



Securities Litigation & Regulation

Andrews Litigation Reporter 

VOLUME 14 ★ ISSUE 14 ★ NOVEMBER 18, 2008

Expert Analysis

The Civil, Regulatory and Criminal Responses To the Subprime Mortgage Meltdown

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Many words have been used to describe the deterioration of the credit markets caused by the subprime mortgage industry: debacle, crisis, meltdown, implosion. Regardless of how it is described, the effects of the subprime mortgage collapse have been extraordinary, and the fallout is lingering.

The economic losses to financial companies still are growing and seem to get worse daily as more banks fail and the markets drop. Since the beginning of 2007, subprime losses among more than 100 U.S., Canadian and European firms have been reported to be in the hundreds of billions of dollars.

Estimates of the total economic subprime-related losses are mind-boggling, reaching into the trillions. To illustrate, as early as last April, figures predicted by the International Monetary Fund put the losses at \$143 for every person on earth, or \$3,100 for every U.S. resident.¹

As a natural consequence of the collapse, much effort has been and will continue to be spent in pursuit of those who bear the blame. Studies have concluded that subprime litigation has outpaced the litigation stemming from the savings and loan scandal of the early 1980s.² And, in this post-Enron environment, federal and state authorities are looking at the potential culpability of all people involved in subprime lending and in the securities that were collateralized by subprime mortgages.

This article focuses not on the losses, but on the efforts by government regulators to root out the causes and punish those at fault.

SEC Response

The Securities and Exchange Commission's 2008 agenda will continue to be dominated by the subprime crisis. The SEC is in full swing examining the entire subprime industry, looking at all players, "from the lender that

originated the loans to the buyers of mortgage-backed securities that first ran into trouble,” according to Chairman Christopher Cox.

With the agency’s Enforcement Division conducting nearly four dozen investigations, a wide variety of people and entities, including banks, underwriters, officers and directors, credit agencies, accountants, and even lawyers, will find themselves entangled in an SEC investigation or worse — an enforcement action or civil suit.³

The SEC has a dedicated subprime task force that includes attorneys from nearly every division of the agency and an Enforcement Division working group, with more than 100 lawyers investigating possible fraud or breaches of fiduciary duty. The task force is coordinating with other divisions within the SEC and talking with other regulators, including the Federal Reserve, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency and Office of Thrift Supervision.⁴

And, as part of the President Bush’s Working Group on Financial Markets — a group that rarely met before the subprime crisis — Cox is talking to the heads of the Federal Reserve, the Treasury Department and the Commodity Futures Trading Commission.

Cheryl Scarborough, who heads the Enforcement Division’s subprime working group, summarized the SEC’s investigative focus: “The big question is who knew what, when and what did they disclose to the marketplace?”⁵

She broke down the investigations into three main categories: the securitization process, the origination process and the retail area. Specifically, the SEC’s investigations will include the following issues:

- Whether hedge funds and financial institutions provided adequate disclosure to investors of the risks of mortgage-related securities;
- Whether banking holding companies and securities firms made appropriate and full disclosures in their filings and public statements of the valuation of the collateralized debt obligations portfolios;
- How financial firms valued mortgage-backed securities and whether the firms valued mortgage-related securities

differently on their own books compared to the valuations they applied to the holdings of customers such as hedge funds;

- Whether banks and brokers carried out proper due diligence before selling mortgage-related securities and whether brokers adhered to suitability requirements in the complex securities, especially concerning seniors;
- Whether, in order to publish higher ratings of mortgage-related securities, credit agencies diverged from their standard methodologies and procedures, failed to adjust their ratings as the underlying assets deteriorated, and failed to maintain appropriate independence from issuers and underwriters;
- Whether insiders liquidated or sold short securities backed by subprime assets in advance of public downgrades;
- Whether public companies intentionally failed to make adequate allowances for loan defaults;
- Whether companies ignored the weakness of their subprime-related portfolios; and
- Whether lenders were aware of possible collusion between mortgage brokers and appraisers in artificially inflating home values.

Simply put, no one with even a fingerprint on subprime mortgage industry is safe, including auditors and attorneys.⁶

The SEC has not revealed the targets of its inquiries and investigations, but their identities trickle out in news reports, public filings and statements by the companies themselves. For example, one investigation is looking into whether Washington Mutual “accurately disclosed to investors of mortgage-backed securities how its loans were appraised, as well as whether the company properly accounted for its loans in financial disclosures to investors.”⁷

The SEC reportedly also is investigating Merrill Lynch & Co.’s valuation of its mortgage bonds and looking at deals the company allegedly struck with hedge funds to cloak its vulnerability to subprime mortgage debt. UBS AG is the focus of allegations that a hedge

fund trader was fired after he valued mortgage securities below the assigned value of the same securities elsewhere at UBS. The agency also has contacted a Royal Bank of Canada trader about allegations that the bank overvalued government agency and corporate bonds.⁸ The SEC has accused two Credit Suisse Securities brokers of defrauding customers by making more than \$1 billion in unauthorized purchases of subprime-tied securities.⁹

Other SEC investigations are targeting Morgan Stanley for its mortgage securities valuations and disclosures; Bear Stearns for its valuation methods; Countrywide for several issues, including stock sales by its CEO under a 10b5-1 plan; and New Century Financial Corp. for executives' accounting practices and 10b5-1 stock sales.¹⁰

Recently, the SEC's probe into Countrywide became a formal investigation.¹¹ Goldman Sachs, Morgan Stanley and Bear Stearns all disclosed in public filings in late January that they were cooperating with inquiries from multiple government regulatory agencies but did not provide specifics.¹² A wide-ranging probe of Washington Mutual by the SEC, the FBI, the FDIC's Office of Inspector General and the Internal Revenue Service's criminal investigation unit was announced Oct. 15.¹³

The agency also is examining the three credit rating agencies over which it gained oversight in late 2007: Moody's Investors Service, Standard & Poor's and Fitch Ratings. The examination is focusing on whether the agencies "diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings" and whether they "followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings."¹⁴

The SEC sent letters to the three rating agencies May 23, asking how they identify and correct mistakes in rating structured finance products. On July 8 the agency issued a report blaming the credit agencies for much of the credit crisis.¹⁵

Federal Criminal Investigations

In late January the FBI announced it had teamed with the SEC to investigate 14 companies for accounting fraud, insider trading and other violations related to

risky loans, thus adding a criminal element to the mix. That probe, led by the FBI's economic crimes unit in Washington, has since grown to include more than two dozen companies. The investigation reportedly targets mortgage lenders, investment banks and loan brokers and focuses on whether lenders and banks included actual loans in the creation of mortgage-related securities.¹⁶

In an investigation that is even "broader and deeper" than its partnership with the SEC, the FBI has teamed with the IRS' criminal division to form a separate task force to examine mortgages given with little or no proof of income. The group of investigators includes federal prosecutors in New York, Los Angeles, Philadelphia, Dallas and Atlanta.¹⁷

Among the companies being investigated by the FBI and/or the Department of Justice are Bear Stearns (concerning the collapse of two hedge funds), Countrywide and UBS (concerning whether it knowingly mispriced subprime mortgage securities).

Comparing the FBI's work following the saving and loan crisis, FBI Director Robert Mueller said, "We will see the same extensive investigations that we saw then, with successful prosecutions following those investigations."¹⁸

The U.S. attorney's offices of New York's Southern and Eastern Districts reportedly are investigating several firms. The Manhattan office has asked the SEC for information about its investigation of Merrill, and federal prosecutors in Sacramento, Calif., are looking into Countrywide. The Los Angeles U.S. attorney's office reportedly is investigating New Century, the nation's largest mortgage company that specializes in subprime lending, for its accounting practices and executives' 10b5-1 stock sales.

The Brooklyn U.S. attorney's office has formed a task force composed of as many as 15 federal, state and local agencies to investigate potential crimes ranging from mortgage fraud by brokers to securities fraud, insider trading and accounting fraud. The task force, which had its first formal meeting May 2, builds on work already underway in the office, including investigations into the collapse last summer of two Bear Stearns hedge funds, whether UBS improperly valued its mortgage securities holdings, and potential accounting fraud and false statements by current and former American Home Mortgage Investment Corp.

executives. Other task force investigations target some of the companies being probed by the FBI.¹⁹

State Regulators

State authorities have joined the SEC, FBI and Justice Department in investigating potential misconduct in the subprime mortgage industry. Notably, New York Attorney General Andrew Cuomo is conducting a wide-reaching investigation into the subprime crisis, including whether Wall Street firms failed to sufficiently disclose risks tied to subprime mortgage lending. He has sent subpoenas to numerous market players, with a focus on whether loans purchased by Washington Mutual were overvalued through the use of fraudulent appraisals. Cuomo also sued the bank in November 2007 for allegedly “exerting pressure” on appraisal company First American Co. to inflate property values to ensure WaMu’s loans went through.²⁰

The Ohio attorney general likewise launched a probe into potential violations by subprime-mortgage players and has sued 10 mortgage lenders, accusing them of pressuring real estate appraisers to inflate home values. A number of states, including Massachusetts and Maine, reportedly are investigating Merrill Lynch’s valuation and sale of its mortgage bonds. Massachusetts has sued one Wall Street firm, and Maine officials are reportedly investigating the same firm. Countrywide reportedly is the subject of scrutiny by regulators in Indiana, West Virginia, Connecticut, Florida, California and Illinois.²¹

Some cities, including Baltimore and Cleveland, also are getting involved as civil litigants against companies involved in the subprime industry, alleging loss of tax revenue and increased costs associated with rising numbers of home foreclosures.²²

FINRA

Wall Street’s regulatory agency, the Financial Industry Regulatory Authority, also has joined the investigatory mix. FINRA CEO Mary L. Schapiro has said its surveillance and examination staffs are “fully engaged” in the subprime mortgage fallout. Among the areas of FINRA’s focus are broker-dealers’ inventory valuation of asset-backed securities and marketing practices in the sale of subprime-related securities.²³

In December 2007 FINRA sent letters to more than a dozen brokerage houses, indicating a sweeping investigation of the marketing and sales of mortgage-related products, particularly how they are sold to individual investors. The letters said FINRA is investigating “whether brokers sold the products to individuals just as the market for related products was collapsing.” The letter asked for, among other documents, transaction details, written supervisory procedures, and presentation and marketing materials from the period of June 30, 2006, to July 31, 2007.²⁴

Civil Suits

As one writer put it: “Homeowners are suing mortgage lenders. Mortgage lenders are suing Wall Street banks. Wall Street banks are suing loan specialists. And investors are suing everyone.”²⁵ Every constituency has been sued — mortgage brokers, lenders, title companies, home builders, underwriting firms, bond issuers, money managers, public accounting firms and company directors. One commentator said, “the low-hanging fruit” of litigation also will include companies in related industries like home improvement, construction, real estate and title insurance.²⁶ Supporting players such as lawyers, accountants, rating agencies and appraisers also will likely face lawsuits.

The subprime crisis has caused many lenders to file for bankruptcy and a number of class action and breach-of-contract cases to be filed against lenders. Homeowner class actions based on predatory lending, particularly involving loans with two-year “teaser” fixed-rate periods before converting to adjustable-rate mortgages, are expected as well. Already, according to one study, securities fraud class actions against finance industry companies from 2006 to 2007 quadrupled to 47, 25 of which involved subprime issues.²⁷

Merrill Lynch alone is a defendant in four class actions, seven derivative suits and 10 class actions under the Employee Retirement Income Security Act. One class action was filed by a group of shareholders who acquired securities as part of Merrill’s 2007 merger with First Republic Bank. In the \$1.8 billion deal First Republic shareholders received cash or Merrill stock worth \$55 a share. Merrill is accused of issuing false and misleading financial statements and making prospectus statements on the deal that failed to state that the company was overexposed to subprime loans.²⁸

Citigroup and UBS face multiple lawsuits, including ERISA actions by current and former employees who allege that the banks breached their fiduciary duty by investing workers' pension funds in risky mortgage-backed securities. Shareholders and consumers are also targeting firms such as Bear Stearns, Credit Suisse, Downey Financial Corp., Freddie Mac, KKR Financial Holdings, Lehman Bros., New Century Financial, Nomura Asset Acceptance Corp., PMI Group Inc., Schwab, State Street Corp. and Wachovia.²⁹

In one of the first published rulings in a subprime-related suit, a federal judge permitted a securities class action to proceed against Accredited Home Lenders Holding Co. The judge said the plaintiffs' theories of liability — that the defendant's financial projections and statements regarding its underwriting practices, which deviated from their publicly disclosed standards, were false and misleading — met the rigorous federal securities fraud pleading requirements.³⁰

Many experts believe that the bulk of the lawsuits will not appear for many months, perhaps well into 2009. And, a study shows that when the lawsuits make it to trial, jurors likely will side with consumers and against lenders.³¹

Indeed, a number of states have recently enacted legislation or regulations that will allow disgruntled borrowers to file lawsuits rather than raise complaints with regulators. Included among those states that have either passed or are considering such statutes or regulations are Colorado, Illinois, Maine, Massachusetts, Minnesota, North Carolina and Ohio.³² Such legislation can only increase the number of suits that will be filed.

Conclusion

The devastating collapse and widespread effect of the subprime mortgage industry necessitated swift and thorough action from the SEC, Department of Justice and other regulatory authorities. While the news cycle has moved away from the underlying regulatory issue, the government agencies and plaintiffs' attorneys have not. All those who facilitated or participated in the growth of the subprime mortgage industry and the Wall Street investments that allowed that growth are and will continue to be in the crosshairs of

focused and intense civil and criminal investigations and suits.

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