

- Growing regulatory interest in subprime mortgage-backed investments
- The SEC has expanded investigation to credit rating agencies, and further expansion appears likely
- Market troubles could result in new wave of securities litigation brought by investors
- Those involved in issuing, rating, purchasing, repackaging, recommending or selling mortgage backed investments should assess risk profile and act accordingly

Subprime Shake-Up: Regulators' Growing Interest in Securities Backed by Subprime Mortgages

Following the collapse of two Bear Stearns hedge funds that invested heavily in securities backed by subprime mortgages, Securities and Exchange Commission ("SEC") Chairman Christopher Cox disclosed in late June 2007 that the SEC's Enforcement Division had opened approximately a dozen investigations involving collateralized debt obligations ("CDOs"), the investment vehicle through which subprime mortgages are often pooled and sold to investors. Since then, alarms have been ringing in many quarters. Former SEC Chairman Arthur Levitt recently remarked that "the subprime mortgage crisis has the potential to rival just about anything in recent financial history from the savings-and-loan crisis of the 1980s to the post-Enron turndown at the beginning of the decade." Over the past several months, securities regulators' interest in the collapse of subprime mortgage market has only grown.

The SEC announced late last week that it has broadened its investigation to examine the role of credit rating agencies such as Moody's, Standard & Poors, and Fitch Ratings, which provided investment grade ratings to mortgage-backed securities. In addition, the SEC is coordinating with other regulators in the President's Working Group on Financial Markets (which includes the Treasury Department, the Federal Reserve Board, and the Commodity Futures Trading Association), and federal regulators across the financial services industry are getting into the act. Meanwhile, state regulators in Ohio, New York, Massachusetts, and Illinois have started investigations of their own.

In recent testimony before the House Financial Services Committee, Erik Sirri, the Director of the SEC's Division of Market Regulation, noted that while the SEC does not regulate the origination and sale of mortgage loans, "it does have a role when the mortgages are sold to securitization vehicles and when securities are backed by those loans." Sirri's remarks indicate that the SEC views itself as having broad authority to investigate virtually every player in the subprime mortgage market, including: (1) mortgage lenders that sold subprime mortgages into the secondary market; (2) investment banks that purchased subprime mortgages, pooled them into mortgage backed securities, and sold them to investors as CDOs; (3) credit rating agencies that gave investment-grade ratings to those CDOs; (4) hedge funds, pension funds, banks, and public companies that invested in those CDOs; and (5) key individuals at each level of the process.

SEC regulation of CDOs and other asset-backed securities starts with the registration, disclosure, and reporting requirements contained in Regulation AB, adopted in 2005 and phased in by 2006. In addition to investigating any potential specific violations of Regulation AB, the SEC will also examine each player's conduct through the lens of the primary antifraud provisions of the securities laws: Section 10(b) of the Securities Exchange Act, Section 17(a) of the Securities Act, and SEC Rule 10b-5. The relevant inquiry under each of these provisions is whether an individual: (1) engaged in fraudulent conduct (i.e., made an untrue statement of material fact, omitted a fact that rendered a prior statement misleading, or committed a manipulative or deceptive act as part of a scheme to defraud) and (2) acted with an intent to defraud.

For example, the SEC will seek to determine whether, when it provided a favorable rating in connection with a CDO, a credit rating agency knew that its rating underreported the actual risk of the investment but nevertheless issued the report with the intent of encouraging investment in the security and thereby increasing its own financial gain. Similarly, the SEC will likely examine whether stakeholders in CDOs with poorly performing loans were accurately marking down the value of their assets and whether they were conveying accurate information in a timely fashion about their CDO holdings to their own shareholders.

In addition to potential SEC enforcement, the subprime mortgage market troubles will also likely result in a wave of securities litigation brought by those who invested in CDOs – whether directly or through an intermediary such as a hedge fund. Insurance broker and risk adviser Marsh, Inc. recently warned the financial services sector, including insurance companies, hedge funds, banks, and ratings agencies, that it expects a large number of subprime-based claims brought under directors' and officers' policies and errors and omissions policies. The focus of shareholder lawsuits will most likely closely approximate the focus of the

SEC, including allegations of misrepresentation, conflicts of interest, inadequacy of disclosure, erroneous valuation, and improper accounting.

Those involved in the various parts of the market present different risk profiles. Participants possessing information may be subject to criticism for irrational exuberance, conflicts of interest, or inadequate disclosure. Participants who made investment decisions may be criticized for poor judgment, inadequate diligence, or breach of fiduciary responsibilities. Any of these entities might face scrutiny for inadequate accounting practices. Ironically, some entities may be viewed as potential victims from one perspective and as potential wrongdoers from another. For example, the fund investing in CDOs may perceive itself as victimized by inadequate disclosure, faulty ratings, or outright fraud, yet may simultaneously be perceived as having breached its duties to its own investors.

The SEC and state regulators are embarking on a broad-based investigation of those involved in issuing, rating, purchasing, repackaging, recommending, or selling mortgage backed securities. Such a sweeping response will likely evolve over time, ensnare a number of individuals and entities along the way, and ultimately increase the number of "follow-on" shareholder suits brought by securities plaintiffs. In the meantime, entities with close ties to investments in subprime mortgage-backed securities would be well served to assess their risk profile and take appropriate steps towards dealing with any potential issues in a proactive manner.

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