions of dollars by secretly paying individuals to serve as name plaintiffs. **Page 1432**

GAO Recommends SEC Update Policies on Opening, Closing Probes
The U.S. Government Accountability Office recommends that the Securities and Exchange Commission establish written policies for approving new enforcement investigations and that it consider expediting its procedures for closing stalled investigations. **Page 1439**

Analysis & Perspective

SECURITIES LITIGATION: Washington lawyers Stephen J. Crimmins, Andrew J. Morris, and Daniel T. Brown, Mayer Brown LLP, write about the risks of securities litigation faced by subprime mortgage lenders. **Page 1455**

Special Report

FAIR VALUE: BNA writes about the Center for Audit Quality's tentative advice to auditors and corporate management regarding fair valuation of financial assets in a market rocked by the crisis in subprime mortgage lending. **Page 1461**

ALSO IN THE NEWS

CREDIT RATING AGENCIES: Securities and Exchange Commission Chairman Christopher Cox will testify Sept. 26 at a Senate Banking Committee hearing on credit-rating agencies. **Page 1444**

FUTURES TRADING: Sen. Carl Levin introduces that a bill that would subject exempt over-the-counter energy markets to Commodity Futures Trading Commission oversight. **Page 1466**

JURISDICTION AND PROCEDURE: The Illinois Securities Law applies to stock sellers as well as purchasers, a federal appeals court says, affirming the dismissal of a lawsuit under the act's limitations period. **Page 1463**

FINANCIAL FRAUD: A federal district court dismisses class securities charges that BearingPoint Inc. disseminated false financial data due to lax internal controls. **Page 1470**

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Analysis&Perspective

SECURITIES LITIGATION

Subprime Mortgage Lending: Possible Securities Litigation Exposure

BY STEPHEN J. CRIMMINS, ANDREW J. MORRIS, AND DANIEL T. BROWN

Securities and Exchange Commission Chairman Christopher Cox told Congress in March that he was forming a 25-member working group within the SEC's Enforcement Division to investigate possible fraud involving subprime mortgage lending,[1] and by June he reported that the agency already had a dozen active investigations.[2]

In announcing the group's first filed case last month, the head of the SEC's subprime working group pointed to ''significant resources'' already focused on ''disclosure and accounting issues relating to the mortgage industry,'' and advised those with securities-related subprime issues to contact the SEC staff ''as soon as possible.''[3] With subprime issues impacting large numbers of ordinary citizens through mortgage foreclosures and fund losses, Congress is considering its response to ''financial markets today that are very different than they were 10 years ago.''[4] Against this backdrop, the SEC and private plaintiffs will likely be active in pursuing securities law claims.

This article reviews recent regulatory and litigation developments illustrating the securities law exposure of subprime mortgage lenders, securitization participants, credit rating agencies and fund managers, as well as the uncertainty as to how broadly secondary liability concepts may be used to pull collateral players into the unfolding subprime story.[5]

A. The New Problem in Securities Enforcement and Litigation. The subprime lending problem, largely unforeseen until early this year, had its roots in: (i) the softening in housing demand that began in Summer 2005 and led to decelerating or declining house prices; (ii) rising interest rates; (iii) substantial increase in adjustable-rate lending to nonprime borrowers; and (iv) slippage in loan underwriting standards, including high loan-to-value ratios, limited or no documentation of borrowers' income, and higher debt-to-income ratios. Performance has been worst for adjustable-rate subprime mortgages originated in late 2005 and in 2006. And problems may compound as many of these loans were 2/28 or 3/27 hybrid adjustable rate mortgage loans, and borrowers will face their first interest rate resets in the coming quarters.[6]

The wild ride of subprime in 2007 has already seen: multiple subprime mortgage lenders report serious fi-

[1] Testimony of SEC Chairman Christopher Cox before House Subcommittee on Financial Services, Committee on Appropriations, March 27, 2007. Prepared remarks available at www.sec.gov/news/testimony.shtml. *See also* ''Regulator Favors Standards Against Predatory Lending,'' N.Y. Times, March 28, 2007 (report of Chairman Cox's testimony as delivered).

[2] Testimony of SEC Chairman Christopher Cox before House Subcommittee on Financial Services, Committee on Appropriations, June 26, 2007. Prepared remarks available at www.sec.gov/news/testimony.shtml. *See also* ''Chairman Denies That SEC Favors Business,'' N.Y. Times, June 27, 2007 (report of Chairman Cox's testimony as delivered).

[3] Remarks of Cheryl J. Scarboro, Associate Director, SEC Enforcement Division, quoted in SEC Press Rel. 2007-161 (Aug. 7, 2007). Several weeks ago, the SEC's Director of Market Regulation briefed Congress on the SEC's ''ongoing and heightened activities'' in light of subprime developments. Testimony of Erik R. Sirri, SEC Director of Market Regulation, before House Financial Services Committee (Sept. 5, 2007), prepared remarks available at www.sec.gov/news/testimony/shtml.

[4] Remarks of Rep. Barney Frank, Chairman, House Financial Services Committee, Sept. 5, 2007, reported in ''Regulators, Lawmakers Seek Answers to Origins of Subprime Mortgage Debacle,'' 172 Daily Report for Executives (BNA) Page A-34 (Sept. 6, 2007).

[5] Subprime mortgage loans are generally (i) high interest loans to borrowers with weak credit (*e.g.* FICO score below 630, payment delinquency in the last 24 months, bankruptcy in the last 5 years, or debt-to-income ratio over 50%); or (ii) loans to borrowers with good credit that do not qualify for a prime rate due to loan characteristics (*e.g.* second mortgages or ''piggy-back'' loans to finance 100% of the home value, or ''teaser rate'' mortgages such as 2/28 hybrid adjustable rate mortgage loans that switch from low fixed rates to adjustable rates after 2 years).

[6] Remarks of Federal Reserve Chairman Ben S. Bernanke, Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyo., Aug. 31, 2007, available at http://federalreserve.gov/newsevents. *See also* ''Moody's Downgrades Subprime First-Lien RMBS,'' Moody's Investors Service press release, July 10, 2007, available at www.moodys.com (subprime problem reflects ''environment of aggressive underwriting,'' coupled with ''prolonged, slowing home price appreciation,'' resulting in ''significant loan performance deterioration'' and ''delinquency rates that are higher than original expectations,'' particularly for subprime mortgage loans securitized in 2006).

Stephen J. Crimmins, Andrew J. Morris, and Daniel T. Brown are partners at Mayer Brown LLP in Washington.

nancial difficulties early in the year; one of the largest subprime lenders, New Century Financial, make a bankruptcy filing in April; two Bear Stearns hedge funds with subprime exposure collapse during June and July; credit rating agencies downgrade a large volume of mortgage backed securities in July and warn of additional downgrades; another lender, American Home Mortgage, make a bankruptcy filing in August; and hearings before the Senate Banking Committee and the House Financial Services Committee on possible legislative responses.

The reach of the subprime problem will keep it a priority at least through 2008. Federal Reserve Chairman Ben Bernanke recently noted that the subprime situation has triggered broader concerns about overall economic growth. ''Investor uncertainty has increased significantly, as the difficulty of evaluating the risks of structured products that can be opaque or have complex payoffs has become more evident.'' In this context, investors' increasing reluctance to assume risk has created ''significant market stress.''[7]

B. Exposure of Subprime Lenders. As public companies, subprime mortgage lenders can face securities law claims by the SEC and by their own shareholders where it is arguable that the lenders did not fairly present their subprime exposure in financial statements and other disclosures.[8]

On August 7, in the first case brought by the SEC's new subprime working group, the SEC charged First BanCorp with aiding and abetting Doral Financial Corp.'s efforts to get subprime mortgages off its books and overstate income. The SEC charged that Doral's sales of nonconforming (including subprime) mortgages to First Bancorp were not ''true sales'' for accounting purposes because, while transaction documents provided buy-back recourse for only 24 months for mortgages that defaulted, the parties allegedly agreed orally to extend the recourse to the full duration of the mortgages. The SEC fined First BanCorp $8.5 million and had earlier fined Doral $25 million, and both consented to injunctive relief.[9]

Subprime mortgage lenders are now beginning to see securities claims by their own shareholders. Recent shareholder litigation against Countrywide Financial Corp., one of the nation's largest mortgage lenders, followed announcements in July and August that it would take a $417 million impairment charge and add $292.9 million to its loan loss reserves, and that it had concerns over potential short-term liquidity issues. Plaintiffs claim that, while making ''risky subprime and low-documentation loans,'' Countrywide misrepresented that it ''had strict and selective underwriting and loan origination practices, ample liquidity. . ., and a conservative approach that set it apart from other mortgage lenders.''[10]

In general, plaintiffs appear to be focusing on disclosures relating to the quality of the loans, and adherence to procedures designed to ensure loan quality. Shareholders suing Accredited Home Lenders Holding Co. claim that it misrepresented that it was committed to originating ''high-quality loans'' and would ''constantly track the factors that impact portfolio quality''; that it instead permitted ''rampant overrides'' of negative credit appraisals; and that it ''manipulated'' reserves for bad loans in violation of GAAP.[11] A shareholder suit against Fremont General Corp. claims that it failed to disclose that it had ''inadequate underwriting criteria,'' ''a large volume of poor quality loans,'' and ''unsatisfactory lending practices,'' and that it marketed adjustable-rate mortgages ''to subprime borrowers in an unsafe and unsound manner'' and ''without adequately considering the borrower's ability to repay.''[12]

Plaintiffs also appear to be focusing on whether companies made timely disclosure of material developing trends in their mortgage business. A suit by shareholders against American Home Mortgage Investment Corp. alleges that it failed to disclose that it ''was experiencing an increasing level of loan delinquencies'' and ''increasing difficulties in selling its loans.''[13] Shareholder litigation against New Century Financial Corp. claims that it did not properly account for loan buy-back obligations where it allegedly ''knew that more investors would sell back loans because loan repurchases surged throughout 2006 amid payment defaults.''[14] A shareholder complaint against NovaStar Financial, Inc. claims that it failed to disclose that deterioration in the subprime market would force a tightening in its underwriting guidelines that would have a material negative impact on its loan production, and that it failed to properly account for its loan loss allowance.[15]

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[7] Remarks of Chairman Bernanke, Aug. 31, 2007, *supra*. A recent survey of economists ''pegged the recession risk at 36%, up from a 28% probability a month earlier,'' with credit availability being the primary reason for an economic slowdown. Sudeep Reddy, ''Forecasters Increase Odds of Recession Over Next Year,'' Sept. 12, 2007, available at online.wsj.com/article_print/SB118954072982324112.html.

[8] Such charges are brought under Securities Act § 17(a), 15 U.S.C. § 77q(a), Exchange Act § 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (securities fraud); Exchange Act § 13(a) and Rules 12b-20, 13a-1 and 13a-13, 15 U.S.C. § 78m(a) and 17 C.F.R. §§ 240.12b-20, 13a-1 and 13a-13 (periodic reporting); Exchange Act § 13(b)(2)(A), 15 U.S.C. § 78m(b)(2)(A) (books and records); and Exchange Act § 13(b)(2)(B), 15 U.S.C. § 78m(b)(2)(B) (internal accounting controls).

[9] *SEC v. First BanCorp*, Lit. Rel. 20227 (S.D.N.Y. Aug. 7, 2007); *SEC v. Doral Financial Corporation*, Lit. Rel. 19837 (S.D.N.Y. Sept. 19, 2006). As in all SEC settlements, the defendants settled without admitting or denying liability. The authors' law firm represents a former senior First BanCorp officer in litigation concerning this matter.

[10] *Norfolk County Retirement System v. Countrywide Financial Corp.*, No. 07-cv-05727-SVW-CT (C.D. Cal., complaint filed Aug. 31, 2007); *Pappas v. Countrywide Financial Corp.*, (C.D. Cal., complaint filed Aug. 14, 2007). Shareholder litigation against Thornburg Mortgage, Inc. claims that it failed to disclose that its ''unique'' business model and strategies would not shield it from mortgage market turmoil, and that it was suffering from ''significant liquidity problems.'' *Gonsalves v. Thornburg*, No. 07-CIV-7897 (S.D.N.Y., complaint filed Sept. 7, 2007).

[11] *Atlas v. Accredited Home Lenders Holding Co.*, No. 3-07-cv-00488-H-RBB (S.D. Cal., corrected complaint filed Aug. 24, 2007).

[12] *D'Errico v. Rampino*, No. CV-07-3915-MMM (C.D. Cal., complaint filed June 15, 2007).

[13] *Greenberg v. American Home Mortgage Investment Corp.*, No. 2:07-cv-03152-TCP-ETB (E.D.N.Y., complaint filed July 31, 2007).

[14] *Gold v. Morrice*, No. 07-00931 (C.D. Cal., complaint filed Feb. 8, 2007).

[15] *Boyd v. Novastar Financial, Inc.*, No. 07-0139-CV-W-HFS (W.D. Mo., complaint filed Feb. 23, 2007). *See also Reese v. Indymac Financial, Inc.*, No. CV-07-01635-JFW (C.D. Cal., com-

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With the sort of generalized fact allegations evident in the complaints referenced above, plaintiffs asserting federal securities law claims over subprime problems may be unable to overcome the strict pleading requirements announced in recent U.S. Supreme Court rulings. Among other things, plaintiffs will be expected to plead with particularity facts giving rise to a ''strong'' inference of scienter. When weighed against ''plausible nonculpable explanations,'' the facts pled will have to be sufficient to give rise to an inference of scienter that is ''cogent and compelling.''[16] Plaintiffs will also be expected to identify the relevant economic loss they claim, and specify a causal connection between such loss and any alleged misrepresentation or omission, *i.e.* that the stock fell due to a revelation about *this* company, not a market-wide decline in similar stocks.[17]

In addition to charging lenders with misrepresentations to their own shareholders, it remains to be seen whether the SEC or private litigants will try to argue that subprime lenders should have direct liability, aiding-and-abetting liability or some other form of secondary liability to downstream investors in mortgage-backed securities, for example on a theory that they should have made additional disclosures when they transferred subprime loans to a securitization vehicle.[18] However, such claims may be difficult where sellers have made dozens of representations—backed up by repurchase obligations—and have provided other information that gave buyers and credit rating agencies a fair understanding of the underwriting criteria. In such cases, the fault may instead be with analytical models that failed to accurately predict performance and risk.

C. Exposure of Securitization Participants. Mortgage loans, subprime and higher quality, are often packaged for sale to investors as mortgage-backed securities. In an asset-backed securities (''ABS'') transaction, the ''sponsor'' typically organizes and initiates the ABS transaction by selling assets to the ''issuing entity'' or to a ''depositor,'' which then acts as an intermediary in reselling the assets to the issuing entity. The issuing entity is a trust or other entity created by the sponsor or depositor to own or hold the pool assets and to issue the asset-backed securities supported by the pool assets. The ''servicer'' manages and collects pool assets, and may also make distributions to the ABS investors.[19]

Claims against entities involved in the securitization process will likely focus on the adequacy of disclosures in offering documents and in annual and quarterly periodic reports. In December 2004, the SEC adopted Regulation AB (''Reg AB'') to clarify the disclosures required in offering documents and periodic reporting for asset-backed securities.[20] Required Reg AB disclosures germane to the present subprime problem include:

- ''the solicitation, credit-granting or underwriting criteria used to originate or purchase the pool assets, including, to the extent known, any changes in such criteria and the extent to which such policies and criteria are or could be overridden,'' as well as the ''method and criteria by which the pool assets were selected for the transaction'' (Item 1111(a)(3) and (4));
- ''material characteristics'' of the asset pool, which may include ''information about the origination channel and origination process for the pool assets, such as originator information (and how acquired) and the level of origination documentation required''; ''standardized credit scores of obligors and other information regarding obligor credit quality''; and ''loan-to-value (LTV) ratios and debt service coverage ratios (DSCR)'' (Item 1111(b)(7)(iii), (11) and (13));
- ''delinquency and loss information for the asset pool, including statistical information regarding delinquencies and losses'' (Items 1111(c) and 1121(a)(9)). A pool asset is ''delinquent'' if it is more than a month or single payment cycle past due (Item 1101(d));
- external credit enhancement such as bond insurance, letters of credit or guarantees; derivatives to provide credit enhancement; and internal credit enhancement such as subordination provisions, overcollateralization and reserve accounts (Item 1114(a));

Reg AB also specifies that the ''senior officer in charge of securitization of the depositor'' must certify that the annual and quarterly reports, ''taken as a whole, do not contain any untrue statement of a material fact or omit to state a material fact.''[21] Alternatively,

plaint filed March 8, 2007) (failed to disclose that ''the deterioration and the increased volatility in the subprime market'' would force company to ''increase its loan loss provisions and tighten its underwriting guidelines,'' resulting in a ''direct material negative impact on its loan production'').

[16] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007). Scienter is intentional or severely reckless conduct that represents ''a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers [of securities] that is either known to the defendant or is so obvious that the actor must have been aware of it.'' *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977), *quoted in Ponce v. SEC*, 345 F.3d 722, 729 (9th Cir. 2003).

[17] *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).

[18] Federal Reserve Chairman Bernanke has pointed to the danger of compromised underwriting standards when securitization allows risks of default to be ''largely passed on to the investors rather than being borne primarily by the company that originated the loan,'' particularly in a highly competitive lending environment. Remarks of Federal Reserve Chairman Federal Reserve Bank of Chicago Conference on Bank Structure and Competition, Chicago, May 17, 2007, available at http://federalreserve.gov/newsevents.

[19] SEC Regulation AB, Item 1101, 17 C.F.R. § 229.1101.

[20] Regulation AB, Final Rule Rel. 33-8518, 34-50905 (Dec. 22, 2004), codified at 17 C.F.R. § 229.1101 *et seq*. The SEC recognized important differences between ABS and other issuers' securities. The disclosure requirements for other issuers do not cover the areas important to the ABS investor because there is typically no business or management to describe with an ABS issuer. Investor interest focuses instead primarily on the transaction structure, quality of the underlying asset pool, and issues related to the servicing of the asset pool. The SEC had addressed these differences over the years informally, and adopted Regulation AB to ''consolidate and codify . . . staff positions and industry practice.'' 70 Fed. Reg. 1508 (Jan. 7, 2005). The final rule was published in the Federal Register on Jan. 7, 2005 with an effective date of March 8, 2005. Different compliance dates applied to offerings depending upon the date of the commencement of the offering, the date of registration statement filing, and whether the offering relied on Securities Act Rule 415(a)(1)(x), with the earliest date being certain offerings commencing after Dec. 31, 2005 and the latest being certain offerings commencing after March 31, 2006.

[21] Exchange Act Rule 13a-14(d). In this and other contexts, the SEC has specified that ''materiality'' includes both quantitative and qualitative aspects. *See* SEC Staff Accounting Bulletins 99, 108.

if the servicer signs the report instead of the depositor, the ''senior officer in charge of the servicing function of the servicer'' must so certify.

An example of investor claims against securitization participants is the litigation filed in April against Credit Suisse Securities (USA) LLC (''Credit Suisse'') and others in connection with a series of mortgage-backed securities. The transaction illustrates the structure of a typical securitization transaction: (i) DLJ Mortgage Capital, Inc. (a Credit Suisse affiliate) bought certain pools of mortgages (alleged to be subprime) from various originators and sold them to Credit Suisse First Boston Mortgage Securities Corp. (''Credit Suisse Mortgage,'' also a Credit Suisse affiliate); (ii) Credit Suisse Mortgage formed a trust (the ''Trust'') that issued mortgage-backed securities (the ''Certificates''), collateralized by the mortgage pools and divided into ''tranches'' (reflecting payment priority, the so-called ''waterfall''); (iii) Credit Suisse Mortgage sold the Certificates to Credit Suisse, as underwriter; and (iv) Credit Suisse sold the Certificates to investors in individually negotiated transactions.[22]

Among other claims, the original complaint included a federal securities fraud count against Credit Suisse under Exchange Act § 10(b) and Rule 10b-5, as well as a claim based on Securities Act § 12(a)(2).[23] However, a recent amended complaint has dropped all federal securities counts and is pursuing only state common law claims.[24] In moving to dismiss the original complaint, Credit Suisse had argued that investors knew that ''market events that cause mortgage loan borrowers to have difficulty making their payments (such as rising interest rates for an adjustable rate mortgage) or selling their property (such as a softening of the housing market) will affect the performance and outlook'' of the mortgage-backed securities. Credit Suisse relied on the recent Supreme Court precedent, discussed above, interpreting the PSLRA's pleading requirements for federal securities law claims.[25]

Another case involving securitization participants was brought by the bankruptcy trustee of American Business Financial Services, Inc. (''ABFS''), an originator and wholesale purchaser of subprime mortgage loans. In addition to suing ABFS officers and directors, the trustee sued five major financial institutions that provided revolving credit facilities to ABFS and served as underwriters, depositors, trustees or collateral agents in securitization transactions for the ABFS mortgage loans. The trustee contended that ABFS manipulated and falsely reported the performance of the loans and that, by reviewing financial information while participating in ABFS' capital raising efforts, the institutions allegedly became aware of and aided and abetted its fraudulent conduct.[26]

D. Exposure of Credit Rating Agencies. The role of credit rating agencies in the subprime mortgage crisis is also coming under scrutiny. Rating agencies have recently been challenged for taking compensation from the issuers of securities they rate, and for consulting with issuers on how to structure securities to achieve particular ratings.[27] The SEC's Director of Market Regulation recently told Congress that, given recent subprime developments, his staff had ''begun a review'' of credit rating agencies that would cover, among other things, ''the advisory services they may have provided to underwriters and mortgage originators, their conflicts of interest, disclosures of their rating processes, the agencies' rating performance after issuance, and the meanings of the assigned ratings.''[28]

The SEC's interest in the role of credit rating agencies follows the September 2006 enactment of the Credit Rating Agency Reform Act, which expanded the SEC's jurisdiction over the rating agencies.[29] The new legislation provides that:

- A rating agency must register with the SEC,[30] and must disclose, among other things, its procedures and methodologies for determining credit ratings; its poli-

[22] Select Portfolio Servicing, Inc. (a Credit Suisse affiliate) acted as servicer of the mortgage loans that were the collateral; Triad Guaranty Insurance Corp. issued a mortgage guaranty insurance policy; and Bank of New York served as trustee for the Certificate holders.

[23] *Bankers Life Insurance Co. v. Credit Suisse First Boston*, No. 8:07-cv-00690-EAK-MSS (M.D. Fla., complaint filed April 23, 2007). *See also Sterling Federal Bank, F.S.B. v. Credit Suisse First Boston*, No. 07-CV-2922 (N.D. Ill., complaint filed May 24, 2007).

[24] *Bankers Life Insurance Co. v. Credit Suisse First Boston*, No. 8:07-cv-00690-EAK-MSS (M.D. Fla., amended complaint filed August 27, 2007). *See also Sterling Federal Bank, F.S.B. v. Credit Suisse First Boston*, No. 07-CV-2922 (N.D. Ill., amended complaint filed August 27, 2007).

[25] *Sterling Federal Bank, F.S.B. v. Credit Suisse First Boston*, No. 07-CV-2922 (N.D. Ill., memorandum supporting dismissal motion, filed July 20, 2007). The remaining state common law counts in the amended complaint allege negligent misrepresentation, false information negligently supplied, and common law fraud against Credit Suisse and Credit Suisse Mortgage; breaches of fiduciary duty against Credit Suisse, the servicer and the trustee; various breaches of contract stemming from the pooling and servicing agreement and the mortgage guaranty insurance policy; and civil conspiracy directed at all of the defendants.

[26] *Miller v. Santilli*, No. 060701225 (Philadelphia Court of Common Pleas, complaint filed July 13, 2006). The five financial institutions are U.S. Bank National Association, J.P. Morgan Chase Bank, Credit Suisse (USA), Inc., Bear Stearns & Co, Inc., and Morgan Stanley & Co., Inc., together with certain affiliates.

[27] The rating process relies on information from public filings, market data, economic data, expert information and data from the issuer. A committee considers the data and develops a conclusion on the appropriate rating, which represents a rank-ordering of credit-worthiness. The rating agency then continues to monitor the rating to determine whether it should be changed. ''Moody's Ratings System in Brief,'' available at www.moodys.com. Principal credit rating agencies include Moody's Investors Service, Standard and Poor's Ratings Services, and Fitch, Inc. John Moody introduced the rating system to the bond market in 1909.

[28] Testimony of Erik R. Sirri, SEC Director of Market Regulation, before House Financial Services Committee (Sept. 5, 2007), available at www.sec.gov/news/testimony.

[29] Pub.L. 109-291, codified at Exchange Act § 15E, 15 U.S.C. § 78o-7, adopted Sept. 29, 2006. On June 5, 2007, the SEC adopted final implementing rules, which are already in effect. Exchange Act Rules 17g-1 through 17g-6, 17 C.F.R. §§ 240.17g-1 through 240.17g-6.

[30] On June 28, 2007, the SEC announced that each of the credit rating agencies previously identified as a nationally recognized statistical rating organization (''NRSRO'') had applied to be registered with the SEC. These included: Standard and Poor's Ratings Services; Moody's Investors Service; Fitch, Inc.; DBRS; A.M. Best Company, Inc.; Japan Credit Rating Agency, Ltd.; and Rating and Investment Information, Inc. SEC Press Rel. 2007-124, available at www.sec.gov/news/press.shtml.

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cies for dealing with material nonpublic information and conflicts of interest; and on a confidential basis, the 20 largest issuers and subscribers using its services.

- The SEC can deny the registration application if the rating agency lacks ''adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with'' its disclosed ratings procedures and methodologies.

- A rating agency must maintain internal documents and communications relating to its rating activities and a record of the persons who participated in particular ratings, and must submit to periodic SEC inspections.

- The SEC may censure, limit, suspend or revoke the registration of a rating agency that fails to maintain resources to consistently produce credit ratings with integrity, or that it has willfully violated or aided others to violate any provision of the securities laws or rules.[31]

Other regulators are likewise concerned about the rating agencies' involvement in the subprime crisis. The New York Attorney General recently served subpoenas to gather information from the rating agencies, and state regulators in Ohio and elsewhere have also expressed interest. The European Union's Internal Market Commissioner will work with international regulators to explore the role of the rating agencies.[32]

Meanwhile, one credit rating agency has already been challenged over its bond rating practices. The trouble began on July 10 when Moody's Investors Service announced that it was downgrading 399 securities originated in 2006 and backed by subprime mortgage loans, and that it was downgrading an additional 52 securities originated in 2005.[33] Just over a week later, a class action charged that Moody's had failed to disclose that it allegedly ''assigned excessively high ratings to bonds backed by risky subprime mortgages—including bonds packaged as collateralized debt obligations.'' The complaint further charged that ''even as a downturn in the housing market caused rising delinquencies of the subprime mortgages underlying such bonds, Moody's maintained its excessively high ratings, rather than downgrade the bonds to reflect the true risk of owning subprime-mortgage-backed debt instruments.''[34]

Credit rating agencies have historically escaped blame by stressing that their ratings are simply opinions and thus not actionable. For example, Moody's Investors Service cautions that a rating is a ''forward looking'' statement providing its ''opinion of the credit quality of individual obligations or of an issuer's general creditworthiness,'' and ''not recommendations to buy or sell, nor are they a guarantee that default will not occur.''[35]

In this regard, the rating agencies will find comfort in a Sixth Circuit ruling last month. In affirming dismissal of defamation and breach of contract challenges to a Moody's rating, the court found the rating to be ''a predictive opinion, dependent on a subjective and discretionary weighing of complex factors,'' that does not convey ''any provably false factual connotation.''[36] While the Sixth Circuit decision did not involve a securities law claim, the credit rating agencies will argue that its analysis should be read as supporting the argument that credit ratings are ''forward-looking statements'' of opinion protected by the PSLRA.

E. Exposure of Fund Managers. The troubles in the subprime mortgage market may also put managers of hedge funds, pension funds, real estate investment trusts (''REITs''), and mutual funds at risk. These managers were the ones who purchased, on behalf of their funds, the mortgage-backed securities discussed above. They thus may face claims from their own investors and the SEC over their investment decisions as well as over the disclosures they made to fund investors about such matters as underlying asset quality, valuation, risk, techniques for monitoring and hedging risk, and underlying loan performance.

On July 18, Bear Stearns advised that two of its hedge funds were in serious trouble. The High-Grade Structured Credit Strategies Fund had ''very little value,'' and the High-Grade Structured Credit Strategies Enhanced Leveraged Fund had ''effectively no value.'' Both funds invested in collateralized debt obligations (''CDOs'') backed by subprime mortgages. On August 6th, an investor in the first fund filed a class and derivative complaint against the fund's investment manager (Bear Stearns Asset Management Inc.), the prime broker and custodian of the master fund[37] (Bear Stearns Securities Corporation), a broker-dealer (Bear Stearns & Co. Inc.), the parent of the foregoing entities (Bear Stearns Companies Inc.), and the individuals who were the fund's senior portfolio manager, portfolio manager and chief operating officer.[38]

The complaint's theory is that the investment manager and the individuals, aided and abetted by the other defendants, breached their fiduciary duty to the fund's investors and to the fund itself by failing to disclose that defendants were (i) ''not sufficiently monitoring and adequately assessing the credit risk'' of the fund's investments; (ii) ''not determining the frequency and severity

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[31] The Credit Rating Agency Reform Act of 2006 also provides that state securities commissions may continue to investigate and bring enforcement actions for ''fraud or deceit'' against credit rating agencies and their associated persons. Exchange Act § 15E(9)(2), 15 U.S.C. § 78o-7(o)(2).

[32] ''SEC, New York Attorney General Probing Policies, Actions by Credit Rating Agencies,'' 174 Daily Report for Executives (BNA), Page A-25 (Sept. 10, 2007); Remarks of Charlie McCreevy, European Commissioner for Internal Market and Services, before European Parliament Plenary Session (Sept. 5, 2007), available at www.europa.eu.

[33] Moody's Investors Service press releases, July 10, 2007, available at www.moodys.com.

[34] *Nach v. Huber*, No. 07-CV-4071 (N.D. Ill., complaint filed July 19, 2007). Plaintiff is a Moody's shareholder, but the complaint illustrates the nature of claims that other plaintiffs may attempt to make against rating agencies.

[35] ''Moody's Ratings System in Brief,'' available at www.moodys.com.

[36] *Compuware Corp. v. Moody's Investors Services, Inc.*, 2007 U.S. App. LEXIS 20075, at *23 (6th Cir. Aug. 23, 2007).

[37] The fund used a ''master-feeder'' structure that had it and other Bear Stearns funds invest through a master fund (the Bear Stearns High-Grade Credit Strategies Master Fund Ltd.).

[38] *Navigator Capital Partners, L.P. v. Bear Stearns Asset Management Inc.*, No. 07-602663 (Sup. Ct., N.Y. Co., complaint filed Aug. 6, 2007); *Navigator Capital Partners, L.P. v. Bear Stearns Asset Management Inc.*, No. 07 Civ. 7783 (U.S.D.C., S.D.N.Y., notice of removal filed Aug. 31, 2007). The state court complaint charged breach of fiduciary duty under Delaware law, but the removal petition contends that the claim is essentially for misrepresentation or omission of material facts in connection with the purchase or sale of securities, effectively a federal securities fraud claim.

of defaults of the underlying assets of each of the structured finance securities'' the fund invested in; (iii) ''not developing and implementing credit enhancement mechanisms'' to divert cash flow away from riskier investments under certain market conditions; and (iv) ''not otherwise adequately engaging in hedging techniques to minimize risk.''[39]

In August 2007, investors filed class actions against Luminent Mortgage Capital, Inc., an NYSE-listed REIT that invested in mortgage loans and mortgage-backed securities, and certain of its managers. Plaintiffs complained that as late as the end of July 2007, Luminent was issuing public statements that ''attempted to distinguish the Company from the ongoing mortgage subprime downturn and further touted the Company's superior credit position and prospects.'' But on August 6, it announced that it would suspend its dividend, was experiencing increased margin calls, and would delay filing its quarterly report.[40]

The SEC's possible interest in fund managers in the subprime context is suggested by a 2003 administrative proceeding it decided against Piper Capital Management. In that matter, the SEC revoked the firm's registration as an investment adviser, fined the firm $2 million, and censured the firm and individual respondents. The SEC charged the firm with (i) failing to disclose that 90 percent of its fund's portfolio had shifted from Treasury securities and pass-through mortgage-backed securities issued by government-chartered corporations to collateralized mortgage obligations (''CMOs'') and other complex mortgage securities such as inverse floaters; (ii) misrepresenting the risks of investing in CMOs through misleading filings and marketing materials which compared the fund's performance to benchmarks with less sensitivity to interest rates; and (iii) fraudulently pricing the fund's net asset value (NAV), resulting in stale and overvalued prices for the fund's investments.[41]

F. How Wide a Net? The SEC can sue, as ''aiders and abettors,'' those who have knowledge of misconduct and render ''substantial assistance'' to the principal violators. In the subprime context, depending on particular circumstances, this raises the specter of such ''secondary'' liability for mortgage originators who knew that the mortgages they transferred would be packaged and sold to investors, to assorted individuals and entities involved in varying degrees in the securitization process, and to professionals such as accountants and lawyers who assisted in the transactions.

Aiding and abetting liability has changed considerably over the last decade. In 1994, the Supreme Court held that the antifraud provisions of the securities laws do not create liability for aiding and abetting a violation.[42] The following year, as part of the Private Securities Litigation Reform Act, Congress acknowledged the SEC's ability to bring aiding and abetting claims against those who ''knowingly provide substantial assistance'' to a violator, but refused to give that right to private plaintiffs.[43] Congress explained that authorizing private claims for aiding and abetting ''would be contrary to [the PSLRA's] goal of reducing meritless securities litigation.''[44] However, after Enron, class plaintiffs began asserting so-called ''scheme liability'' claims against secondary actors as ''participants'' in a fraudulent scheme.[45]

Those opposing this ''scheme liability'' approach have argued that it is a subterfuge designed to gut the Supreme Court's 1994 ruling barring aiding and abetting claims by private plaintiffs. In a few days, the Supreme Court will hear argument on whether such scheme liability claims will survive.[46] If the Court affirms the decision below, the SEC will continue to be the only plaintiff able to proceed against secondary violators, but a reversal may considerably increase the exposure of banks, accountants, lawyers and others to private securities litigation over subprime failures.

G. Conclusion. Plaintiffs have only begun to explore possible factual and legal theories and file securities litigation on subprime-related claims. And it is still uncertain which of the players in the subprime process—lenders, securitization participants, fund managers and others—will receive the greatest focus. In proceeding with such cases in federal court, plaintiffs will face tight new pleading requirements from recent Supreme Court rulings, and this may lure many plaintiffs to file in state courts.

While under considerable public and Congressional pressure, the SEC is likewise still in the early days of determining what its new 25-lawyer subprime enforcement working group will do about the subprime situation. But the extent of resources the SEC has already committed and its public statements suggest that this will be a significant initiative of the SEC's enforcement program, at least through 2008.

[39] The fund was to generally invest in ''investment-grade structured finance securities rated AA or higher.'' The complaint quoted representations that the ''primary focus of the Investment Manager will be to assess the credit risk inherent in every potential investment and to monitor the credit risk of the investments held by the Master Fund,'' including through analytical systems to ''monitor each deal, run stress tests, monitor monthly trustee reports on each deal and use technology to effectively monitor each position''; and that the fund would manage risk through ''various hedging techniques,'' and would ''monitor and maintain adequate liquidity and look to minimize leverage.''

[40] *Kaplowitz v. Luminent Mortgage Capital, Inc.*, No. C-07-4140 (N.D. Cal., complaint filed Aug. 10, 2007); *Pem Resources LP v. Luminent Mortgage Capital, Inc.*, No. C-07-4184 (complaint filed Aug. 15, 2007); *Rosenbaum Capital LLC v. Luminent Mortgage Capital, Inc.*, No. C-07-4096 (complaint filed Aug. 9, 2007).

[41] *Matter of Piper Capital Management, Inc.*, A.P. No. 3-9657 (Aug. 26, 2003).

[42] *Central Bank v. First Interstate Bank*, 511 U.S. 164, 173, 177, 191 (1994).

[43] Exchange Act § 20(e), 15 U.S.C. § 78t(e).

[44] S. Rep. No. 104-98, at 19. Again in 2002, in considering the Sarbanes-Oxley Act, Congress declined to adopt proposals to restore the ability of private plaintiffs to bring aiding and abetting claims. *E.g.* H.R. Rep. No. 107-414, at 54 (2002); 148 Cong. Rec. S6584 (daily ed. July 10, 2002).

[45] *See Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) (accepting scheme liability); *In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472, 504 (S.D.N.Y. 2005) (same). *Compare Regents of the Univ. of Calif. v. Credit Suisse First Boston*, 482 F.3d 372 (5th Cir. 2007) (rejecting theory).

[46] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43 (oral argument Oct. 9, 2007). *See* Brief for Respondents, at 1, 13-14. The authors' law firm represents Respondents in the Supreme Court in this matter.

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