

# HERE COME THE REGULATORS

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by Kirke Hasson and Ernie Patrikis



**Kirke M. Hasson**  
Partner, Litigation  
+1.415.983.1077  
kirke.hasson@pillsburylaw.com



**Ernest T. Patrikis**  
Partner, Finance  
+1.212.858.1317  
ernest.patrikis@pillsburylaw.com

*Kirke Hasson and Ernie Patrikis are partners at Pillsbury Winthrop Shaw Pittman LLP, where Kirke co-leads the Litigation practice and Ernie co-leads the Financial Services Regulation practice team. Pillsbury launched the nation's first multidisciplinary subprime and credit crisis group in March 2007.*

The fallout from the subprime and credit crisis continues to highlight imperfections in our banking and finance system. A bright light is now being shined on the patchwork of regulatory bodies, often with overlapping jurisdictions and prerogatives, tasked with overseeing financial and banking entities.

As news stories multiply daily on the crisis and its related investigations by federal, state, and in some instances, city authorities, there is understandable confusion for many board members of public companies. An even greater challenge is realizing whose authority has precedence when an investigation begins. An alphabet soup of regulators, each with its own goals and constituencies and sometimes competitive behavior, has mobilized to address the subprime crisis.

When a major financial scandal begins to make an impact on a significant number of people or a particular industry, as we are now seeing with the subprime meltdown and saw less than a year ago with stock-options backdating, it's not unusual for multiple regulators to wage independent investigations against the same company.

For example, the FBI's inquiry into the subprime mortgage crisis is focused on approximately 20 companies suspected of accounting fraud, improperly securing loans, and insider trading. At least three of those 20 companies are also under investigation by the Securities and Exchange Commission, though no one at the SEC could confirm whether its investigations were related to the FBI probes.

Meanwhile, states like New York are getting into the act: Attorney General Andrew Cuomo is investigating the role of a number of Wall Street firms in the crisis.

Even smaller jurisdictions are launching investigations. In January, the city of Cleveland filed lawsuits against 21 banks, according to the Associated Press. The suits claim that the subprime lending practices of these banks have left behind abandoned homes, creating a public nuisance that hurts property values and tax collections.

## Feds and Friends

When dealing with multiple authorities that are engaged in parallel investigations, it is important to understand the modus operandi of all the players involved and the overall chain of command.

Federal, state, and local investigatory mechanisms are often pooled together in a common effort to investigate high-priority issues such as the subprime crisis. For instance, a new task force met in May in the Eastern District of New York (Brooklyn), to look into potential crimes, including mortgage fraud and securities, trading, and accounting fraud. Led by federal prosecutors, the task force includes the FBI's financial institutions fraud unit, the U.S. Postal Inspection Service, the U.S. Secret Service, the New York State Banking Department, the New York City Department of Investigation, and the Federal Deposit Insurance Corporation (FDIC).

The FBI also facilitates multi-agency law enforcement collaboration through its Office of Law Enforcement Coordination. The SEC, Department of Justice (DOJ), and FBI are working as one team to investigate subprime lending practices.

Conversely, the staffs of the New York Attorney General's office and the enforcement division of the SEC are not known for their close cooperation. In addition to interagency friction, unique challenges that have emerged for those companies facing investigations include having to provide different types of documentation to different regulators, sharing the same documentation multiple times, or undergoing multiple depositions, first by the Attorney General's office, then by the SEC.

Civil enforcement proceedings can lead to criminal proceedings. The subprime crisis is one of the most emotionally charged situations we have seen in many years. And this is an election year, which raises the

stakes for numerous entities. A board faced with an actual or possible encounter with several authorities may need to organize to address the multitude of issues that will be thrown at it. One solution may be for the board to consider organizing a special committee of independent directors to keep abreast of developments. The group may be a separate subcommittee of the audit committee or a temporary panel.

### **SEC: The Market's Top Cop**

The SEC is an independent federal government agency with a mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC's approximately 3,800 staff members are located in Washington, D.C., and throughout its 11 regional offices. The SEC, which was established by the Securities Exchange Act of 1934, can bring only civil, not criminal cases. However, the agency often works with law enforcement entities, including the FBI and the DOJ. In wake of the subprime crisis fallout, the SEC is raising questions and investigating the following issues:

- The accounting treatment and assets of special purpose trusts used to package and sell residential mortgages as securities.
- The adequacy of capital and liquidity at major investment banks and the strength of their risk-management practices.
- The impact on money-market funds from the devaluation of presumptively safe assets.
- The quality of issuer disclosure by public companies involved in structured finance.

- The role of the credit-rating agencies, over which the SEC gained regulatory authority in June 2007.
- The possibility of violations of the securities laws by subprime lenders, investment banks, broker-dealers, and other market participants.

The SEC has approached problems in the subprime securities market with a wide array of regulatory and investigative capabilities. In March 2007, it formed the Subprime Working Group, a task force of more than 100 lawyers, led by Cheryl Scarborough, an associate director in the SEC's enforcement division. As of February, the SEC has opened more than 30 non-public investigations into firms and individuals involved in the subprime securities market. The cases generally involve subprime lenders; investment banks; and other market participants, such as insurers, retail broker-dealers, credit-rating agencies, and home builders.

Subprime lenders fall within SEC jurisdiction if the lenders are public issuers or are involved in the securitization process. Specifically, the SEC is examining the valuations, accounting treatments, and disclosures surrounding mortgage-backed securities. Cases in this area have looked into the level of lenders' involvement in the securitization process and the truthfulness of lenders regarding the quality of loans. Many securitized products have "early payment default provisions" that require lenders to buy them back under certain conditions. The SEC is asking whether lenders properly evaluated these provisions, and if sufficient reserves were taken in light of the contingent default

risk. A related issue includes the potential motive of lenders to mask actual defaults or the value of early payment default provisions on their books. Finally, the SEC remains focused on insider trading, especially in advance of the publication of bad news relating to subprime instruments.

As for investment banks, SEC cases against underwriters relate to selling, trading, holding, and the timing of significant write-downs. Some of the top issues the SEC is examining include: whether initial valuations and the accounting treatment for holdings were performed correctly, whether proper methodology and internal controls were used for valuations, and whether inherent risks were properly disclosed.

Finally, in the retail area, the SEC is looking specifically at whether brokers followed “suitability” requirements when they sold their securities. In a broader sense, the agency is also asking to what extent the current crisis was foreseeable.

### **DOJ: The Long Arm of Justice**

DOJ subprime investigations are likely to center on securities fraud and general antifraud provisions. The DOJ is an executive department of the United States government with Attorney General Michael Mukasey as its head, operating in part through U.S. Attorneys who serve as prosecutors in the 94 judicial districts of the country. It controls all criminal prosecutions and civil suits in which the United States has an interest. In addition, the DOJ controls federal law enforcement.

The FBI is the principal investigative arm of the DOJ. The FBI is authorized to investigate all federal criminal violations that have not been specifically assigned by Congress to another federal agency.

### **Subprime fraud investigations would investigate:**

- Whether there were material misrepresentations and omissions in connection with the sale of the mortgage-backed securities.
- Whether there was an awareness of the true value of the collateral for the securities.
- Whether there was collusion among the market players (i.e., the mortgage loan originator, servicer, underwriter, and issuer of the insurance coverage) regarding the true value of the collateral.

For example, by early February, the U.S. Attorney’s office in Manhattan sought information from the SEC with regard to its investigation of Merrill Lynch. The SEC is said to be investigating whether Merrill Lynch booked inflated prices of mortgage bonds it held, despite knowledge that the valuations had dropped.

As another example, Bear Stearns fund manager Ralph Cioffi is being investigated for fraud by the U.S. Attorney’s Office for the Eastern District of New York. Cioffi allegedly told participants in an investor call that he was “cautiously optimistic” about Bear Sterns’ holding of subprime-related securities just one month after he moved \$2 million of his personal money out of a troubled subprime hedge fund. The *Wall Street Journal* observed that the criminal

probe surrounding Cioffi could “become the highest-profile case to deal with the collateral damage caused to investors by the implosion of the subprime-mortgage market.”

The DOJ may also pursue civil and criminal actions under the federal Truth in Lending Act (TILA), part of the Consumer Credit Protection Act that requires clear disclosure of key terms and costs in lending arrangements. Willful and knowing violations of TILA may give rise to criminal liability.

### **OCC: Policing the Banks**

The Treasury Department’s Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises all national banks. The OCC also supervises the federal branches and agencies of foreign banks. In regulating national banks, the OCC has the power to take supervisory actions against banks that do not comply with laws and regulations or that otherwise engage in unsound banking practices. The agency can also remove officers and directors, negotiate agreements to change banking practices, and issue cease and desist orders as well as civil money penalties.

In the regulatory sphere, the OCC has the authority to issue rules and regulations governing bank investments, lending, and other practices. It employs onsite examiners and its regulatory coordinating mechanisms to monitor market conditions relating to the subprime crisis. The OCC has pledged to work with the Treasury Department and other regulatory agencies to develop policies and actions in this area.

Going back as far as 2001, the OCC has worked with other federal banking regulators to issue supervisory guidance on subprime mortgage lending. Because many lending institutions are not federally regulated, the OCC has worked with the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators to encourage individual states to adopt and effectively enforce guidelines for mortgage brokers under their supervision.

### **The Fed: Regulation Z**

The Federal Reserve has supervisory and regulatory jurisdiction over state banks that are members of the system, as well as bank holding companies, state-licensed branches, and agencies of foreign banks. The Fed's supervisory powers are similar to those of the OCC. The Fed is also responsible for various consumer protection statutes. These are implemented through regulations, such as Regulation Z (Truth in Lending). On December 18, 2007, the Fed issued proposed revisions to Regulation Z to protect consumers from unfair or deceptive home-mortgage lending practices.

### **OTS: Thrifty Supervision**

The Treasury Department's Office of Thrift Supervision (OTS) has regulatory authority over thrift institutions and thrift-institution holding companies. The OTS's supervisory powers are also similar to those of the OCC. OTS has stated recently that it could play a role in protecting consumers and ensuring a level playing field if it licensed mortgage originators and had joint oversight with states over mortgage

banking companies. OTS has taken enforcement action against a federal thrift for failure to manage and control loan origination services outsourced to an affiliate, and for weaknesses in home-mortgage loan activities.

### **Cuomo and Company**

Whether acting under general fraud provisions or specific state "blue sky" laws, many state attorneys general have announced investigations of the subprime mortgage industry and are issuing subpoenas. New York's Martin Act, for example, is a particularly broad and sharp prosecutorial tool which authorizes the state attorney general to investigate any "fraudulent practice" in connection with "the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice, or distribution within or from [New York] of any securities." As of mid-February, the following state regulators and cities have filed cases or disclosed investigations related to the subprime crisis:

- New York Attorney General Cuomo has accused a large real estate appraisal company called eAppraiseIT of colluding with Washington Mutual to inflate the values of homes nationwide, contributing to the subprime crisis. Washington Mutual has since suspended its relationship with [the company]. Cuomo also has subpoenaed Fannie Mae and Freddie Mac to look at "wide-spread collusion." Cuomo, along with Connecticut Attorney General Richard Blumenthal, is investigating whether banks failed to make sufficient disclosures or intentionally withheld

information about the risks of mortgages that were bundled into securities sold to investors.

- Massachusetts Secretary of State William F. Galvin has also been active. He accused a unit of Bear Stearns of failing to disclose to investors a conflict of interest in its trading with two hedge funds managed by the company. The funds collapsed after subprime-linked investments soured. In January, Galvin subpoenaed municipal bond insurers MBIA and Ambac Financial Group, seeking information on how much the firms disclosed to cities and towns about their exposure to mortgage-related investments. On February 1, Galvin filed civil charges against Merrill Lynch, alleging fraud and misrepresentation in connection with mortgage securities sold to the city of Springfield, Mass. This occurred one day after Merrill Lynch agreed to reimburse \$13.9 million to Springfield in a dispute over a shaky subprime-related investment.
- Ohio Attorney General Marc Dann recently filed a class-action shareholder suit, brought on behalf of Ohio's public employee pension plan, against Freddie Mac, alleging a number of violations of the Securities Exchange Act and SEC rules.
- Attorneys general in Illinois and Florida are investigating mortgage lender Countrywide. Additionally, state banking supervisors have supervisory and regulatory authority over state-chartered banks, thrift institutions, and mortgage bankers and brokers. The New York

Banking Department, for example, has initiated a number of remedial actions against mortgage banks.

- Local jurisdictions are also bringing litigation through state courts. In addition to Cleveland's actions, the city of Baltimore sued Wells Fargo, alleging the bank intentionally sold high-interest mortgages more often to black customers than to whites in violation of federal law. More suits from cities and localities are likely.

### Tips for Boards

When facing multiple investigations, the board should consider taking the following steps to ensure that it is dealing with the situation properly:

- Become familiar with the jurisdiction of each authority. Retain counsel and consultants familiar with the operations of the authority. Even before it is broached with a regulating authority, discuss internally what goals for a settlement might be, including avoiding commitments that could adversely affect the company in the longer term. Be cognizant of the impact that each board decision can have on the potential for shareholder litigation.
- Think about the potential ramifications an investigation and/or settlement may have not only on the stock price, but also on the company's reputation with clients, customers, and shareholders. Consider hiring crisis communication counsel to assist with managing that reputation, working in conjunction with the board's legal advisers. Actively discuss whether to resist the authority or to take a more accommodating approach in a situation where the board believes that no wrongdoing has occurred. The effect of a decision to resist can be difficult and expensive; it is not a path taken lightly, especially when criminal enforcement authorities are involved. But it should not be dismissed out of hand.
- Whether it's accounting irregularities, stock-options backdating, or failure to disclose securities documentation related to subprime investments, boards should note that federal prosecutors across the country have been charged with the formidable task of rooting out corporate crime in all of its forms. Since President Bush created the Corporate Fraud Task Force to "restore public and investor confidence in America's corporations" in 2002, the task force has recorded more than 1,200 convictions, including 214 chief executive officers and presidents and 53 chief financial officers. To secure future convictions, prosecutors will not hesitate to draw on data and information gathered from investigations by multiple regulatory agencies.

