POSTED ON: **SEPTEMBER 24, 2007** BY SHEPHERD SMITH & EDWARDS

SEC Investigates Credit Rating Agencies' Policies Regarding Debt-Related Securities

The SEC and NY Attorney General Andrew Cuomo are conducting a probe of credit rating agencies to examine their policies regarding debt-related securities. Standard & Poor's (S & P), Fitch Ratings Inc., and Moody's Investors Service have all been contacted by the SEC and questioned about their procedures and policies on rating collateral debt obligations (CDOs) and residential mortgage-backed securities (RMBS). On September 5, before the House Financial Services Committee, SEC Market Regulation Director Erik R. Sirri announced that the probe was taking place. He also said that the commission was examining the advisory services that agencies might have provided to mortgage originators and underwriters, as well as rating performance, disclosures, and what the designated ratings signify. Sirri also informed the committee members that the SEC was looking at two kinds of conflicts of interest at the agencies. One conflict deals with how agencies are paid—either by the customers that are rated or the underwriters. The second conflict deals with the significance of the ratings and the agencies' methods. The investigation could result in investors and others filing lawsuits against the firms. Also on September 5, Charles McCreevy, the European Union Internal Market Commissioner, said that the rating agencies worked too slowly to downgrade structured financial instruments. He also mentioned the conflicts of interest. He wants the roles of the agencies to be more clear-cut. The New York Attorney General's office has sent subpoenas to the agencies. S&P and Moody have promised to cooperate with the investigation. If you are an investor that has lost money because of the inappropriate actions of a credit rating agency, a brokerage firm, or any other company or individual affiliated with the securities industry, you should speak with a securities litigation law firm that is experienced in successfully handling securities fraud cases and can help you recover your investment. Shepherd Smith and Edwards has helped thousands of investors in the United States recover their loss. Contact Shepherd Smith and Edwards today for your free consultation.

Related Web Resources:
SEC to review role of credit rating agencies, CNN.com, September 7, 2007
Standard and Poor's
Moody's Investors Service
FitchRatings Inc.
Attorney General Andrew Cuomo, New York State
U.S. Securities and Exchange Commission

Posted by Shepherd Smith & Edwards

THE WALL STREET JOURNAL.

Friday, February 8, 2008

Rating the Rating Overhaul

New York State Official Calls Voluntary Moves 'Window Dressing'

BY AARON LUCCHETTI

Andrew Cuomo, New York state's attorney general, wants credit-ratings firms to go further in their efforts to overhaul how they rate mortgage-related bonds, criticizing voluntary changes under way at the firms as "too little, too late."

Moody's Corp.'s Moody's Investors Service, the Standard & Poor's Ratings Services unit of **McGraw-Hill** Cos. and **Fimalac** SA's Fitch Ratings announced this week separate plans to improve their analysis of mortgage-related bonds and other structured-finance vehicles.

Mr. Cuomo called the moves "window dressing" that fall short of the systemic change needed to restore investor confidence. S&P and Moody's "are attempting to make piece-meal change that seem more like public relations window dressing than systemic reform," he said in a statement.

The comments show that Mr. Cuomo isn't backing down in his investigating of rating firms to ascertain how culpable they are for assigning ratings that were far too high for various bonds backed by subprime mortgages. Collateralized debt obligations that heavily invested in mortgage instruments also were highly rated. Many have since been downgraded, causing billions of dollars in write-offs at financial firms.

The ratings firms defended the changes that they have proposed or already begun making, ranging from new labels and warnings from Moody's on structured-finance bonds to S&P's tougher oversight of analysts to spot potential conflicts of interest. Fitch is weighing changes in how it rates corporate CDOs.

An S&P spokesman said its moves "are meaningful and important measures to serve the capital markets." Moody's said it welcomes "feedback from all market participants, including government authorities." Fitch said it also is open to "the input of regulators, according to a spokesman.

While critics of the ratings firms say they grew too close to the investment banks that sold billions in mortgage bonds, others say they simply made bad judgment calls about the direction of the housing market and relied on incomplete or incorrect data provided by banks and mortgage firms.

Mr. Cuomo's office has issued subpoenas to S&P, Moody's and Fitch in an effort to find out how much each knew about flaws in the mortgage products that they rated triple-A. The rating firms have been meeting with representatives of the attorney general's office in recent weeks. Meetings between Mr. Cuomo and executives of the three major firms have been taking place this week, according to a person familiar with the matter.

In his statement, Mr. Cuomo said his office "will continue its active investigation of the mortgage industry and the role played by the ratings agencies in the mortgage meltdown."

Mr. Cuomo's office could encourage an industrywide settlement that would include an agreement for the three ratings firms to improve their practices in a coordinated way.

CREDIT CRUNCH

Next Up for Raters: SEC Rules?

Regulator Aims To Make System Investor-Friendly

BY KARA SCANNELL

WASHINGTON—The Securities and Exchange Commission may soon propose rules that require credit-ratings firms to disclose the accuracy of past ratings and distinguish between various products they rate, the first indication how the industry might be regulated in the wake of the subprime crisis.

SEC Chairman Christopher Cox said the potential rules "would require credit-rating agencies to make disclosures surrounding past ratings in a format that would improve the comparability of track records and promote competitive assessments of the accuracy of past ratings."

He added that the SEC "may propose rules aimed at enhancing investor understanding" about the differences between how ratings are treated for standard municipal and corporate debt, as compared with innovative financial instruments crafted by Wall Street banks.

Mr. Cox declined to give specifics of any possible rules. He said they are geared at fostering "healthy competition" that could involve highlighting and rewarding "successful past performance to punish chronically poor and unreliable ratings."

The SEC is in the midst of a broad review of policies and procedures used by the biggest credit-rating firms amid concern about the role they played in buoying the market for residential mortgage-backed investments. Critics say some ratings firms gave overly rosy marks to debt instruments that have since fallen significantly in value. Other policy makers in the U.S. and abroad are studying changes to the credit-rating model. Some of the biggest firms are making changes to get ahead of any government-sponsored push.

Second-Rate?

- **The News:** The SEC may require credit-rating firms to disclose how ratings have done and distinguish among products.
- **Background:** The SEC is reviewing the biggest credit raters to ensure they followed policies.
- **What's Next:** The rules could be voted upon this spring or packaged with a broader governmental proposal on credit-rating firms.

SEC officials said the agency's early reviews of credit-rating firms and investment banks also reveal that some firms used poor assumptions about high-risk mortgage debt in establishing their ratings, while some Wall Street investment banks had poor risk controls.

Erik Sirri, head of the SEC's division of trading and markets, said risk controls at certain investment banks were "weak," noting that some firms were forced to develop pricing models for hard-to-value securities "on the fly" after the market dried up this summer. He said the SEC will continue to push investment banks to perform "more robust stress testing."

Exactly how the SEC plans to measure the performance of ratings firms still needs to be worked out. The SEC wants to ensure that any new rules don't have the unintended consequence of dictating ratings methodology. Congress gave the SEC oversight authority over credit-rating firms in 2006, but the SEC can't review the substance of their ratings.

The areas in which the SEC may require firms to provide more information include: the percentage of rated securities that default, or the number of ratings that resulted in upgrades and downgrades. Another option could be providing more information about how quickly ratings firms change their scores. In the recent market turmoil, a number of securities were downgraded soon after the initial rating was given.

Because credit-rating firms use slightly different performance measures, it is hard to get precise comparisons across firms.

Already some firms are moving toward informing investors that structured securities are different from corporate and government debt. In the past week, **Moody's** Corp. said it is considering overhauling how it rates novel Wall Street-engineered products to distinguish them from corporate debt.

Saturday, February 9, 2008

SEC May Propose New Rules for Credit-Rating Companies

(Naked Capitalism) The Wall Street Journal and Bloomberg report that the SEC is mulling regulations for rating agencies. Note that rating agencies have benefited from being a protected class, since the SEC determines who can be a Nationally Recognized Statistical Ratings Organization, yet heretofore has imposed no obligations on them.

In the 1970s, the SEC set regulatory capital requirements on various types of financial institutions; these in turn rested on credit ratings set by NRSROs. The three large incumbents, Moody's Standard & Poor's and Fitch were given the designation.

Only a very few firms have been able to join the club since then; the SEC has not only failed to set standards for new applicants, but is also has never acknowledged receipt of applications. Thus NRSROs have the unique advantage of enjoying a high regulatory barrier to entry with no accompanying responsibilities.

And the new SEC proposals are a continuation of this proud, hands-off, no obligations tradition. Its great reform proposal? To require the rating agencies to publish how well their past ratings have done and disclose performance differences among ratings for different product categories.

The latter requirement flies in the face of the myth that the rating agencies have promulgated, namely, that their ratings mean the same thing, in terms of default risk, across products. That practice started slipping in the early 1990s, yet the agencies continued to maintain that their ratings standards were the consistent across products.

Note also that this proposal fails to acknowledge the fundamental conflict of interest that created this mess, that the ratings agencies are paid by issuers, when their ratings are for the use of investors. Taking that one on is too hard for an SEC ideologically opposed to meaningful intervention, no matter how patent the need for it is.

Contrast this attitude with the tough words from an EU regulator, as quoted in Reuters:

European Union Internal Market Commissioner, Charlie McCreevy, warned on Wednesday that if credit ratings agencies did not correct the lack of distinctive ratings for structured finance products, he would take action.

"If the proposals are not forthcoming in coming months, I would not hesitate to move forward to have it addressed with regulatory action," McCreevy told the Society of Business Economists in London....

"I am not going to be prescriptive today but I will say this: strong independent professional oversight of the credit professionals within the rating agencies...and of the operation of the ratings function is absolutely essential if market and regulator confidence is to be restored with respect to the effective management of the conflict of interest inherent in the rating agencies' business models," McCreevy told the audience in London. Now consider the harebrained statements from the SEC, via Bloomberg: The U.S. Securities and Exchange Commission may propose new rules for credit-rating companies to help evaluate securities following investor losses related to subprime mortgages, the agency's chairman said.

The rules would increase disclosure about ``past ratings'' to help determine whether rankings successfully predicted the risk of default, SEC Chairman Christopher Cox said at a securities conference in Washington today. The regulations may also address the differences between ratings on structured debt and rankings for corporate and municipal bonds.

Investors could then use the enhanced disclosure to ``punish chronically poor and unreliable ratings,'' Cox told reporters after his speech. ``The rules that we may consider would provide information to the markets in a way that facilitates'' comparisons, he said.
Punish chronically poor and unreliable ratings? What in God's name is that supposed to mean? The market already disagrees plenty with published ratings. Has Cox ever looked at the AAA ABX index? And all of this patently obvious repudiation by the market of rating agency grades has had zero effect on their behavior. Even the specter of monoline credit default swaps of MBIA and Ambac priced at distressed levels still has not embarrassed them into making downgrades. Why? ***They are paid by the issuers!*** What investors and the market thinks has zero effect on their bottom line. If months of horrific press won't induce them to clean up their act (the reforms proposed by S&P are similarly cosmetic), a mere tabulation of past performance certainly won't.

In case you think I am being unfair, consider this excerpt from the Wall Street Journal story:
SEC Chairman Christopher Cox said the potential rules "would require credit-rating agencies to make disclosures surrounding past ratings in a format that would improve the comparability of track records and promote competitive assessments of the accuracy of past ratings."

He added that the SEC "may propose rules aimed at enhancing investor understanding" about the differences between how ratings are treated for standard municipal and corporate debt, as compared with innovative financial instruments crafted by Wall Street banks.
Translation: the problem isn't that the ratings are bogus, it's the investors' fault that they don't understand that the ratings are bogus. So we'll try harder to educate those dumb investors.

Just as the EU is having to do the heavy lifting on antitrust with Microsoft, so too will they with rating agency reform. The US seems unwilling to take steps that will reduce a company's God-given right to its profits, no matter how much their actions cost the greater economy.

Cormick Grimshaw

Thursday, February 7, 2008

Ratings agencies move to restore credibility

(FT) Moves on Thursday by Standard & Poor’s to revamp its governance procedures, analytics and ratings transparency mark the latest in a series of mea culpas from the leading credit rating agencies as they attempt to restore their credibility with investors.

Moody’s, Fitch and S&P have in recent months come under intense fire from investors and regulators in the US and Europe after complex structured finance instruments they rated have suffered losses far in excess of the rating agencies’ initial expectations.

Critics have said the ratings process must become more transparent. Others say the model is fundamentally flawed, because issuers of debt and structured products pay the agencies to issue a rating.

As a result, European and US policymakers have signaled they expect to see increased transparency and information from the agencies to remedy the perceived inaccuracy of ratings for such instruments. And the agencies are responding with proposals to reform their business models, their ratings methods and their loss assumptions for troubled securities.

Moody's this week proposed a new rating system for complex debt securities that would use numerical grades rather than letters, to help investors differentiate ratings for such securities from those for more traditional corporate and sovereign debt securities.

Fitch is reviewing its rating processes by individual product category and this week proposed new methods for rating complex debt securities backed by corporate debt, revised its loss assumptions for subprime mortgages and launched its second review of the bond insurance industry.

Fitch on Tuesday put the AAA credit ratings of bond insurers MBIA and CIFG on negative rating watch, just weeks after affirming the ratings of both companies.

"The need to update loss assumptions at this time reflects the highly dynamic nature of the real estate markets in the US, and the speed with which adverse information on underlying mortgage performance is becoming available," said Fitch.

The crisis in the subprime mortgage market has forced the agencies to downgrade hundreds of billions of dollars worth of securities backed by such mortgages, and to adjust loss assumptions as the US housing market continues to deteriorate. This in turn has negative knock-on effects for related securities such as collateralised debt obligations and for companies that guarantee payments on these instruments, such as the bond insurers.

S&P last week downgraded or put on review for downgrade the ratings of more than $270bn worth of securities backed by subprime mortgages and more than $260bn worth of related CDO securities.

While S&P reviewed its loss assumptions on recent subprime mortgages to 19 per cent from 14 per cent, Fitch also took a more aggressive view of potential losses this week. The ratings agency put $139bn of mortgage bonds on review for downgrade after revising its loss assumptions for 2006 and 2007 subprime mortgages to 21 per cent and 26 per cent respectively.

Part of the problem, say rating agency analysts, is that as the housing market continues to deteriorate, losses have become a fast-moving target that is difficult to track.

"Getting our arms around the potential losses is very difficult at this point," says Thomas Abruzzo, managing director at Fitch.

Cormick Grimshaw

TRADER DAILY

ARTICLE

The Beat of the Street

The jig might soon be up for the credit-rating agencies, among the most conflicted industries ever concocted.

By: Charles Gasparino
November 2007, Page 60

RATING AGENCIES ARE under fire again. That's not exactly surprising, given their abysmal record in doing what they get paid to do — weighing the risks for investors and traders who buy bonds. But this time, the stakes are higher and the damage created by their incompetence is more extensive. Put simply: The rating agencies significantly contributed to the subprime crisis that caused the credit crunch this past summer and that may sink the economy into recession. | The agencies will argue that that's a huge overstatement, that all those pools of subprime loans they rated way above investment grade blew up because of a once-in-a-lifetime housing-price meltdown — or that the true culprits in this fiasco were the banks that pooled the loans. "We have policies to promote the independence of our rating process," a Standard & Poor's spokesman stressed in a statement. A Fitch Investors spokesman echoed that.

Well, the rating agencies are wrong — and regulators are waking up to the fact that something has to change. It began with recent hearings about the subprime crisis on Capitol Hill, and according to Christopher Cox, the chairman of the Securities and Exchange Commission, it could very well continue with new, sweeping federal regulatory oversight. Enforcement could, for once, hold the bond raters accountable for their actions — or, more to the point, their inaction.

Even Federal Reserve chairman Ben Bernanke is keeping an eye on the rating agencies' colossal screw-up. During hearings last month, when grilled about their role in the subprime crisis, he said recent legislation will make the rating agencies "more transparent," before adding: "We'll see how that works in the future."

Which leads us to Cox and the SEC. "We've got the budget to do it, and we now have the people in place," the chairman says about the SEC's new interest in making sure the agencies do their job. In an interview with Trader Monthly, Cox said the SEC's New York City offices will be leading the effort, and with good reason. The Big Apple is home to the three big rating agencies: Moody's Investors Service, S&P and Fitch. Cox said the SEC's market-surveillance unit and Office of Compliance Inspections and Examinations will divvy up the regulatory duties. The enforcement division, he added, will be ready to bring cases referred to it by these divisions.

When I asked Cox if he expects cases in the future, he replied: “Sure, over time.” Then he added, “What we’ve got going, if anything, I can’t talk about.”

During a recent hearing, Congresswoman Carolyn Maloney (D–New York) implored with exasperation, “How could the credit-rating agencies be so wrong consistently?” She then enumerated their many errors. The agencies, she said, were “wrong on Mexico, wrong on Asia, wrong on Enron, wrong on subprime. . . . ”

People have been asking that same question for years, and getting the same slew of nonsensical answers — everything from “the rating agencies can’t force the Enrons of the world to provide honest accounting” to “the rating agencies employ second-rate people who can’t get a job at a big Wall Street firm.”

A better question is the one I’ve been posing to SEC officials, and to Cox during our recent interview: How did the agencies get away with being so wrong so many times without the SEC coming down hard? Remember, the agency screw-ups wouldn’t have been so bad if the agencies weren’t so powerful. Bonds, as everyone knows, can’t be sold without a rating, often two. If a company can’t sell debt to finance its operations, if a city can’t issue bonds to build roads and bridges because investors don’t believe in the integrity of the ratings, the economy is toast. With so much power comes responsibility to get things right.

Cox and his staff seem to have recognized the obvious: The agencies aren’t staffed by evil monsters, but they’ve been getting away with financial murder for years because of lax regulation. Remarkably, Cox and his staff say they were powerless to crack down on the bond raters until new legislation was passed last year that paved the way for more rating agencies to exist (previously, the Big Three had a near-monopoly) and giving the SEC — for the first time — direct oversight responsibilities.

To be fair to Cox, he’s new at being chief of the SEC — he took the job two years ago after a long career as a Congressman from blowup-scarred Orange County, California. But the bureaucracy he inherited has once again shown its ineptitude. It’s hard for me to believe the SEC needed an act of Congress to crack down on a business so vital to the securities markets. The bottom line, as far as I’m concerned: The SEC ignored the problem because it believed it had too many more important battles to fight, enabling the bond raters to make money through one of the most flawed and conflicted business models in corporate America. The bond raters are supposed to be working for investors (hence the name Moody’s Investors Service, for example) by assigning letter grades to a bond’s ability to make principal and interest payments. The reality is much different. In rating-world lexicon, AAA means that barring nuclear war, the bonds are good. D means they’re either nearing or in default. The raters say they do work for investors, but that’s in conflict with the way their business model works. Rating agencies are paid by those they rate: companies, municipalities or, in the case of the subprime market, the big Wall Street firms that packaged the loans and sold them to investors.

This conflict has posed huge problems. Municipalities have canceled contracts with rating agencies that took a negative view, and hired those who were easier graders. All that saber-rattling had an impact. I can remember how former New Jersey Governor Christine Todd Whitman attacked a particularly tough rater at Standard & Poor's, who subsequently withdrew from the team that gave the green light to some suspect financing by the state. Such conflicts were at the heart of the rating agencies that missed Enron and a passel of other financial catastrophes. Kenneth Lay, after all, was a valuable client. With a strong economy and a booming housing market, no one seemed to think twice about the fact that the rating agencies were beginning to make big bucks in the subprime-loan market, where their conflicted business model posed a broader problem to the housing market and the entire economy. Over the past decade, packaging subprime loans into sellable securities has been a huge business for Wall Street. Raters who were the easiest graders of the pools of subprime loans — those that demanded the least equity to back up all those CDOs being sold in recent years — got the business. Those who didn't got left out.

Don't just take my word for it — listen to a source of mine who until recently was employed at a Big Three rating agency. "Most people don't really know how the bond raters compete in the structured-finance area," he says. "[At my agency], we tried to do our best, but we also understood the conflicts. We all assumed that if we pounded the table too much we'd be left out of the deal." The rating agencies, in effect, became regulators — by handing out all those investment-grade ratings to the CDOs, they were allowing the banks to lend money. Analysts I speak to say the agencies may have been the single most important factor in the recent housing boom — and now bust — by enabling all those subprime loans to be packaged and sold. It's hard to believe a bunch of geeks in New York working at places like S&P, Moody's and Fitch have so much power, but they do. It's the dirty little secret of Wall Street that, finally, the SEC seems to understand. Cox conceded to me that the rating agencies were given far too much power by lawmakers. "They were empowered by laws and legislation," he says, that mandated the need to get ratings from the Big Three before bonds could come to market. New legislation, Cox says, will take power away from the Big Three by making it easier for new bond-rating houses to be created. The SEC, he adds, will scrutinize their activities like never before. "We now have a model for competition with the additional check of much more regulation."

Cox isn't really prescribing a free-market solution by saying additional rating agencies will help cure the problem, because the same old conflicted business model will continue to exist. One way to foster a more strident, less conflicted rating system would be to force the investor, not the bond issuer, to pay the bill. If that happened, we might not have rating agencies at all, because most investors understand just how lousy their analysis has been. Given their recent track record, envisioning a world without Moody's, Fitch and S&P isn't necessarily a scary thing.

Charles Gasparino is a former Wall Street Journal investigative reporter and the author of the just-published book King of the Club: Richard Grasso and the Survival of the New York Stock Exchange. He is currently on-air editor at CNBC.

FT.com FINANCIAL TIMES

COMMENT & ANALYSIS

Ratings reform

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The big rating agencies – Moody's, Standard & Poor's and Fitch – may not have lost any money in the credit squeeze, but they have taken their share of vitriol and blame. The charge against them is that, at best, they are idiots who misunderstood the risks of structured financial products and, at worst, that they cynically overrated bonds in order to increase profits. Yet if regulators are to intervene, it must be with a clear understanding of what went wrong with ratings and why.

All three credit-raters have been forced to downgrade a slew of US bonds backed by subprime mortgages, on which default rates have risen abruptly. The securities downgraded have included some rated triple-A, which is the safest rating possible and implies an extremely low probability of default. The downgrades do not, by themselves, mean that the original ratings were wrong: a triple-A rating is a likelihood, not a guarantee, and gives no assurance that a bond will maintain its market value. It is also meaningless to say that the ratings agencies were wrong in hindsight – the question is whether they made responsible use of the data they had in 2006 or early 2007. Where they clearly erred, however, is in using the same triple-A ratings that are given to the most creditworthy governments and banks. The ratings were probably wrong – but they were certainly misleading.

Regulators may want to look at how ratings are presented but they should not fiddle with the process. Would the Securities and Exchange Commission have interpreted the minimal historical data available on subprime defaults better than Moody's? It seems unlikely. The more serious charge is that credit ratings were distorted by a fundamental conflict of interest: the agencies are paid by bond issuers, who seek high ratings, rather than investors, who want ratings that are accurate. Regulators should investigate whether there is any evidence that this conflict actually influenced the ratings assigned to mortgage-backed bonds. If there is such evidence then it will be time to consider difficult structural reforms to the industry.

One option is a subscription model, in which investors pay for ratings, but many would try to "free-ride" on the subscriptions of their competitors. The result would be fewer ratings on fewer securities. A better option would be for issuers to pay into an independently managed pool, which would then assign a rating agency, thus breaking the commercial incentive to rate bonds high. Just like a credit rating, however, any regulation or reform should be based on the evidence.

washingtonpost.com

Credit Crisis Caused Rise In Class-Action Fraud Suits

By Carrie Johnson
Washington Post Staff Writer
Friday, January 4, 2008; D01

Class-action lawsuits that accuse companies of defrauding investors increased more than 40 percent last year, fueled by troubled mortgage investments and a volatile stock market, according to a study released yesterday.

Researchers said the rise reflected a surge in lawsuits in the last six months of the year, when the markets bounced on reports of tightened credit access and widening troubles with housing investments. Absent what the study's authors call "systemic shocks" from the credit crisis, the number of class-action cases filed last year would have fallen below recent averages.

Plaintiff lawyers targeted 166 companies last year, including 47 financial services businesses, which have been among the hardest hit by losses in subprime mortgages, according to the report by Stanford University and Cornerstone Research. The 2007 tally contrasts with 116 cases during the comparable period a year earlier. A separate study issued yesterday by NERA Economic Consulting drew similar conclusions.

Word of the spike in litigation came as State Street Corp., which manages money for major institutions, yesterday set aside $618 million to cover legal and other costs related to its subprime mortgage portfolio. The Boston company is one of dozens of industry players fending off investor allegations that it downplayed the risks of mortgage securities that later produced steep losses.

Disputes over bum housing investments are likely to continue, as analysts predict Wall Street banks and lenders will post more losses in the months to come.

"There will be additional companies sued because of subprime in 2008," said Stanford law professor Joseph Grundfest. "I think you can take that to the bank."

At the same time, **law enforcement authorities are investigating possible wrongdoing** among brokers, lenders, **credit-rating agencies** and financial institutions. Investigations of dozens of companies by **officials in several states, the Securities and Exchange Commission and federal prosecutors** are looking to see if mortgage losses were not disclosed and problems or risks were hidden from shareholders. In some cases, investigators are trying to determine whether corporate executives may have dumped their own stock when they knew of approaching problems.

The surge in investor lawsuits bucks a series of setbacks last year for plaintiff lawyers, including a Supreme Court ruling that raised the hurdle for shareholders to proceed with securities cases. One closely monitored 2007 civil fraud case involving California telecommunications company JDS Uniphase ended with a victory for the company last November after a rare, month-long trial.

And two of the nation's most prominent lawyers representing shareholders faced criminal charges for their alleged roles in a decades-long kickback scheme. William S. Lerach, who led the case involving Enron investors, will be sentenced next month after he pleaded guilty last fall to a single criminal conspiracy charge. His former law partner, Melvyn I. Weiss, awaits trial on multiple criminal charges and is fighting the government case.

Although Lerach and Weiss were distracted by their own legal woes, other plaintiff lawyers more than picked up the slack last year.

"Reports of the death of securities class actions are premature," said Columbia University law professor John C. Coffee Jr.

Black Swans

By Thomas Brom

In *The Black Swan: The Impact of the Highly Improbable* (2007), former derivatives trader Nassim Nicholas Taleb uses the 17th-century discovery of Australian black swans-considered impossible by Europeans-as a metaphor to describe rare events with high impact that, in retrospect, seem utterly predictable. Though Taleb's book predates the subprime mortgage melt-down, black swans are a perfect fit for the recurring crises of 21st-century speculative finance.

Certainly the subprime crisis has had high impact. Mortgage originators have gone belly up, and investment banks still aren't finished firing executives and writing off billions of dollars in bad bets associated with their special investment vehicles (SIVs). Treasury Secretary Henry Paulson proposed a "super SIV" bailout-ultimately rejected by the big banks-while Rep. Barney Frank (D-Mass.) cosponsored a reform bill (HR 3915) to assist mortgage consumers.

In retrospect, the unwinding of the speculative subprime market seems utterly predictable. For awhile everyone got a piece, and then everyone got greedy. Risk assessments went undone, or undisclosed, or unread, or unheeded. Crisis followed bad bets, which yielded reluctant devaluations. Lots of investors lost lots of money. Financial markets thrive on crises. But someone has to be blamed. That's why we have lawsuits.

By now plaintiffs attorneys have filed scores of securities class actions and derivative suits against loan originators, underwriters, credit-rating agencies, and SIV sponsors seeking billions of dollars in compensatory damages. Some shareholder complaints allege that banks aided and abetted fraud committed by hedge funds. Others, filed by the purchasers of commercial paper issued by the SIVs, allege the banks that sponsored the SIVs failed to disclose their risks. And finally, complaints filed by current and former bank employees allege breach of fiduciary duties that resulted in huge losses to company pension funds.

With this much alleged wrongdoing, you'd expect defense attorneys to be worried. Apparently, they're not. "The cases filed to date are mostly traditional securities-fraud claims that tend to be brought whenever a public company has a significant write-down," says Richard A. Spehr, a litigation partner in the New York office of Mayer Brown who represents several investment banks and AIG in pending subprime litigation. "What's new here is the variety of defenses, all recently affirmed by the U.S. Supreme Court, that are available to financial institutions." Chief among them, Spehr says, are the heightened pleading requirements incorporated in the Court's decisions in *Dura Pharmaceuticals, Inc. v. Broudo* (544 U.S. 336 (2005)), *Bell Atlantic Corp. v. Twombly* (127 S. Ct. 1955 (2007)), and *Tellabs, Inc. v. Makor Issues & Rights Ltd.* (127 S. Ct. 2499 (2007)).

Establishing loss causation could be a huge hurdle. David M. Furbush, national coleader of the securities litigation group at the Silicon Valley office of Pillsbury Winthrop Shaw Pittman, says that plaintiffs suing based on losses on mortgage-backed securities "may have a hard time tracing the loss to any particular misstatement or omission in the offering documents, since these types of instruments are losing value across the board."

So far the most interesting twist is litigation filed against the credit-rating agencies that graded mortgage-backed securities. At least two putative class actions against credit-rating agencies allege securities fraud and breach of fiduciary duty based on misrepresentations in company financial disclosures. (*Teamsters Local 282 Pension Trust Fund v. Moody's Corp.*, S.D.N.Y., No. 07-CV-8375, filed 9/26/07.); (*Reese v. Bahash*, D.D.C, No. 1:07-CV-01530, filed 8/27/07.)

"The credit-rating agencies are well-paid cheerleaders that helped design and structure these deals," claims Darren J. Robbins, a partner in the San Diego office of Coughlin Stoia Geller Rudman & Robbins and co-counsel in the Reese case, which alleges McGraw-Hill subsidiary Standard & Poor's assigned excessively high ratings to bonds backed by risky subprime mortgages. "Human greed and lucrative business practices are not a good mix," says Robbins. A McGraw-Hill spokesperson simply stated, "We believe the complaint is without any factual or legal merit."

Certainly the credit agencies had an incentive to grade high, because the SIVs that sold commercial paper based on securitized mortgages could do so only if they were rated investment grade. Last fall Congress held hearings on the potential for conflicts of interest when credit agencies provide both credit-risk ratings to investors and regulatory licenses to the issuers of securitized debt. The SEC has begun its own review, and the offices of several state attorneys general have also opened investigations.

At bottom, the factual questions are about risk assessment, conflicts of interest, and disclosure. In a draft study published last year, finance professor Joseph R. Mason of Drexel University and Joshua Rosner of Graham Fisher & Co. noted that the essential role played by the rating agencies gives reason to question whether their asserted and legally upheld "freedom of the press" protection would be valid were it challenged in relation to a structured-finance transaction. ("Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions," Hudson Institute (2007).)

The authors speculated that, "if a rating agency's role in an issuance were determined to move beyond the traditional role of publishing opinions and extended to being determined an 'underwriter,' their liability could become tied to any liabilities of any other 'underwriter' of the transaction."

Plaintiffs lawyers, including Gerald H. Silk, a partner in the New York office of Bernstein Litowitz Berger & Grossmann, find that argument intriguing. "These cases are in the early stages," says Silk, whose firm represents institutional investors in shareholder litigation. "We believe the earlier rulings [regarding the First Amendment rights of rating agencies] occurred in different contexts, and are distinguishable."

But once again, defense attorneys don't appear concerned. Furbush at Pillsbury Winthrop says, "The credit-rating agencies claim their predictions are based on mortgage-default rates-and nothing so far shows that those predictions aren't accurate."

Still, someone needs to be blamed for the high impact of this black swan. Officials must investigate, reports must be written, lawsuits must be filed. "My bones tell me that much of the litigation will be in the Second Circuit-that's where the investment banks are," says Ernest T. Patrikis, a partner in the New York office of Pillsbury Winthrop. "We are now up to our knees in it."

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