

ESSAY

REGULATORY INVESTIGATIONS AND THE CREDIT CRISIS: THE SEARCH FOR VILLAINS

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Many commentators have remarked that 2008 will be known as the modern financial system's *annus horribilis*.² Certainly, the current upheaval in the financial markets is unprecedented. Assumptions about the U.S. financial system that have gone unquestioned since the Great Depression have been shown—in some cases overnight—to be invalid. Former pillars of the financial community have collapsed, been taken over, or been humbled into begging for federal government aid as part of the Troubled Assets Relief Program (“TARP”).³ Economists are predicting the current recession likely will be the worst since the 1930s.⁴ And across the country, citizens are asking angrily how this happened and who is to blame.

Amidst this wreckage, as legislators consider proposals for sweeping regulatory

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2. See, e.g., Rich Miller & Simon Kennedy, *Annus Horribilis Peaks in Anxiety for Global Economy*, BLOOMBERG.COM, Dec. 15, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTb1r1e.BCkY#> (last visited Mar. 20, 2009) (“2008 has been the *Annus Horribilis* for markets, and 2009 is shaping up to be the *Annus Horribilis* for the economy.”) (quoting chief economist at UniCredit MIB in London); *Wall Street's Annus Horribilis*, ECONOMIST, Dec. 11, 2008, available at http://www.economist.com/finance/PrinterFriendly.cfm?story_id=12777703.

3. Pursuant to the Emergency Economic Stabilization Act, passed on October 3, 2008, the Secretary of the Treasury is authorized to establish the Troubled Asset Relief Program (“TARP”) to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary in accordance with the Act. Pub. L. No. 110-343, § 101(a)(1), 122 Stat. 3765, 3767 (2008) (codified at 12 U.S.C. § 5211). The Act provides for funding up to a total limit of \$700 billion. 12 U.S.C. § 5225. The program has been used in part to fund capital infusions by the government into U.S. financial institutions and other corporations totaling approximately \$302 billion as of March 20, 2009. See The Committee For a Responsible Federal Budget, US Budget Watch, <http://www.usbudgetwatch.org/stimulus?filter0=80&filter1=&filter2=&filter3=> (last visited Mar. 20, 2009).

4. See Mark Landler, *Dire Forecast for Global Economy and Trade*, N.Y. TIMES, Dec. 9, 2008, at B1 (“As the World Bank's experts struggled to find a historical analog for the slump, they said it had more in common with the Depression of the 1930s than with the severe recessions of the 1970s or 1980s.”).

reforms, prosecutors and regulatory agencies have begun the arduous and time-consuming process of determining whether any criminal wrongdoing led to the credit crisis.⁵ The fundamental question that prosecutors and regulators face is whether the breakdowns in the American financial system—such as the pandemic of mortgage defaults, writedowns on structured products, massive plummeting in financial institutions' stock prices, and the failures of some of those institutions—were caused by intentional or reckless misconduct, or whether they were simply the result of errors in business judgment. This question will occupy criminal and regulatory enforcement for the coming years. If these breakdowns were the result of criminal misconduct, wrongdoers may face prosecutions and other regulatory sanctions; if, however, the breakdowns were caused merely by poor business decisions, sanctions will be more appropriately limited to the extensive media criticism corporations and executives have already received.

This article surveys the various facets of the credit crisis, the responses of federal and state prosecutors and regulators, and the challenges law enforcement faces in addressing the problems that have arisen in the financial system. Law enforcement agencies have been essentially reactive to these problems, even as they have publicized their efforts extensively. For example, at the federal level, the first credit crisis investigations, into the issuance of subprime mortgages,⁶ were initiated after several subprime mortgage lenders began to report large losses due to widespread mortgage defaults.⁷ Federal regulators then shifted their focus to Collateralized Debt Obligations (“CDOs”)⁸ after leading financial institutions announced massive writedowns arising from their exposure to these complex products. After the collapse of several of these institutions, including Lehman Brothers, AIG, Fannie Mae, Freddie Mac, and Washington Mutual, federal regulators shifted their attention to investigating the accuracy of the companies' public disclosures regarding liquidity and asset valuations.⁹ And when allegations surfaced that illegal short selling had contributed to the precipitous stock price

5. We use the term “credit crisis” as a general label for the financial havoc that began in 2007 with the writedowns by banks and other financial institutions due to exposure to subprime residential mortgages and that has since led to a general deterioration in the credit and equity markets.

6. Subprime mortgages are loans made to borrowers who have impaired creditworthiness because of weak credit histories, payment delinquencies, charge-offs, judgments or bankruptcies, lower credit bureau risk scores (“FICO scores”), or other characteristics that are associated with higher probabilities of default. *See* Julie R. Caggiano et al., *Subprime Mortgage and Predatory Lending Law Developments*, 63 *BUS. LAW.* 625, 625-26 (2008); *see also* DOUGLAS J. LUCAS ET AL., *COLLATERALIZED DEBT OBLIGATIONS: STRUCTURES AND ANALYSIS* 113 (2d ed. 2006) (describing subprime mortgages).

7. *See infra* Part II.A.

8. In a CDO, issuers offer securities to investors and use the money raised to purchase a portfolio of financial assets such as corporate loans, credit card receivables, or mortgage-backed securities. Under the CDO arrangement, cash flows from the underlying asset portfolio are distributed to investors in a set priority determined by the relative seniority of the securities, called “tranches.” *See* DOUGLAS J. LUCAS ET AL., *DEVELOPMENTS IN COLLATERALIZED DEBT OBLIGATIONS: NEW PRODUCTS AND INSIGHTS* 3 (2007).

9. *See infra* Part II.B.

drops preceding some of these institutions' collapse, short sellers became the primary regulatory focus.¹⁰

The same reactive pattern has occurred at the state level. Accusations that deceptive and fraudulent lending practices had contributed to widespread subprime mortgage defaults led state regulators to investigate predatory lending at major mortgage lenders.¹¹ After the leading credit rating agencies announced downgrades on securities backed by subprime mortgages in July 2007, causing a steep drop in the prices of many equity and fixed income securities, state regulators began investigating the propriety of the procedures agencies had used in rating mortgage-backed securities.¹² And when the credit crisis spread from the mortgage-backed securities market to the auction rate securities ("ARS") market in early 2008, state investigations of ARS issuers followed.¹³ In all of these areas, ex ante regulation failed to prevent the financial crisis, and state and federal agencies have been playing catch up ever since. To underscore the point, the latest regulatory push—or perhaps more accurately, regulatory windfall¹⁴—as we go to press has been uncovering Ponzi schemes, sparked by Wall Street investment manager Bernard Madoff's revelations in the closing weeks of 2008.¹⁵

Despite the number of credit crisis-related investigations that law enforcement agencies have opened over the last two years, there have been remarkably few major regulatory actions or prosecutions to date.¹⁶ As this article explains, public anger and the resulting pressure on regulators to find culprits aside, serious hurdles

10. See *infra* Part II.C.

11. See *infra* Part III.A. In many of the areas state law enforcement agencies have been active, federal agencies also have been involved or launched their own investigations. Similarly, state law enforcement agencies have opened investigations into some of the areas where their federal counterparts have focused. As this article discusses, the investigations led by state law enforcement into predatory lending practices, rating agency decisions, and disclosures about auction rate securities provide an interesting contrast to the investigations led by federal law enforcement into mortgage fraud, valuation issues at major financial institutions, and short selling. Thus, it is useful to make a distinction between areas where federal law enforcement has focused and those where state law enforcement has focused, notwithstanding the absence of a completely clean division.

12. See *infra* Part III.B.

13. See *infra* Part III.C.

14. Cf. White Collar Crime Prof Blog, Fraud is the "In" Crime, http://lawprofessors.typepad.com/whitecollarcrime_blog/2009/03/fraud-is-the-in.html (Mar. 1, 2009) (last visited Mar. 20, 2009) (noting that DOJ has growing number of fraud cases "dropping in its lap" as more investors scrutinize their investments).

15. See Amir Efrati et al., *Top Broker Accused of \$50 Billion Fraud: Sons Turned in Madoff After He Allegedly Told Them His Investment-Advisory Business for the Wealthy was Giant Ponzi Scheme*, WALL ST. J., Dec. 12., 2008, at A1 (describing SEC and FBI actions against Madoff); see also Glenn R. Simpson et al., *The Stanford Affair: Madoff Case Led SEC to Intensify Stanford Probe*, WALL ST. J., Feb. 19, 2009, at A14 (describing SEC civil action against R. Allen Stanford); Steve Stecklow, *In Echoes of Madoff, Ponzi Cases Proliferate*, WALL ST. J., Jan. 29, 2009, at A1 (describing six multimillion dollar fraud cases including alleged Ponzi schemes).

16. This is in sharp contrast to the civil realm, in which class actions suits have been filed at a torrid pace. 607 subprime-related civil cases were filed in the 18 months ending June 30, 2008; 249 (41%) of these cases were securities class actions. See *Subprime Mortgage Litigation Filings Surpass S&L Benchmark, Navigant Consulting Study Finds More Subprime-Related Lawsuits Filed So Far in 2008 Than All of 2007*, REUTERS.COM, Sept. 11, 2008, <http://www.reuters.com/article/pressRelease/idUS165694+11-Sep-2008+BW20080911> (last visited Mar. 20, 2009). By contrast, 599 civil cases were filed during the entire S&L crisis in the early 1990s. See *id.*

confront successful law enforcement actions relating to wrongdoing that may have occurred during the credit crisis. The financial instruments and arrangements at issue in the credit crisis investigations are highly complex. In many of the areas being investigated, there simply may not have been intentional misconduct or criminally reckless behavior, but rather plain bad judgment on the part of market actors. Even in situations where there was wrongdoing, the time and resources required to mount investigations and the burden of proving intent to defraud are formidable obstacles for prosecutors and regulators to surmount, except in the most straightforward of fraud cases. In sum, in its search for credit-crisis villains, law enforcement may not be able to bring successful criminal or regulatory enforcement cases to punish wrongdoing, at least in connection with the most complicated areas of financial transactions involving the largest dollar amounts. At the very least, these investigations will be highly time and resource intensive.

Part I of this article provides a brief chronology of the credit crisis to provide background and context for the resulting law enforcement investigations. Part II discusses the various DOJ, SEC, and other federal law enforcement investigations that have emerged from the crisis; the many challenges federal prosecutors and regulators face in making cases; and the few criminal and regulatory cases that have been brought thus far. Part III provides an overview of state law enforcement investigations. The credit crisis has witnessed, often behind the scenes, an intense competition between different state and federal agencies under pressure to demonstrate aggressive action in addressing the breakdowns in the financial system; a comparison of the different general approaches and focus of state and federal regulators provides an interesting contrast in enforcement tools, tactics and goals. The federal approach of conducting thorough, historical investigations in search of individual and corporate wrongdoers, while advancing the important goals of deterrence and upholding the rule of law, has produced few cases thus far because of the substantial obstacles to uncovering wrongdoing noted above. By contrast, some state investigations (sometimes in partnership with federal regulators like the SEC) have avoided these obstacles by focusing on consumer relief and systemic reform. This approach has yielded some immediately visible results, although it may be questionable whether the corporate conduct involved has always justified the type of relief or reforms imposed. After comparing the federal and state investigations, the article concludes with some tentative predictions of what the future holds for law enforcement actions relating to the credit crisis.

PART I: THE CREDIT CRISIS UNFOLDS

Financial commentators have competed to find language sufficiently hyperbolic to describe the events of the last two years. Most would probably agree with John Lipsky, First Deputy Managing Director of the International Monetary Fund (“IMF”), who has described the recent events as “the worst financial crisis since

the Great Depression.”¹⁷ Similarly, John C. Dugan, Comptroller of the Currency, has described the financial crisis as “stunning, mind-boggling, earth shaking, eye-popping,” but conceded that “even these words . . . don’t adequately capture what’s happened.”¹⁸

In short, the last two years have completely reordered the global financial system. Financial institutions have suffered unparalleled losses. More than \$800 billion in asset writedowns and credit losses at more than one hundred of the world’s largest banks and securities firms had been announced by February 2009, most of which stemmed from mortgage-related products.¹⁹ Some commentators have predicted that the worst is not over, and that additional asset writedowns are in the offing.²⁰ Since early 2008, there has been a severe lack of liquidity in nearly every corner of the credit markets,²¹ including mortgage-backed securities,²² auction rate securities,²³ commercial paper,²⁴ and municipal and corporate bonds.²⁵ Established financial institutions, including Bear Stearns, Lehman Brothers, AIG,

17. IMF’s *Financial General Plots Strategy to End the Credit Crisis*, TELEGRAPH.CO.UK, Apr. 15, 2008, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2788081/IMF's-financial-general-plots-strategy-to-end-the-credit-crisis.html> (last visited Mar. 20, 2009).

18. John C. Dugan, Comptroller of the Currency, Remarks Before the Office of the Comptroller of the Currency’s 2008 Managers’ Conference (Oct. 20, 2008), <http://www.occ.treas.gov/ftp/release/2008-126a.pdf> (last visited Mar. 20, 2009).

19. Rodney Yap & Dave Pierson, *Banks’ Subprime Market-Related Losses Top \$713 Billion*, BLOOMBERG.COM, Nov. 25, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&sid=aQBNVIONOiAc> (last visited Mar. 20, 2009). Since July 2007, these financial institutions have raised more than \$855 billion in capital to cope with these losses. *Id.*

20. The IMF in its Global Financial Stability Report (“GFSR”), issued in October 2008, increased its estimate of total near-term global losses on U.S. credit-related debt from \$945 billion in its April 2008 GFSR to \$1.4 trillion. The upward revision reflects its increased loss estimates on corporate debt and prime residential mortgages, reflecting the “deterioration in the debt of financial institutions since April,” and “a more negative base case home price scenario.” INT’L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL STRESS AND DELEVERAGING, MACROECONOMIC IMPLICATIONS AND POLICY, OCTOBER 2008, at 66 (2008), available at <http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf>; see also Robin Goldwyn Blumenthal, *Yes, That’s \$2 Trillion of Debt-Related Losses*, BARRONS.COM, Aug. 4, 2008, <http://online.barrons.com/article/SB121763156934206007.html?page=1> (last visited Mar. 20, 2009) (quoting estimate by economist Nouriel Roubini that financial crisis will lead to credit losses of at least \$1 trillion and “most likely closer to \$2 trillion”).

21. Knowledge@Wharton, *Collateralized Damage: Commercial Mortgage Securities Are at a Standstill*, RESEARCH AT PENN, July 23, 2008, <http://www.upenn.edu/pennnews/researchatpenn/articleprint.php?1471&bus> (last visited Mar. 20, 2009) (quoting Wharton Professor Todd Sinai as saying “[t]he liquidity crunch is across the board.”).

22. Press Release, Real Estate Roundtable, Real Estate CEOs Foresee Dark Clouds on Economic Horizon; Paralyzed Credit Markets, Property Value Expected to Drop Further (Nov. 19, 2008), <http://www.mortgagemag.com/news/2008/1116/1000009815070.htm> (last visited Mar. 20, 2009) (“Real estate is now experiencing a seismic liquidity shock.”).

23. See Dakin Campbell, *Broker-Dealers Face Auction-Rate Failures: Fourteen Banks See As Much As \$10B Fail*, BOND BUYER, Feb. 14, 2008, at 1 (describing liquidity shortages in auction rate securities market).

24. See *Fitch Comment: Bank Agreements & Revolving Credit Draws*, BUS. & FIN. WK., Oct. 11, 2008, at 570 (describing lack of liquidity in commercial paper market).

25. Tim Grogan & Steve Setzer, *All Sectors Go Negative Next Year As A Real Recession Rattles Markets*, ENGINEERING NEWS-RECORD.COM, Nov. 12, 2008, <http://enr.construction.com/features/bizLabor/archives/081112-1.asp> (last visited Mar. 20, 2009) (“[T]here is an unprecedented backlog of long-term project-related municipal

Washington Mutual, Fannie Mae, and Freddie Mac, have gone bankrupt, undergone fundamental reorganizations, or at best, continue to hobble along in a state of near-bankruptcy.²⁶ The American financial system has undergone an historic restructuring, as “the big five” independent investment banks have essentially disappeared,²⁷ and independent financial institutions such as American Express and CIT Group²⁸ have restructured or applied to restructure themselves as bank holding companies in order to access billions in aid from the TARP.²⁹ Under President Barack Obama, the U.S. Government has pledged nearly \$800 billion in stimulus spending,³⁰ but as this article goes to press, the U.S. government and governments around the world continue to struggle with how to respond to these events and restore the vitality of the global economy.³¹

These developments did not arise overnight. The proliferation of subprime adjustable-rate mortgages, the ensuing pandemic of defaults in the subprime sector, and the collapse of the housing market provided the catalysts.³² From the housing market, the crisis spread to the broader structured products market,³³ then to other types of fixed income securities,³⁴ and ultimately to the broader equity

debt waiting to come to market, but the market remains frozen.”) (citing managing director of Municipal Market Advisors).

26. See E.S. Browning, *After the Collapse, Guarded Hope for '09*, WALL ST. J., Jan. 2, 2009, at R1 (reviewing financial crisis developments in 2008).

27. See Editorial, *And Then There Were None: What the Death of the Investment Bank Means for Wall Street*, ECONOMIST, Sept. 25, 2008, available at http://www.economist.com/finance/displaystory.cfm?story_id=12305537&fsrc=rss; Editorial, *The End of Wall Street*, WALL ST. J., Sept. 23, 2008, at A28.

28. See Eric Dash, *American Express To Be Bank Holding Company*, N.Y. TIMES, Nov. 10, 2008, at B2; Kerry E. Grace, *CIT Looks to Transform Into Bank*, WSJ.COM, Nov. 13, 2008, <http://online.wsj.com/article/SB122659073481624621.html> (last visited Mar. 20, 2009).

29. Even GMAC Financial Services, the financing arm of General Motors, has changed its capital structure to qualify as a bank holding company in order to be eligible for TARP funds. See Maurna Desmond, *GMAC's Inside-Out TARP*, FORBES.COM, Nov. 20, 2008, http://www.forbes.com/2008/11/20/gmac-tarp-capital-markets-equity-cx_md_1120markets11.html (last visited Mar. 20, 2009).

30. See Laura Meckler, *Obama Signs Stimulus into Law*, WSJ.COM, Feb. 18, 2009, <http://online.wsj.com/article/SB123487951033799545.html> (last visited Mar. 20, 2009).

31. See Damian Paletta & Stephen Fidler, *G-20 Commits to Recovery Measures, Not Stimulus Spending*, WALL ST. J., Mar. 16, 2009, at A6.

32. For a concise treatment of the catalysts of the credit crisis, see generally JAMES R. BARTH ET AL., MILKEN INSTITUTE, *THE RISE AND FALL OF THE U.S. MORTGAGE AND CREDIT MARKETS* (2009), available at <http://www.milkeninstitute.org/pdf/Riseandfallexcerpt.pdf>.

33. Structured products are nonstandard financial instruments specifically tailored to meet client needs. Structured products may not trade actively; in such instances (as has occurred for many structured products during the credit crisis), financial institutions must rely on a model to determine the price they charge for these products. The risk of mispricing these instruments accordingly is much greater than for actively traded products that are regularly quoted on exchanges. See JOHN C. HULL, *RISK MANAGEMENT AND FINANCIAL INSTITUTIONS* 351–52 (2007).

34. Fixed-income securities typically promise the investor a specified cash flow (or multiple cash flows) at a specified time or times in the future. If all of these cash flows (except for the last one) are of the same size, they are generally referred to as coupon payments. The specified date beyond which the investor will no longer receive cash flows is known as the maturity date. On this date, the investor receives the principal (also known as the par value or face value) associated with the security, along with the last coupon payment. Examples of fixed-income

markets and the global economy. Here, in brief, is a chronology of the credit crisis up to the present:

- *2006—Spring 2007: Subprime mortgage defaults increase.* Throughout 2006, delinquency rates on U.S. subprime mortgages rose, leading to bankruptcies at several subprime lenders.³⁵ In December 2006 and January 2007, interest rate premiums on CDOs, many of which had subprime mortgages as the underlying securities, jumped sharply in response to the spike in defaults.³⁶ In early February, the ABX Index, which purportedly reflects the price of a basket of subprime securities, fell to a new low.³⁷
- *June—August 2007: Bear Stearns CDO hedge funds collapse.* Two Bear Stearns hedge funds reported in June 2007 that the continued slump in housing had brought them to the brink of collapse.³⁸ Despite Bear Stearns' pledge of over \$3 billion to bail out one of the affected funds, both eventually failed, filing for bankruptcy on August 1, 2007.³⁹ As the subprime problems began to ripple through other markets, Goldman Sachs announced that, along with its investors, it would inject over \$3 billion into its Global Equity Opportunities Fund, which had lost about 30% of its value in one week.⁴⁰
- *July 2007: Main rating agencies downgrade subprime securities.* Responding to the problems in the subprime mortgage market, the three largest credit rating agencies announced plans to downgrade hundreds of bonds backed by subprime residential mortgages.⁴¹ The ratings downgrades immediately spooked an already nervous market, leading investors to flee certain stocks and low-quality bonds.⁴²
- *October 2007—January 2008: Major financial institutions take massive CDO writedowns.* In October 2007, major financial institutions started to announce substantial writedowns on CDO positions and other subprime assets as a result of the deterioration of the subprime market. By the end of

securities range from ultra-safe U.S. Treasury Bonds to bonds issued by private or foreign corporations or other entities of varying degrees of credit risk. See WILLIAM F. SHARPE ET AL., *INVESTMENTS* ch. 14 (5th ed. 1994).

35. See *Timeline: The Credit Crunch of 2007/2008*, REUTERS.COM, Aug. 5, 2008, <http://www.reuters.com/article/gc06/idUSL155564520080805> (last visited Mar. 20, 2009).

36. See *id.*

37. See Jody Shenn & Shannon D. Harrington, *Subprime Mortgage Bond Risks Surge, Index Suggests*, BLOOMBERG.COM, Feb. 8, 2007, http://www.bloomberg.com/apps/news?pid=20601103&sid=a3ztUp9Z6_UE&refer=us (last visited Mar. 20, 2009).

38. See Kate Kelly et al., *Two Big Funds at Bear Stearns Face Shutdown*, WALL ST. J., June 20, 2007, at A1.

39. See Matthew Goldstein & David Henry, *Bear Stearns Bets Wrong*, BUS. WK., Oct. 22, 2007, available at http://www.businessweek.com/magazine/content/07_43/b4055001.htm (detailing the collapse and bankruptcy of the Bear Stearns hedge funds).

40. See Jenny Anderson, *Goldman and Investors to Put \$3 Billion Into Fund*, N.Y. TIMES.COM, Aug. 14, 2007, <http://www.nytimes.com/2007/08/14/business/14goldman.html> (last visited Mar. 20, 2009).

41. See Serena Ng & Ruth Simon, *Rating Cuts By S&P, Moody's Rattle Investors*, WALL ST. J., July 11, 2007, at A1.

42. See Bloomberg News, *Fitch May Downgrade Bonds Tied to Subprime Mortgages*, N.Y. TIMES, July 13, 2007, at C7.

October, Merrill Lynch reported the biggest loss in its 93-year history after taking \$8.4 billion in writedowns, primarily on subprime mortgages and CDO positions.⁴³ In December, UBS announced a further \$10 billion writedown in debts linked to subprime U.S. residential mortgages, on top of \$3.7 billion in writedowns it had announced just two months earlier.⁴⁴ Morgan Stanley followed UBS, reporting a \$9.4 billion writedown, primarily due to soured bets on mortgage-related debt.⁴⁵ On December 19, 2007, S&P put AAA-rated monoline insurers MBIA Inc. and Ambac Financial Group Inc., the world's largest bond insurers, on negative watch, as the subprime crisis infected the traditionally safe business of insuring municipal bonds.⁴⁶ According to one estimate, MBIA's guaranty business had insured about \$652 billion of municipal and structured finance bonds, while Ambac had insured \$546 billion.⁴⁷ In January 2008, Citigroup wrote down approximately \$18.1 billion on subprime mortgage-related debt, resulting in a \$9.83 billion fourth-quarter loss, the largest quarterly loss in the bank's history.⁴⁸

- *Late January—Early February 2008: Auction rate securities market breaks down.* In January 2008, in the face of the deterioration of the monoline insurers who insured many auction rate securities and the decrease in demand for fixed income securities, a large portion of the \$330 billion Auction Rate Securities (“ARS”)⁴⁹ market began to fail; by mid February, the ARS market came to a virtual halt.⁵⁰
- *March 14–16, 2008: Bear Stearns collapses.* Bear Stearns collapsed after

43. See Bradley Keoun, *Merrill Lynch Reports Loss on \$8.4 Billion Writedown*, BLOOMBERG.COM, Oct. 24, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aL9aYm7aCkqY&refer=home> (last visited Mar. 20, 2009).

44. See Mark Landler & Julia Werdiger, *UBS Records a Big Write-Down and Sells a Stake*, N.Y. TIMES, Dec. 11 2007, at C1.

45. See Joe Bel Bruno, *Morgan Stanley Reports \$9.4 Billion Writedown, Sells \$5 Billion Stake to China*, SEATTLE TIMES, Dec. 19, 2007, http://seattletimes.nwsource.com/html/business/technology/2004082759_webmorgan19.html (last visited Mar. 20, 2009).

46. See Vikas Bajaj, *Bond Insurer Cut to Junk; Negative Outlook for 4 More*, N.Y. TIMES, Dec. 20 2007, at C1.

47. See Christine Richard, *Ambac, MBIA Outlook Lowered by S&P, ACA Cut to CCC*, BLOOMBERG.COM, Dec. 19, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a0IcyRVRTZxk> (last visited Mar. 20, 2009).

48. See Andrew Ross Sorkin, *Citi Writes Down \$18 Billion; Merrill Gets Infusion*, DEALBOOK, Jan. 15, 2008, <http://dealbook.blogs.nytimes.com/2008/01/15/citi-writes-down-181-billion-and-cuts-dividend> (last visited Mar. 20, 2009).

49. ARS are taxable and tax-exempt long-term securities—either bonds with maturities up to thirty years or preferred stock with no maturity—issued primarily by municipalities, student loan authorities, and closed-end mutual funds. The interest payments on ARS are determined through a modified Dutch auction, which operates to reset interest rates every seven to forty-nine days. The mechanism thus allows issuers to issue long-term debt while paying short-term interest rates (generally lower than long-term interest rates). See *FACTBOX: What Are Auction-Rate Securities?*, REUTERS.COM, Aug. 7, 2008, <http://www.reuters.com/article/businessNews/idUSN0727775620080807> (last visited Mar. 20, 2009).

50. See *Auction Rate Securities Market: A Review of Problems and Potential Resolutions: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 11, 37 (2008) (statement of Linda Thomsen, Director, Division of Enforcement, U.S. Securities and Exchange Commission) [hereinafter Thomsen Testimony].

market rumors of its imminent failure caused a run on the bank, leading to its sale to JPMorgan Chase at the Federal Reserve's insistence.⁵¹

- *July 11, 2008: IndyMac seized by FDIC.* Because of its exposure to subprime and Alt-A loans, IndyMac Bancorp Inc. was seized by FDIC, after a bank run by depositors left the California mortgage lender without sufficient liquidity to meet its obligations.⁵²
- *September 7, 2008: U.S. government seizes control of Fannie Mae and Freddie Mac.* Faced with massive loan losses on their book of insured mortgages, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) were taken over by the Federal Housing Finance Agency ("FHFA"), which placed the two government-sponsored entities into a so-called "conservatorship," replacing the two companies' chief executives and eliminating their dividends. The plan called for the Treasury to purchase up to \$100 billion of stock in each company and provided for secured short-term funding.⁵³
- *September 15, 2008: Lehman Brothers files for bankruptcy and Merrill is sold.* As a result largely of the market's rejection of independent investment banks that had little depository base and relied on the credit markets for funding, Lehman Brothers Holdings Inc., the fourth-largest U.S. investment bank, filed for Chapter 11 bankruptcy, the largest such filing in history, with more than \$613 billion in debt.⁵⁴ The same day, Bank of America agreed to acquire Merrill Lynch for about \$50 billion, after Merrill suffered \$52.2 billion in losses and writedowns from subprime-related mortgage debt.⁵⁵
- *September 16, 2008: AIG bailed out.* Faced with massive losses in a unit of insurance giant American Insurance Group ("AIG") that had sold credit default swap ("CDS")⁵⁶ protection on mortgage-backed CDOs, the Federal

51. See Andrew Ross Sorkin, *JP Morgan Pays \$2 a Share for Bear Stearns*, N.Y. TIMES, Mar. 17, 2008, at A1; see also Landon Thomas Jr. & Eric Dash, *Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid*, N.Y. TIMES, Mar. 15, 2008, at C1 (describing change in Bear sale terms).

52. Ari Levy & David Milkenberg, *IndyMac Seized by U.S. Regulators Amid Cash Crunch*, BLOOMBERG.COM, July 11, 2008, <http://www.bloomberg.com/apps/news?pid=20601110&sid=afqgUyWiMPuY> (last visited Mar. 20, 2009). IndyMac specialized in so-called Alt-A mortgages, which were considered less risky than subprime but more risky than prime mortgage loans, and which did not require borrowers to provide documentation of their incomes. See *id.*

53. Rebecca Christie & Dawn Kopecki, *Paulson Engineers U.S. Takeover of Fannie, Freddie*, BLOOMBERG.COM, Sept. 7, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=auCiw0BP4Fyk&refer=home> (last visited Mar. 20, 2009).

54. Yalman Onaran & Christopher Scinta, *Lehman Files Biggest Bankruptcy After Suitors Balk*, BLOOMBERG.COM, Sept. 15, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a6cDDYU5QYyw&refer=home> (last visited Mar. 20, 2009).

55. David Milkenberg & Bradley Keoun, *Bank of America to Acquire Merrill as Crisis Deepens*, BLOOMBERG.COM, Sept. 15, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=az4ntq7NOJME&refer=home> (last visited Mar. 20, 2009).

56. CDS are contracts intended to insure against the risk of a particular company's default. A CDS buyer will make periodic payments to the seller during the swap period or until a default (called a "credit event") occurs. If a credit event occurs at the company during the swap period, the CDS buyer has the right to sell bonds issued by the company for their face value to the seller, who is obliged to purchase them. In this event, the payout is often substantial. See HULL, *supra* note 33, at 526–27.

Reserve Bank of New York provided \$85 billion emergency funding to the company in exchange for nearly 80% of its stock, after deciding that its disorderly failure would have created too much disruption to the nation's economy.⁵⁷

- *September 21, 2008: Goldman Sachs and Morgan Stanley become bank holding companies.* The last of the major independent investment banks transformed themselves into bank holding companies, subject to greater regulation and capital limitations, in a move that allowed them access to the full array of the Federal Reserve's lending facilities.⁵⁸
- *September 26, 2008: Washington Mutual seized by federal regulators.* Washington Mutual ("WAMU") was seized by regulators and its branches and assets were sold to JPMorgan Chase in the biggest bank failure in history.⁵⁹
- *October 2008: Financial institution bailed out.* On October 3, 2008, Congress approved a \$700 billion bailout plan, pursuant to the Economic Emergency Stabilization Act.⁶⁰ On October 13, 2008, the Department of Treasury announced a plan to invest up to \$250 billion in U.S. banks. The plan also called for government guarantees of new debt issued by banks for three years, as well as an unlimited FDIC guarantee on bank deposits in accounts that do not bear interest (typically those of businesses).⁶¹
- *December 2008: Madoff scandal emerges.* Bernard Madoff, a former non-executive Chairman of the NASDAQ stock market, was arrested and charged with securities fraud for allegedly swindling \$50 billion dollars from investors in what has been billed as the largest Ponzi scheme in U.S. history.⁶²
- *January–February 2009: U.S. passes stimulus package.* On February 17, 2009, President Barack Obama signed into law a \$787 billion stimulus package, calling it the most sweeping financial legislation enacted in U.S. history.⁶³

57. *Fed to Lend \$85 Billion to AIG, Take 80 Percent Stake*, REUTERS.COM, Sept. 16, 2008, <http://www.reuters.com/article/businessNews/idUSN1440161120080917> (last visited Mar. 20, 2009).

58. Andrew Ross Sorkin & Vikas Bajaj, *Radical Shift for Goldman and Morgan*, N.Y. TIMES, Sept. 22, 2008, at A1.

59. Ari Levy & Elizabeth Hester, *WaMu Assets Sold to JPMorgan in Record Bank Failure*, BLOOMBERG.COM, Sept. 26, 2008, <http://www.bloomberg.com/apps/news?pid=20601110&sid=aVA8ErWOAjmI> (last visited Mar. 20, 2009).

60. See David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 3, 2008, at A1.

61. Mark Landler, *U.S. Investing \$250 Billion in Banks*, N.Y. TIMES.COM, Oct. 13, 2008, <http://www.nytimes.com/2008/10/14/business/economy/14treasury.html?pagewanted=all> (last visited Mar. 20, 2009).

62. Diana Henriques & Zachery Kouwe, *Prominent Trader Accused of Defrauding Clients*, N.Y. TIMES, Dec. 11, 2008, at A1. In a criminal information filed on Mar. 10, 2009, the United States Attorney's Office for the Southern District of New York estimated that on or about December 1, 2008, Madoff's company issued account statements totaling \$64.8 billion, when in fact the company held only a small fraction of that balance on behalf of its clients. See Information at 7–8, *United States v. Madoff*, No. 09 Crim 213 (S.D.N.Y. Mar. 10, 2009).

63. See Michael A. Fletcher, *Obama Leaves D.C. to Sign Stimulus Bill*, WASH. POST, Feb. 18, 2009, at A05.

The credit crisis has severely impacted the United States and the rest of the world,⁶⁴ and additional significant events may well lie ahead. In the wake of these calamitous developments, a natural question is whether, and to what extent, the crisis was caused not simply by bad judgments or greed, but by criminal misconduct. All of the market actors mentioned in this chronology accordingly have come under scrutiny from various federal and state law enforcement agencies, themselves under pressure to demonstrate aggressive action in addressing the credit crisis. These investigations, and the obstacles confronting prosecutors and regulators during the course of these investigations, are the subject of the next two sections.

PART II: FEDERAL CRIMINAL AND SEC INVESTIGATIONS

Federal regulators and law enforcement agencies, eager to demonstrate they are acting to uncover criminal activity, have responded to the credit crisis by opening a substantial number of investigations. While many of the investigations are ongoing, to date there have been few major cases against wrongdoers. A number of significant obstacles, including the time and resources necessary to investigate and uncover wrongdoing, as well as the difficulty in apportioning blame and proving intent to defraud, confront successful law enforcement actions. This Part discusses the various federal investigations related to the credit crisis, the challenges prosecutors and regulators face, and the few cases that have been brought thus far.

A. *Mortgage Fraud Investigations*

Many have pointed to mortgage fraud as one of the major catalysts for the credit crisis. Unlike the other financial markets discussed in this article, where law enforcement may struggle to find widespread wrongdoing, the mortgage industry undoubtedly faced a widespread and growing problem in the years leading up to the crisis. Nonetheless, as in other financial sectors under investigation, there have been relatively few major federal mortgage fraud prosecutions to date, recent publicity and law enforcement scrutiny notwithstanding. The complexity inherent in investigating mortgage fraud, combined with the sheer size of the problem and federal resource constraints, makes difficult effective prosecution of criminal behavior in the industry. At the same time, in the ongoing federal investigations into whether major mortgage lenders were complicit in mortgage frauds or committed other accounting or securities frauds, law enforcement must confront the tricky task of how to prove that criminal behavior occurred. These obstacles likely will continue to stymie law enforcement efforts to systematically punish

64. See, e.g., Adrian Michaels, *From Wall Street to All Streets*, DAILY TELEGRAPH (London), Feb. 21, 2009, at 17; Ian Bremmer & Nouriel Roubini, *Expect the World Economy to Suffer Through 2009*, WALL ST. J., Jan. 23, 2009, at A15.

fraudulent acts in the industry.⁶⁵

There are many different types of mortgage fraud, ranging from simple misrepresentations regarding income or assets on mortgage applications⁶⁶ to more sophisticated schemes involving multiple parties. For example, one common scheme involves illegal property “flipping”: the fraudster purchases property, obtains a fraudulent appraisal that artificially inflates the value of the property, and sells (“flips”) the property to a victim who unwittingly relies on the fraudulent appraisal as a true measure of the property’s value.⁶⁷ Another scheme involves equity “skimming”: the fraudster uses a straw buyer to obtain a mortgage loan, often with false income documents or credit reports. After closing, the straw buyer deeds the property to the fraudster, surrendering all rights to it and providing no guarantee to title. The fraudster fails to make mortgage payments, but rents the property until the lender forecloses.⁶⁸

While mortgage fraud dates back centuries, recent real estate market conditions—including rising prices and reduced oversight—have served as a perfect incubator for fraud. Rapidly rising property prices, fueled by a prolonged period of low interest rates in the years preceding the credit crisis,⁶⁹ increased the temptation for borrowers to misrepresent mortgage applications in order to qualify for loans.⁷⁰ During the same period, mortgage lenders streamlined loan application processes, reducing documentation requirements and other safeguards against fraud in approving mortgage loans.⁷¹ These conditions have contributed to a reported

65. There is no single federal statute covering mortgage fraud. Rather, mortgage fraud may be punishable under a variety of statutes, including 18 U.S.C. § 1341 (2006) (mail fraud), 18 U.S.C. § 1343 (2006) (wire fraud); and 18 U.S.C. § 1344 (2006) (bank fraud). Several specific forms of mortgage fraud are also criminalized under separate statutes. *See infra* notes 66 & 68 and accompanying text. In addition, mortgage fraud schemes may include particular actions that are criminalized under separate statutes. *See, e.g.*, 18 U.S.C. § 1005 (2006) (fraudulent bank entries, reports and transactions); 18 U.S.C. § 1028 (2006) (identity theft); 18 U.S.C. § 1029 (2006) (credit card and related “access device” frauds); 18 U.S.C. § 1030 (2006) (computer fraud); 18 U.S.C. § 1342 (2006) (use of fictitious name or address for mail fraud); 18 U.S.C. § 1349 (2006) (conspiracy); 18 U.S.C. §§ 1961–1968 (2006) (RICO); 18 U.S.C. §§ 1956–1957 (2006) (money laundering).

66. *See* 18 U.S.C. § 1014 (2006) (criminalizing knowingly making false statements on loan applications and overvaluing property).

67. *See* FED. BUREAU OF INVESTIGATION, FINANCIAL CRIMES REPORT TO THE PUBLIC FISCAL YEAR 2007 (2007), http://www.fbi.gov/publications/financial/fcs_report2007/financial_crime_2007.htm (last visited Mar. 20, 2009) [hereinafter 2007 FBI Financial Crimes Report].

68. *See id.*; *see also* 12 U.S.C. § 1709-2 (2006) (criminalizing failing to make payments under mortgage or deed of trust, whenever a person, with intent to defraud, purchases one to four family dwelling subject to loan in default secured by mortgage or deed of trust insured or held by Secretary of Housing and Urban Development or guaranteed or made by Department of Veterans Affairs).

69. *See* CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH 65–68 (2008) (noting that home values rose by more than 50% from 2000 to 2005 during period of low interest rates).

70. *See* 2007 FBI Financial Crimes Report, *supra* note 67.

71. *See* James R. Hagerty et al., *At a Mortgage Lender, Rapid Rise, Faster Fall*, WALL ST. J., Mar. 12, 2007, at A1.

explosion in mortgage fraud.⁷² The number of suspicious activity reports that financial institutions filed relating to mortgage fraud in 2004 was more than double that in 2003; in 2007, the number was more than six times the 2003 figure.⁷³ In 2006, the FBI estimated that national mortgage fraud losses were between \$1 billion and \$4.2 billion;⁷⁴ by the end of 2008, the FBI was reporting that annual losses were between \$4 billion and \$6 billion.⁷⁵ Given its prevalence and scope, many commentators have speculated that such fraud was at least partly to blame for the collapse of the mortgage market, and in turn for triggering the credit crisis.⁷⁶

Despite the explosion of mortgage fraud, federal prosecutions of frauds against financial institutions dropped 48 percent from 2000 to 2007.⁷⁷ Why the low number of overall mortgage fraud prosecutions? Several factors make the successful investigation and prosecution of mortgage fraud inherently difficult. Because lending institutions normally do not discover fraud until a mortgage has gone into default,⁷⁸ a relatively long period of time may pass before law enforcement officials are alerted, reducing the likelihood that investigation and prosecution of the fraud will be successful.⁷⁹ Moreover, because mortgage fraud often involves industry insiders⁸⁰ (and because inflated prices and more loan originations may

72. Cf. MORTGAGE ASSET RESEARCH INST., CURBING MORTGAGE FRAUD: PROACTIVE STRATEGIES 4 (2008), available at http://www.marisolutions.com/pdfs/ChoicePoint_White_Paper_Curbing_Mortgage_Fraud.pdf (listing “perfect storm” of factors contributing to growth in mortgage fraud).

73. See FED. BUREAU OF INVESTIGATION, 2007 MORTGAGE FRAUD REPORT (2008), http://www.fbi.gov/publications/fraud/mortgage_fraud07.htm (last visited Mar. 20, 2009) [hereinafter 2007 FBI Mortgage Fraud Report].

74. See *Mortgage Fraud: New Partnership to Combat Problem*, FED. BUREAU OF INVESTIGATION, Mar. 9, 2007, <http://www.fbi.gov/page2/march07/mortgage030907.htm> (last visited Mar. 20, 2009).

75. Fed. Bureau of Investigation, Mortgage Fraud, http://www.fbi.gov/hq/mortgage_fraud.htm (last visited Mar. 20, 2009).

76. See, e.g., MORTGAGE ASSET RESEARCH INST., *supra* note 72, at 4 (speculating that mortgage fraud may have helped cause subprime mortgage market collapse); John D. Arterberry, *Mortgage and Securitization Fraud: The Department of Justice Enforcement Program*, in THE GLOBAL SUBPRIME CRISIS: ISSUES YOU NEED TO KNOW 405, 407 (2008) (same); Lynnley Browning, *Mortgage Inquiries Focusing on Florida*, N.Y. TIMES, Oct. 16 2008, at B10 (same); Adam Geller, *Drawn into Frenzy, Home Loans Too Good To Be True*, AUGUSTA CHRON., May 27, 2007, at A16 (citing study linking 70 percent of mortgage defaults to misrepresentations on loan applications).

77. See Eric Lichtblau et al., *F.B.I. Struggling to Handle Wave of Finance Cases*, N.Y. TIMES, Oct. 19, 2008, at A1. In 2006, banks reported more than 59,000 cases of mortgage fraud to the FBI, which secured 263 indictments and 204 convictions—ratios of roughly 225 and 290 to 1, respectively. See Daniel Lathrop, *FBI Lacks Resources to Fight Boom in Mortgage Fraud*, SEATTLE POST-INTELLIGENCER, July 5, 2007, at A1.

78. See *Home Insecurity: Although the Housing Market has Slumped, Mortgage Fraud is Thriving*, S. FLA. SUN SENTINEL, Nov. 23, 2008, at 1A (quoting head of FBI’s mortgage fraud unit in South Florida); Jeff Ostrowski, *Florida Leads U.S. in Mortgage Fraud*, PALM BEACH POST (Florida), Mar. 14, 2008, at 1D.

79. This period may be months or even years. Cf. MORTGAGE ASSET RESEARCH INST., NINTH PERIODIC MORTGAGE FRAUD CASE REPORT TO THE MORTGAGE BANKERS ASSOCIATION 6 (2007), available at <http://www.marisolutions.com/pdfs/mba/MBA9thCaseRpt.pdf> (“It will likely take three to five years to uncover most of the fraud and misrepresentation in the 2006 book of business.”).

80. See 2007 FBI Financial Crimes Report, *supra* note 67 (estimating that 80 percent of all reported mortgage fraud losses involve industry insiders).

increase profits from mortgage loans, at least in the short run⁸¹), individuals and institutions in the mortgage industry may be reluctant to alert law enforcement to fraud.

Once law enforcement agencies are alerted to potential instances of mortgage fraud, investigating complaints is a complex, time and resource intensive process. Tracing the most straightforward cases of false statements on mortgage applications can take months of gathering and scrutinizing income and employment statements, tracking down borrower assets, examining how these assets were appraised, and interviewing borrowers and lenders.⁸² Identifying criminal activity is even more difficult in the many cases that involve industry insiders who understand how to manipulate the mortgage system.⁸³ Even where criminal activity is identified, it can be difficult for investigators to distinguish the fraudsters from the victims.⁸⁴

The obstacles inherent in investigating mortgage fraud have been exacerbated by federal law enforcement resource and manpower shortages. Following the September 11th attacks, the FBI shifted more than 1,800 agents, nearly one third of all agents in criminal programs, including many of those trained in financial investigations,⁸⁵ to counterterrorism and intelligence duties.⁸⁶ In the years prior to the credit crisis, the FBI mounted several investigations into mortgage fraud,⁸⁷ but its repeated warnings of the threat mortgage fraud posed and its requests for additional resources for non-terrorism investigations were left unaddressed by policymakers.⁸⁸ By 2007, the number of FBI agents nationwide pursuing mortgage fraud had shrunk to about 100, in sharp contrast to the roughly 1,000 agents that

81. See Richard B. Schmitt, *FBI Saw Threat of Loan Crisis*, L.A. TIMES, Aug. 25, 2008, at A1; Patrik Jonsson, *Real Estate Fraud Rises in U.S.*, CHRISTIAN SCI. MONITOR, Dec. 14, 2006, at 2 (“When the market was booming . . . lenders were loathe to publicize the fraud, especially since a rising market often erased their losses.”).

82. See Terry Sheridan, *Too Many Crooks: Investigators, Prosecutors Can’t Keep Pace as They Try to End Florida’s Reign as Nation’s Worst for Mortgage Fraud*, BROWARD DAILY BUS. REV. (Fla.), June 11, 2008, at 1 (quoting South Florida prosecutor); Tom Kelly, *Keeping Fraud Cases from Falling Through the Cracks*, L.A. TIMES, July 30, 2006, Real Estate Section, at 17.

83. See Lathrop, *supra* note 77; Jonsson, *supra* note 81.

84. See Jonsson, *supra* note 81 (“One of the toughest things for prosecutors is sorting out who’s guilty.”) (interviewing Assistant U.S. Attorney in Atlanta).

85. See Lathrop, *supra* note 77.

86. See Lichtblau, *supra* note 77.

87. For example, in September 2004, 205 people were arrested in an operation known as “Operation Continued Action,” which targeted a variety of fraud schemes directed at financial institutions, including mortgage and loan fraud. See Press Release, Fed. Bureau of Investigation, FBI Announces Operation Continued Action Targeting Financial Institution Fraud (Sept. 17, 2004), available at <http://www.fbi.gov/pressrel/pressrel04/contactation091704.htm>. Similarly, in December 2005, the FBI announced operation “Quick Flip,” a joint operation in cooperation with the Department of Housing and Urban Development, the Office Inspector General, Internal Revenue Service, the U.S. Postal Inspection Service, and the DOJ, designed to address mortgage fraud. Press Release, Fed. Bureau of Investigation, Mortgage Fraud Operation “Quick Flip” (Dec. 14, 2005), available at <http://www.fbi.gov/pressrel/pressrel05/quickflip121405.htm>.

88. See Lichtblau, *supra* note 77; Schmitt, *supra* note 81.

were deployed on banking fraud during the S&L crisis of the 1980s and 1990s.⁸⁹ In addition, because mortgage fraud cases are often one-off incidents involving relatively small losses, law enforcement officials have faced a difficult trade-off between going after low-impact, widespread cases⁹⁰ or focusing on the smaller number of more complicated mortgage scams that have higher impact, but that require more resources to pursue.

Reacting to the credit crisis and continuing criticism that not enough was being done to combat the problem,⁹¹ the FBI and other law enforcement agencies have begun to place additional emphasis on mortgage fraud. In the summer of 2008, the FBI announced operation “Malicious Mortgage,” a multi-agency takedown of more than 400 defendants charged with mortgage fraud schemes nationwide.⁹² By October 2008, the number of full-time agents working mortgage fraud cases had grown to about 180, with the FBI planning to double the number of agents investigating financial crime.⁹³ By the end of 2008, the FBI had over 1,500 open mortgage fraud investigations, and had secured over 500 indictments and 300 convictions⁹⁴—a significant improvement over 2006, although still a tiny percentage of reported mortgage fraud.⁹⁵ Nonetheless, many of the prosecutions the government has announced have been relatively small: about half of the investigations involve losses of less than \$1 million, comprising just two or three loans.⁹⁶ Faced with the difficult choice between pursuing small cases with limited impact or more time and resource-intensive cases with greater impact, the FBI has been forced to focus its attention largely on the low-hanging fruit.

One potential source of prosecutions of greater scope and impact are the ongoing federal investigations into whether some of the nation’s largest mortgage lenders and their high-level executives were complicit in mortgage fraud or committed other, related illegal acts. For example, in March 2007, New Century Financial Corporation disclosed that the SEC and Los Angeles U.S. Attorney’s Office were conducting investigations into insider stock sales and accounting

89. See Schmitt, *supra* note 81 (quoting FBI agent who oversaw FBI financial crime investigations during S&L crisis). Indeed, this figure was up from only 15 full time agents in 2005. See Lichtblau, *supra* note 77.

90. Former Attorney General Michael B. Mukasey has labeled these frauds “white-collar street crime.” See Eric Lichtblau, *Mukasey Declines to Create a U.S. Task Force to Investigate Mortgage Fraud*, N.Y. TIMES, June 6, 2008, at C4.

91. See, e.g., *Rep. Kline Sends Letter to FBI Director Mueller*, U.S. FED. NEWS, Oct. 18, 2008; *Reps. Carney, Kirk: FBI Needs to Triple Resources to Target Corporate Criminals*, U.S. FED. NEWS, Oct. 10, 2008; Schmitt, *supra* note 81.

92. Press Release, Fed. Bureau of Investigation, More than 400 Defendants Charged for Roles in Mortgage Fraud Schemes as Part of Operation “Malicious Mortgage” (June 19, 2008), available at <http://www.fbi.gov/pressrel/pressrel08/mortgagefraud061908.htm>.

93. See Lichtblau, *supra* note 77.

94. See Fed. Bureau of Investigation, *supra* note 75.

95. Cf. Lichtblau, *supra* note 77; Lathrop, *supra* note 77.

96. See Schmitt, *supra* note 81.

errors at the company.⁹⁷ In March 2008, the Wall Street Journal and other news agencies reported that the Justice Department and FBI had opened investigations into whether Countrywide Financial had misrepresented the value of its loans and its general financial condition.⁹⁸ And in October 2008, the Seattle U.S. Attorney's Office, in conjunction with the FBI, Federal Deposit Insurance Commission, SEC, and Internal Revenue Service, opened an investigation into whether any wrongdoing was committed by Washington Mutual in the period before its collapse.⁹⁹ Allegations have already arisen in the popular press that mortgage appraisers at these and other large lending companies faced enormous pressure from their superiors to accept mortgage applications, even those with clearly inflated housing appraisals or applicant incomes, and were overruled or censured when they did not.¹⁰⁰ The clear implication of these allegations is that lenders knew of the pervasive fraud underlying their loan originations, but nonetheless chose to ignore it.

Proving that these mortgage lenders and their executives acted criminally, however, may be hard, aside from any straightforward instances of insider trading. The substantial difficulties in demonstrating wrongdoing in the valuation of mortgage-related securities (which underlie the question of whether lenders misrepresented the value of loans on their books or their financial condition) are discussed in more detail in the next section.¹⁰¹ Demonstrating lender complicity in

97. See Alex Viega, *New Century Subpoenaed, Faces Delisting*, FOXNEWS.COM, Mar. 13, 2007, http://www.foxnews.com/printer_friendly_wires/2007Mar13/0,4675,NewCenturyFinancialSubpoena,00.html (last visited Mar. 20, 2009); Vikas Bajaj & Julie Creswell, *Authorities Investigate Big Lender*, N.Y. TIMES, Mar. 3, 2007, at C1.

98. See Raymond Hernandez, *Countrywide Said to be Subject of Federal Criminal Inquiry*, N.Y. TIMES, Mar. 9 2008, at A20; Glenn R. Simpson & Evan Perez, *FBI Investigates Countrywide*, WALL ST. J., Mar. 8, 2008, at A3.

99. See Press Statement, Jeffrey C. Sullivan, U.S. Attorney, W. Dist. Of Wash., Statement by United States Attorney Jeffrey C. Sullivan Regarding Washington Mutual (Oct. 15 2008) <http://www.usdoj.gov/usao/waw/press/2008/oct/washingtonmutual.html> (last visited Mar. 20, 2009). Washington Mutual was also the subject of an investigation initiated in December 2007 by the Securities and Exchange Commission, in conjunction with the Office of Thrift Supervision, into how the bank reported mortgage loans that potentially involved inflated appraisals. See Amir Efrati, *SEC Probes WaMu on Appraisals*, WALL ST. J., Dec. 21, 2007, at A2.

100. See, e.g., Peter S. Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008, at A1 (describing corporate culture at Washington Mutual); David Cho, *Pressure at Mortgage Firm Led to Mass Approval of Bad Loans*, WASH. POST, May 7, 2007, at A1 (describing corporate culture at New Century).

101. See *infra* Part II.B. In addition to the mortgage-related securities discussed in the next section, mortgage lenders had large numbers of mortgage loans "held for sale" to third-party securitizers on their books. Accounting for these loans (under either fair value or lower of cost and market accounting) involved a calculation of the loans' value once securitized. See, e.g., Countrywide Financial Corp., Annual Report (Form 10-K), at 53 (2007) (stating that loans held for sale generally were valued "based on quoted market prices for securities backed by similar types of loans" or, if market prices were not available, "based on other relevant factors" including valuation models). Thus, calculating the value of these loans presented the same difficulties as did valuing mortgage-related securities as the market grew more and more illiquid during the credit crisis. Cf. Vikas Bajaj, *Inquiry Assails Accounting Firm in Lender's Fall*, N.Y. TIMES, Apr. 13, 2008, at A1 (quoting conclusion by examiner for United States Bankruptcy Court that accounting irregularities did not provide "sufficient evidence to conclude that New Century engaged in earnings management or manipulation").

the reportedly widespread fraud occurring in the mortgage market presents other obstacles. Under federal law, those who aid, abet, counsel, command, induce or procure a crime can be found criminally liable in its commission.¹⁰² These actions all entail some active participation in the crime: mere knowledge, approval, or acquiescence is not sufficient.¹⁰³ In the case of mortgage lenders, prosecutors readily may demonstrate that lenders relaxed their oversight of loan applications in order to increase profits, but this does not prove that lenders or their executives were complicit in fraud. The structure of the mortgage industry exacerbates this problem: large lenders and their employees likely will claim that independent mortgage brokers, who prepared the majority of loan applications,¹⁰⁴ were responsible for any fraudulent applications, and that their own hands were clean.¹⁰⁵

Even where prosecutors are able to establish that lenders' low and mid-level employees knew of widespread mortgage fraud and were complicit in approving fraudulent applications, they may still face obstacles in pursuing more high-profile actions against high-level executives and corporations. Executives may only be found guilty if they were accomplices themselves or if they knew of crimes being committed by subordinates and did not attempt to halt them.¹⁰⁶ Absent the existence of explicit directives that promoted fraud, however, it may be difficult to show that any criminal acts were taken at executives' behest or with their knowledge.¹⁰⁷ For criminal actions against corporations themselves, prosecutors do not face this hurdle, as criminal liability may attach under principles of respondeat superior if any employees committed criminal acts within the scope of

102. See 18 U.S.C. § 2 (2006).

103. See RICHARD S. GRUNER, *CORPORATE CRIMINAL LIABILITY AND PREVENTION*, § 13.12[2] (2004); KATHLEEN F. BRICKEY, *CORPORATE CRIMINAL LIABILITY* § 5:09 (2d ed. 1992). To be clear, a corporate employee who knows that a colleague has committed a felony but conceals this knowledge may be found guilty for misprision of a felony. 18 U.S.C. § 4 (2006). However, the employee must still take "an affirmative step to conceal the crime"—a "mere failure to make a felony known to public authorities" is not sufficient. GRUNER, *supra*, § 13.12[2][c]; cf. Audrey Strauss, *Corporate Liability for Misprision of Felony*, N.Y.L.J., May 2, 1996, at 5 (describing historical use of misprision of felony and its application in 1995 guilty plea of Daiwa Bank for concealing trading loss of employee).

104. See Hagerty et. al, *supra* note 71 (noting that majority of mortgage loans involve mortgage brokers).

105. See Lichtblau, *supra* note 77 ("The reason we saw such huge growth in independent brokers was because [lenders and investment banks] wanted brokers to do the dirty work . . . They were able to put a shield between themselves and liability for wrongdoing.") (quoting Kathleen Engel, Professor at Cleveland-Marshall College of Law).

106. See BRICKEY, *supra* note 103, § 5:02 & § 5:09 (stating that corporate managers may be accountable for crimes committed by subordinates under principles of accomplice liability or for knowingly failing to control corporate misconduct).

107. See GRUNER, *supra* note 103, § 13.12[2] ("In most cases this [accomplice liability] rule will shield corporate executives or directors from criminal liability based on offences by subordinates or fellow managers."); cf. Cho, *supra* note 100 (exploring whether accepting fraudulent loan applications was systematically promoted by New Century)

their employment for the benefit of the corporation.¹⁰⁸ But because many lenders have declared bankruptcy or been purchased by other entities,¹⁰⁹ going after these entities may be a pointless endeavor: while criminal liability generally survives corporate bankruptcy¹¹⁰ or succession,¹¹¹ prosecutors facing resource constraints may decide it is not worth pursuing criminal sanctions against companies once their responsible employees have left or they are under new management.

In addition, new frauds arising from the credit crisis itself and the government's response to it may drive law enforcement agencies to turn their attention away from frauds that predated the crisis. The economic situation has led to a significant rise in mortgage frauds targeting desperate borrowers.¹¹² For example, there has been a ballooning of "foreclosure rescue" frauds, in which scammers induce property owners to sign over title of the property on the pretense of helping the owners avoid mortgage foreclosure.¹¹³ In addition, FBI and other government officials reportedly have voiced concerns that the federal bailout of the financial industry contains inadequate controls to deter fraud and thus may require additional attention from law enforcement.¹¹⁴ Given these developments, it seems likely that law enforcement agencies will shift some of their focus to new cases of fraud, instead of investigating past malfeasances.

108. See *N.Y. Cent. & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 494–95 (1909) (establishing general standard for corporate criminal liability under respondeat superior); see also GRUNER, *supra* note 103, § 3.03[2]. Indeed, under the principles of collective knowledge and action, criminal liability may exist for corporations even where no one employee committed a crime, if the aggregated knowledge or actions of employees amounts to criminal behavior. See *generally id.* §§ 4.01–.04.

109. See, e.g., Eric Dash & Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y. TIMES, Sept. 26, 2008, at A1 (detailing bank's seizure by federal regulators and sale of bank's assets to JPMorgan Chase); Vikas Bajaj & Julie Creswell, *Home Lender is Seeking Bankruptcy*, N.Y. TIMES, Apr. 3, 2007, at C1 (reporting New Century's bankruptcy filing); Heidi N. Moore, *Winners & Losers in Bank of America's Purchase of Countrywide*, WSJ.COM, July 1, 2008, <http://blogs.wsj.com/deals/2008/07/01/winners-losers-in-bank-of-americas-purchase-of-countrywide/> (last visited Mar. 20, 2009) (reporting closing of Bank of America's acquisition of Countrywide); see also Gretchen Morgenson & Eric Dash, *Troubled Giant in Home Loans Close to Rescue*, N.Y. TIMES, Jan. 11, 2008, at A1 (reporting that in 2007 nearly 150 mortgage lenders failed and more than 40 were acquired by other institutions).

110. See GRUNER, *supra* note 103, §§ 5.03 & 5.05 (discussing effect of dissolution and bankruptcy on corporate criminal liability); see also BRICKEY, *supra* note 103, § 3:10 (same).

111. See GRUNER, *supra* note 103, § 5.04 (discussing effect of merger or acquisition on corporate criminal liability); see also BRICKEY, *supra* note 103, § 3:11 (same).

112. See Dina ElBoghady, *Mortgage Fraud up as Credit Tightens*, WASH. POST, Mar. 17, 2009, at D01 (reporting that mortgage fraud jumped 26% in 2008); see also 2007 FBI Mortgage Fraud Report, *supra* note 73 ("The downward trend in the housing market provides an ideal climate for mortgage fraud perpetrators to employ a myriad of schemes suitable to a down market.").

113. See Zachary E. Davies, *Rescuing the Rescued: Stemming the Tide of Foreclosure Rescue Scams in Washington*, 31 SEATTLE U. L. REV. 353, 353 (2008) (calling foreclosure rescue "a nationwide epidemic").

114. See Lichtblau, *supra* note 77; Michael R. Crittenden, *TARP Fraud Could Cost Taxpayers Billions, Watchdog Warns*, WSJ.COM, Feb. 24, 2009, <http://online.wsj.com/article/SB123549501648160845.html> (last visited Mar. 20, 2009). Indeed, several investigations of TARP-related fraud have already been launched. See Jason Ryan, *'Fraud Directly Related' to Financial Crisis Probed*, ABC NEWS.COM, Feb. 11, 2009, <http://abcnews.go.com/TheLaw/Economy/Story?id=6855179&page=1> (last visited Mar. 20, 2009).

In sum, even with the increased resources that federal law enforcement agencies are beginning to devote to mortgage fraud,¹¹⁵ it is unlikely that they will be successful in systematically prosecuting the frauds that may have helped trigger the credit crisis. The potential amount of fraud in the mortgage industry, coupled with the complexity of fraud investigations and federal resource constraints, makes systematic prosecution difficult. In the ongoing investigations of major mortgage lenders, even where criminal behavior occurred, attributing blame and proving intent to defraud will present significant impediments to law enforcement. New frauds arising from the credit crisis and the government's response to it may well push law enforcement attention and resources elsewhere.

B. Investigations of Major Financial Institutions

As the credit crisis expanded, major financial institutions began reporting substantial writedowns on their mortgage-related assets; a number of these institutions subsequently collapsed. In reaction, the focus of federal criminal and regulatory investigations shifted to investigating whether these institutions had misrepresented the value of their assets and whether their disclosures regarding asset writedowns were timely and adequate. Notwithstanding the large number of open federal investigations into these developments,¹¹⁶ however, prosecutors and regulators face significant hurdles in proving that criminal wrongdoing occurred. The financial instruments at issue are extremely complex, and financial institutions had considerable flexibility and discretion in determining and accounting for their value. Aside from clear instances where market actors deliberately misrepresented the value of mortgage-related assets or financial institutions' financial health, it will be challenging for law enforcement to demonstrate malfeasance occurred.

As in other areas of the credit crisis, the federal investigations of valuation and disclosure issues at major financial institutions were essentially reactive to market developments. In the fall of 2007, large financial institutions—most prominently Citigroup, Merrill Lynch, UBS, and Morgan Stanley—started reporting substantial

115. Federal law enforcement may be continuing to ramp up efforts against mortgage fraud as this article goes to press. See Posting of Joe Palazzolo to The BLT: The Blog of LegalTimes, <http://legaltimes.typepad.com/blt/2009/03/ag-talks-about-gitmo-fraud-and-pot.html> (Mar. 18 2009, 17:39) (noting discussions about establishing a federal mortgage fraud task force are ongoing, according to Attorney General Eric Holder).

116. In February 2009, the FBI confirmed that it had 38 open investigations of large financial institutions See Ryan, *supra* note 114. In September 2008, then SEC Chairman Christopher Cox confirmed that the SEC had over 50 open subprime-related investigations. See Christopher Cox, Chairman, Sec. and Exch. Comm'n, Testimony Before U.S. Senate Committee on Banking, Housing, and Urban Affairs Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks, and Other Financial Institutions (Sept. 23, 2008), <http://www.sec.gov/news/testimony/2008/ts092308cc.htm> (last visited Mar. 20, 2009). According to the SEC, the investigations are divided into three broad categories: "(1) the retail aspect involving broker-type elements; (2) insider trading; and (3) cases involving valuation of securitized products," the last of which is further subdivided into two subcategories: mortgage originators and securitizers/underwriters. See Yin Wilczek, SEC, DOJ Subprime Investigations Focused on Misrepresentations, Manipulation, 40 BNA SEC. REG. & L. REP. 1603 (2008) (quoting Andrew Calamari, SEC New York associate regional director).

writedowns on their holdings, particularly CDOs and CDSs, in piecemeal fashion.¹¹⁷ The pattern of these disclosures raised questions about whether the firms' valuation approaches complied with relevant accounting standards, whether the losses on the firms' positions were promptly disclosed, and whether the firms' disclosures of the extent and contours of these positions prior to the writedowns were adequate; federal agencies responded by opening several investigations that appear focused on these issues.¹¹⁸

As a number of major financial institutions collapsed in the fall of 2008, regulators reportedly opened additional investigations to determine the cause of these failures. For example, within a few weeks of Lehman Brothers' collapse, the Wall Street Journal reported that the United States Attorney's Offices for the Southern District of New York, Eastern District of New York, and New Jersey had launched investigations into the events underlying the company's bankruptcy. The three U.S. Attorney's Offices are all examining whether Lehman misrepresented its financial health to investors while acknowledging internally that it faced imminent insolvency;¹¹⁹ individual offices are also investigating whether Lehman overvalued real estate assets or made other misrepresentations to investors in the run-up to its collapse.¹²⁰ Similarly, the Department of Justice's Fraud Division reportedly is examining the events underlying the fall of AIG, including whether company executives intentionally overstated the value of CDS contracts.¹²¹ Fannie

117. See Elizabeth Hester & Adam Haigh, *Write-offs Predicted to Add Up at 3 Firms*, CHI. TRIB., Dec. 28, 2007, at C1; David Reilly, *Heard on the Street: For Banks, the Hurt Just Goes On*, WALL ST. J., Nov. 26, 2007, at C1; *Write-Downs May Rise*, N.Y. TIMES, Nov. 9, 2007, at C6; Randall Smith, *Storm May Hit Morgan Stanley After its Calm*, WALL ST. J., Nov. 7, 2007, at C1; Serena Ng & Carrick Mollenkamp, *Merrill Takes \$8.4 Billion Credit Hit*, WALL ST. J., Oct. 25, 2007, at A1; see also Al Yoons & Dan Wilchin, *Wall Street's Subprime CDO Write-downs Seen \$64 billion: Citi*, REUTERS.COM, Nov. 8, 2007, <http://www.reuters.com/article/gc06/idUSN0823401520071108> (last visited Mar. 20, 2009) (questioning whether banks had faced up to reality).

118. See, e.g., Amir Efrati et al., *Prosecutors Widen Probes into Subprime—U.S. Attorney's Office Seeks Merrill Material; Sec Upgrades Inquiry*, WALL ST. J., Feb. 8, 2008, at C1; Kara Scannell et al., *The Subprime Cleanup Intensifies: Did UBS Improperly Book Mortgage Prices? Several Probes Expand*, WALL ST. J., Feb. 2, 2008, at B1; see also Lori A. Richards, Director, Office of Compliance Inspection & Examinations, Sec. and Exch. Comm'n, *Focus Areas in SEC Examinations of Investment Advisers: The Top 10*, Speech at the IA Compliance Best Practices Summit 2008 (Mar. 20, 2008), available at <http://sec.gov/news/speech/2008/spch032008lar.htm> (listing valuation of securities as one of SEC's top ten areas of concern).

119. See Amir Efrati & Susan Pulliam, *Three U.S. Attorneys Probe If Lehman Misled Investors*, WALL ST. J., Oct. 7, 2009, at A3.

120. The United States Attorney's Office for the Southern District of New York is also investigating whether Lehman valued its \$32.6 billion of commercial real estate assets at artificially inflated levels and whether the company improperly transferred \$8 billion from its London office to New York shortly before its bankruptcy filing. The United States Attorney's Office for the Eastern District of New York is investigating whether Lehman misled investors about the firm's financial condition by making positive remarks during conference calls with analysts and investors. The United States Attorney's Office for the District of New Jersey is investigating whether Lehman misled New Jersey's pension fund about its financial condition in connection with a June 2008 \$6 billion stock offering in which New Jersey invested \$180 million. See *id.*; see also *Lehman Brother's Demise Probe Launched in Jersey*, N.J. LAWYER, Oct. 20, 2008, at 2.

121. Amir Efrati, *Chart: Credit Crisis Probes*, WSJ.COM, Oct. 22, 2008, http://online.wsj.com/public/resources/documents/st_creditchris_20081022.html (last visited Mar. 20, 2009).

Mae and Freddie Mac are also reportedly under investigation: three weeks after they were seized by federal regulators and placed under conservatorship, the companies confirmed that the United States Attorney's Office for the Southern District of New York and the SEC had opened investigations into accounting, disclosure, and corporate governance matters relating to events dating back to January 1, 2007.¹²²

Under Rule 10b-5, promulgated by the SEC under the Securities Exchange Act of 1934, it is illegal to employ a deceptive device or make a false or misleading statement in connection with the purchase or sale of securities.¹²³ For criminal liability to apply under Rule 10b-5, prosecutors must demonstrate the defendant knowingly engaged in a scheme to defraud or made a material misrepresentation or misleading statement.¹²⁴ For a 10b-5 civil enforcement action, the SEC need only show that the conduct was reckless.¹²⁵ Similarly, under the federal mail¹²⁶ and wire¹²⁷ fraud statutes, misrepresentations may be subject to criminal liability if the defendant knew they were false¹²⁸ or consciously avoided discovering whether they were true or false.¹²⁹ Thus, to bring an action in connection with misconduct at these institutions, federal law enforcement will have to demonstrate that employees knowingly or recklessly overvalued assets, failed to disclose material

122. Zachary A. Goldfarb, *Probe Into Fannie Mae, Freddie Mac Widens*, WASH. POST, Sept. 30, 2008, at D1. Several additional investigations appear focused on misconduct by individual traders, including unauthorized trading, insider trading, and inaccurate pricing of securities. For example, the SEC and the DOJ reportedly are investigating possible insider trading by a board member of Société Générale shortly before the company's announcement on January 24, 2008 that a rogue trader had caused €4.9 billion in derivative trading losses. See Peggy Hollinger et al., *SocGen Faces US Investigation*, FINANCIALTIMES.COM, Feb. 6, 2008, http://www.ft.com/cms/s/0/517a5fe2-d4f3-11dc-9af1-0000779fd2ac.html?nclick_check=1 (last visited Mar. 20, 2009). The U.S. Attorney for the Eastern District of New York is taking the lead in investigating possible criminal violations concerning the same board member's sale of Société Générale shares. See Randall Mikkelsen & Rachelle Younglai, *U.S. Regulators Probe Stock Sales of SocGen Director*, REUTERS.COM, Feb. 4, 2008, <http://www.reuters.com/article/ousivMolt/idUSWEN376420080204?pageNumber=1&virtualBrandChannel=0> (last visited Mar. 20, 2009).

123. 17 C.F.R. § 240.10b-5 (2008); see also 15 U.S.C. § 78j(b) (2006) (authorizing SEC to prescribe rules "necessary or appropriate in the public interest or for the protection of investors"); 15 U.S.C. § 78ff(a) (2006) (establishing criminal penalties for willful violations of Securities Act of 1934 and SEC rules promulgated under the Act).

124. See 4 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.8[1] (6th ed. 2009) ("In the context of a criminal case . . . the prosecution must establish that the defendant acted willfully, which means that he or she acted with a realization that the acts were wrongful.").

125. See, e.g., SEC v. Collins & Aikman Corp., 524 F. Supp 2d 477, 487 & n. 83 (2007); see also SEC v. U.S. Environmental, Inc., 155 F.3d 107, 111 (2d Cir. 1998). At least one circuit, however, has held that recklessness may be sufficient for criminal liability under 10b-5. See *United States v. Tarallo*, 380 F.3d 1174, 1188-89 (2004).

126. 18 U.S.C. § 1341 (2006).

127. 18 U.S.C. § 1343 (2006).

128. See, e.g., *United States v. Smith*, 133 F.3d 737, 743 (10th Cir. 1997).

129. See, e.g., *United States v. Stewart*, 185 F.3d 112, 126 (3d Cir. 1999). At least some circuits have held that recklessly disregarding the accuracy of statements' accuracy may also be grounds for criminal liability under these statutes. See, e.g., *United States v. Munoz*, 233 F.3d 1117, 1136 (9th Cir. 2000); *United States v. Prows*, 118 F.3d 686, 692 (10th Cir. 1997).

changes in asset valuations, or made misrepresentations in public statements or disclosures regarding these assets.

Because of the nature of the complex financial instruments involved, however, demonstrating the requisite level of scienter will be very challenging. As discussed in detail below, there are no objective pricing indicators for many of these instruments, and accounting rules allow for significant flexibility and discretion in their valuation. Thus, law enforcement officials face a dual hurdle in identifying and punishing criminal wrongdoing: not only to establish the “correct” price for these instruments at the relevant time, but also to demonstrate that any alleged overvaluations or misrepresentations were deliberately fraudulent, and not merely the product of erroneous but non-criminal business judgments.

To understand the obstacles confronting law enforcement, a more complete explanation of the nature of accounting treatment for the financial instruments at issue is necessary. Since the S&L debacle of the early 1990s, banks and financial institutions normally have accounted for investment assets like CDOs and CDSs at fair value, and not at their historical cost.¹³⁰ Generally, the fair value approach entails accounting for assets and liabilities at the price at which they can be bought or sold in a current transaction between willing parties (other than in circumstances of a forced or liquidation sale).¹³¹ While a relatively simple concept to state, translating that concept into actual pricing determinations can be extremely difficult, particularly for complicated instruments like CDOs and CDSs. CDOs and CDSs are not traded on an organized exchange; instead, dealers make markets in them by contracting with each other bilaterally or through a broker acting as intermediary. If the market is liquid, the price for these securities for fair value accounting purposes may be determined by looking at actual trades. Pricing becomes more difficult, however, if the market is illiquid, with fewer trades that can be used as benchmarks for pricing, requiring the substitution of complex financial modeling. After mid-2007, the CDO market became increasingly illiquid¹³² and other mortgage-backed securities were traded far less than previously,

130. See Holman W. Jenkins, Jr., Op-Ed, *Mark to Meltdown?*, WALL ST. J., Mar. 5, 2008, at A16 (discussing introduction of fair value accounting for banks’ financial assets).

131. PUB. CO. ACCOUNTING OVERSIGHT BD., STAFF AUDIT PRACTICE ALERT NO. 2, MATTERS RELATING TO AUDITING FAIR VALUE MEASUREMENTS OF FINANCIAL INSTRUMENTS AND THE USE OF SPECIALISTS 3 (2007) (citing Section 137 of Statement of Financial Accounting Standards No. 115 (“Accounting for Certain Investments in Debt and Equity Securities”), Section 540 of Statement of Financial Accounting Standards No. 133 (“Accounting For Derivatives And Hedging Activities”), and Section 69 of Statement of Financial Accounting Standards No. 140 (“Accounting For Transfers And Servicing Of Financial Assets And Extinguishments Of Liabilities”)).

132. See, e.g., Neil Unmack, *CDO Buyers Put Investments on Hold, Royal Bank of Scotland Says*, BLOOMBERG, Sept. 20, 2007 (available via Bloomberg Professional service); Jody Shenn, *Credit Suisse CDO is Sole Sale in Past Week, JPMorgan Says*, BLOOMBERG, Sept. 11, 2007 (available via Bloomberg Professional service); Darrell Hassler, *CDO Spreads are Unchanged; New Sales “Meager,” JP Morgan Says*, BLOOMBERG, Aug. 27, 2007 (available via Bloomberg Professional service).

making pricing an increasingly difficult task.¹³³

Because of the difficulty in pricing these financial instruments, Generally Accepted Accounting Principles (“GAAP”) allow considerable flexibility and discretion in making valuation decisions. Prior to the credit crisis, the applicable Financial Accounting Standard Board (“FASB”) standard¹³⁴ on pricing debt and equity securities stated that quoted market prices provide the most reliable measure of fair value, observing that these prices often “are easy to obtain and are reliable and verifiable,”¹³⁵ but that when they are not available, “a reasonable estimate of fair value can be made or obtained.”¹³⁶ In the decade following issuance of FAS 115, however, the FASB recognized that there was limited guidance offered for applying the fair value standard.¹³⁷ Consequently, in September 2006, responding to the need for expanded disclosure and increased consistency and comparability in fair value measurements, the FASB issued FAS 157.¹³⁸ FAS 157 stipulated that fair value was the price to sell an asset in an “orderly transaction,” i.e. not one in which the seller is experiencing financial difficulty.¹³⁹ To provide consistency and comparability in fair value measurements and related disclosures, FAS 157 created a three-tier hierarchy of assets based on available valuation sources, in descending order of availability and precision:¹⁴⁰

- Level 1 assets may be valued based on quoted prices on active markets for identical assets that the reporting entity has the ability to access at the

133. Accord David M. Zornow et al., *Simple Twist of Fate or Outlaw Blues? Not All Incorrect Valuations of Complex Securities Will Lead to Government Action*, N.Y.L.J., Feb. 9, 2009, at S3, S10 (“Valuation [of CDOs and mortgage-related securities] was a genuinely difficult task in the increasingly illiquid marketplace that unfolded in 2007 and 2008 . . .”). During this period, the bid-ask spread (the difference between what sellers are willing to accept and buyers are willing to offer) on these securities widened, as buyers and sellers struggled to reach agreement on the appropriate market price. See Aleksandrs Rozens, *Pop Goes the Credit Bubble*, INVESTMENT DEALERS DIGEST, Aug. 13, 2007, <http://www.iddmagazine.com/issues/20070812/14210-1.html> (last visited Mar. 20, 2009).

134. FIN. ACCOUNTING STANDARDS BD., STATEMENT NO. 115, ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES (1993).

135. *Id.* at § 110.

136. *Id.* at § 111.

137. See FIN. ACCOUNTING STANDARDS BD., SUMMARY OF STATEMENT NO. 157, FAIR VALUE MEASUREMENTS (2006) [hereinafter FAS 157].

138. See *id.*

139. See FAS 157, *supra* note 137, at § 5, (giving definition of fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”); see also *id.* at § C25 (clarifying that an orderly transaction is distinct from “a forced transaction (for example, if the seller is experiencing financial difficulty)” and that an orderly transaction “assumes exposure to the market for a period prior to the measurement date to allow for information dissemination and marketing in order to transact at the most advantageous price for the asset or liability at the measurement date”).

140. *Id.* at § 22.

measurement date.¹⁴¹ These quoted prices are the most accessible and precise inputs for valuation.¹⁴²

- Level 2 assets may be valued indirectly by referring to observable market data for similar or comparable assets, such as dealer or third-party pricing vendors. These inputs are less available and less precise than Level 1 market data.¹⁴³
- Level 3 assets must be valued using “unobservable” inputs, such as pricing models based on estimates of future cash flows or other formulae.¹⁴⁴ FAS 157 provides that “unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available [where] there is little, if any, market activity for the asset or liability at the measurement date.”¹⁴⁵ Thus, Level 3 asset valuations involve the most subjective inputs.¹⁴⁶

Most of the securities at issue in the ongoing valuation investigations, like CDOs and CDSs, are Level 3 assets. In the absence of actual trades that can be used as benchmarks, pricing these assets involves the least accessible and most subjective valuation inputs. Because of the enormous complexity of these securities, banks and other security holders must rely on sophisticated, and often proprietary, “black box” quantitative valuation models that produce probability-weighted estimates of the future cash flows from these financial instruments.¹⁴⁷ As the FASB has acknowledged, these models are necessarily based on various assumptions: while FAS 157 provides some guidance on how to value positions in these securities, it also leaves a significant amount of room for the exercise of judgment in making assumptions supporting pricing and valuation determinations.¹⁴⁸

As the subprime meltdown spread, the SEC and FASB reemphasized the significant discretion necessarily involved in pricing these assets. When the credit

141. *Id.* at § 24. An active market “is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.” *Id.*

142. Level 1 assets include publicly-traded securities, listed futures and options, government and agency bonds, and mutual funds. See Susan Pulliam et al., *U.S. Investors Face an Age of Murky Pricing*, WALL ST. J., Oct. 12, 2007, at A1.

143. Assets in this category include emerging market government bonds, some infrequently-traded corporate and municipal bonds, structured notes, some mortgage and asset-backed securities, and some derivatives that are not publicly traded. See *id.*

144. FAS 157, *supra* note 137, at § 30; see also Pulliam, *supra* note 142.

145. FAS 157, *supra* note 137, at § 30.

146. See Pulliam, *supra* note 142.

147. See, e.g., John Hull & Alan White, *Valuation of a CDO and an Nth to Default CDS Without Monte Carlo Simulation*, 12 JOURNAL OF DERIVATIVES *passim* (2004) (describing one proposed model for CDO tranche valuation).

148. For example, assumptions must be made concerning such arcane factors as statistical correlation among the mortgages within the asset pool; probabilistic estimates of default and prepayment rates based on best-guess scenarios of future interest rates and economic conditions; “one-size fits all” recovery rates (the estimated “salvage” value of defaulted mortgages based on estimated real estate values prevailing at the time of default); and estimates of the appropriate interest rates to use in discounting future cash flows. See generally LUCAS ET AL., *supra* note 6.

markets seized up, transactions in all but the most plain vanilla securities came to a virtual standstill,¹⁴⁹ and financial institutions were left with little or no guidance concerning the degree to which they could rely on their proprietary models to meet fair value accounting and disclosure requirements. To calm the market and address these concerns, in September 2008, the SEC's Office of the Chief Accountant and the staff of the FASB issued a series of clarifications on fair value accounting.¹⁵⁰ In nearly all areas, the clarifications acknowledged that application of fair value accounting standards requires the exercise of significant judgment on the part of financial institutions making pricing determinations, including the use of valuation models.¹⁵¹

One can readily see that accounting standards and guidance that give considerable deference to market participants' pricing determinations create difficult issues for prosecutors and regulators seeking to demonstrate corporate wrongdoing. As described above, the problem for law enforcement is two-fold. First, the evolving standards and subjective judgment required for pricing Level 3 assets, particularly in distressed markets, makes it difficult to conclude that an institution's pricing was wrong. Indeed, law enforcement officials will have difficulty determining a "correct" price for these assets at any given time. Targets of investigations will argue that the prices available in the market from mid-2007 forward for CDOs and CDSs were unreliable given the lack of "orderly transactions," and that internal cash-flow models thus were appropriately used to determine pricing. Second, even if law enforcement officials can demonstrate that the pricing determinations made were outside corporations' considerable area of discretion, proving that any mispricing was fraudulent will be extremely difficult, absent some sort of clear evidence of deliberate or conscious misrepresentation.¹⁵² This difficulty applies

149. See *supra* notes 132–133 and accompanying text.

150. Press Release, Sec. and Exch. Comm'n, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008), available at <http://www.sec.gov/news/press/2008/2008-234.htm>.

151. See *id.* In addition, the September 2008 guidance provided that "disorderly transactions" are not determinative of fair value because the concept of fair value embodies an orderly transaction between market participants. According to the guidance, "[d]etermining whether a particular transaction is forced or disorderly requires judgment." *Id.* At the same time, the guidance provides that, even if a transaction is orderly, if management judges that the price does not reflect current prices for the same or similar assets, "adjustments may be necessary to arrive at fair value." *Id.*

Similarly, the FASB recently has issued a proposed Staff Position to provide additional guidance to firms for determining when a market is active or inactive and transactions are orderly or disorderly for purposes of fair value measurements under FAS 157. See News Release, Fin. Accounting Standards Bd., FASB Issues Proposals to Improve Guidance on Fair Value Measurements and Impairments (Mar. 17, 2009), available at <http://www.fasb.org/news/nr031709.shtml>. Consistent with previous guidance, the proposed Staff Position gives considerable flexibility in determining whether a market is active or inactive and suggests that firms evaluate and consider "the significance and relevance" of seven nonexclusive factors before "us[ing] their judgment." See FIN. ACCOUNTING STANDARDS BD., PROPOSED FASB STAFF POSITION, No. FAS 157-E, at 4 (Mar. 17, 2009), available at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas157-e.pdf.

152. Cf. *infra* notes 159–169 and accompanying text (discussing prosecution of two Bear Stearns fund managers).

equally to any financial statements, public disclosures, or representations to investors based on these valuations.¹⁵³

Two other aspects of current business and law enforcement practice further complicate law enforcement objectives. The first is financial institutions' controls on traders' pricing and risk decisions. Typically, banks employ back-office financial personnel who perform independent price verification procedures at month and quarter-end on front-office pricing and do not report to front-office managers or traders. They draw on external pricing sources and other information available in the market to assess the appropriateness of pricing decisions made by traders. Similarly, banks often employ risk management personnel that independently assess the company's risk from outstanding positions, an analysis that can also detect pricing irregularities. While one may question their reliability—given the lower compensation of control personnel, the balance of power in financial institutions that favors the front-office, and the difficulty that control personnel may face in acquiring sufficient market exposure without daily interactions with other market actors—these controls are designed to catch the very sort of pricing irregularities that are the focus of many ongoing investigations. Thus, the existence of such processes presents a further challenge for regulators and prosecutors. Individuals and institutions accused of mispricing or overvaluing securities may point to the concurrence of the institutions' control functions with front-office pricing decisions as support for the reasonableness of these decisions.¹⁵⁴

Another complicating factor for law enforcement is the lack of resources and incentives that weakened and bankrupt financial institutions have to cooperate with investigations. In recent years, prosecutors and regulators have become heavily reliant on cooperation from company counsel in conducting internal investigations into allegations of wrongdoing.¹⁵⁵ Companies seeking credit for cooperation with law enforcement agencies typically provide the government with the results of internal investigations, which may include witness interviews,

153. As this article goes to print, the future of mark to market accounting is uncertain. Section 133 of the Emergency Economic Stabilization Act stipulated that the SEC conduct a study on fair value accounting standards. See 12 U.S.C. § 5238 (Supp. 2008). In its report to Congress, the SEC, among other things, made recommendations to improve the application of fair value standards in inactive markets, but also concluded that fair value accounting should not be suspended (as the Act gave it the authority to do under 12 U.S.C. § 5237). See Press Release, Sec. and Exch. Comm'n, *Congressionally-Mandated Study Says Improve, Do Not Suspend, Fair Value Accounting Standards* (Dec. 30, 2008), available at <http://www.sec.gov/news/press/2008/2008-307.htm>. Accordingly, the FASB recently has issued a proposed staff position to provide additional guidance to firms on fair value accounting in inactive markets. See *supra* note 151. Nonetheless, Congress is reportedly considering whether to eliminate mark-to-market accounting entirely. See Ronald D. Orol, *Mark-to-Market Rule Compromise Is on the Way*, MARKETWATCH, Mar. 11, 2009, <http://www.marketwatch.com/news/story/mark-to-market-rule-compromise-way/story.aspx?guid=%7B05985C4F-D2CC-4E27-A691-0CEC8EDBABBFF%7D&dist=SecMostRead> (last visited Mar. 20, 2009).

154. See generally GRUNER, *supra* note 103, ch. 6 (discussing possibility of due diligence defense to corporate criminal liability).

155. See generally Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 313-28 (2007).

internal documents or other evidence.¹⁵⁶ This information allows prosecutors and regulators to focus their own investigations and bring them more quickly to a close.¹⁵⁷ Weakened and bankrupt companies, however, may have neither the resources nor the incentives to cooperate with law enforcement investigations to the same degree. For Lehman Brothers, Washington Mutual, and other financial institutions that are no longer in existence, in a weakened condition, or have been purchased by other banks or the government, prosecutors may have to shoulder a greater share of the investigative burden. Without extensive cooperation from the targeted companies, prosecutors will have a more difficult time proving that criminal acts occurred.¹⁵⁸

The significant obstacles confronting law enforcement agencies may explain why only one high-profile criminal case involving alleged misrepresentations in connection with CDOs and other complex securities has been brought thus far stemming from the credit crisis. Perhaps not surprisingly, the case involves allegations of apparently straightforward misrepresentations that do not hinge on valuation questions, and thereby avoids the hurdles discussed above. In *United States v. Cioffi*, the government charged Ralph Cioffi and Matthew Tannin with conspiracy to commit securities and wire fraud for engaging in a scheme to mislead investors in two Bear Stearns hedge funds.¹⁵⁹ Cioffi and Tannin were portfolio managers for the Bear Stearns High Grade Structured Credit Strategies Master Fund Ltd. and the Bear Stearns High Grade Structured Credit Strategies Enhanced Leverage Master Fund Ltd.¹⁶⁰ Both funds, according to the indictment, purported to have “invested in low-risk, ‘high grade’ debt securities, primarily AA and AAA-rated tranches of CDOs.”¹⁶¹ The funds’ strategy was to enhance returns through leverage, using borrowed money to purchase additional income-producing assets, including CDOs.¹⁶²

According to the indictment, the two funds performed as expected until early 2007, when the market for subprime CDOs began to deteriorate.¹⁶³ By March 2007, the defendants allegedly believed that the funds were in grave straits and at risk of collapse; however, rather than disclose the funds’ deteriorating condition to investors and arrange for an orderly wind-down, the defendants “agreed to make misrepresentations” in hope that the funds’ prospects would improve.¹⁶⁴ This allegation is based on a series of emails between Cioffi and Tannin, including a

156. See Matthew L. Siegel, *Corporate America Fights Back: The Battle over Waiver of the Attorney-Client Privilege*, 49 B.C. L. Rev. 1, 4 (2008).

157. See *id.*

158. See *id.* at 13–17 (describing difficulties prosecutors face without corporate cooperation).

159. Indictment at ¶ 17, *United States v. Cioffi*, No. CR-08-415 (E.D.N.Y. Jun. 18, 2008).

160. *Id.* at ¶ 7–8.

161. *Id.* at ¶ 17.

162. *Id.* at ¶ 17–18.

163. *Id.* at ¶ 24.

164. *Id.*

message that Tannin, using his personal account, sent to the personal account of Cioffi's wife on April 22, 2007:

[T]he subprime market looks pretty damn ugly . . . If we believe the [CDO report is] ANYWHERE CLOSE to accurate I think we should close the funds now. The reason for this is that if [the CDO report] is correct then the entire subprime market is toast . . . If AAA bonds are systematically downgraded then there is simply no way for us to make money—ever.¹⁶⁵

The indictment contrasts this email with statements, allegedly made by Cioffi and Tannin at a meeting two days later with senior Bear Stearns executives, to the effect that they were confident that the funds were in good shape and would continue to be successful.¹⁶⁶ Similarly, on April 25, during a conference call that Cioffi and Tannin hosted for the funds' investors, Tannin allegedly told investors:

So, from a structural point of view, from an asset point of view, from a surveillance point of view, we've very comfortable with exactly where we are . . . [T]he structure of the Fund has performed exactly the way it was designed to perform . . . [I]t is really a matter of whether one believes that careful credit analysis makes a difference, or whether you think this is just one big disaster. And there's no basis for thinking this is one big disaster.¹⁶⁷

This exchange illustrates a key point. The indictment claims that Cioffi and Tannin's allegedly fraudulent conduct was knowing and willful;¹⁶⁸ to prove these allegations, the government likely will rely on the contradictory nature of the defendants' internal communications and communications with investors as evidence of an intent to defraud. This comparatively simple and straightforward approach likely will not require reference to complex accounting or valuation models; thus, the case likely will avoid the difficulties of proof inherent in demonstrating fraud in the valuation of securities.¹⁶⁹

Cases involving clearly demonstrable misrepresentations, however, are likely to be few and far between. In the end, regulators and prosecutors may bring far fewer cases against major financial institutions and their employees than the increased level of regulatory activity might suggest. Indeed, SEC staffers have acknowl-

165. *Id.* at ¶ 41 (emphasis in original).

166. *Id.* at ¶ 43.

167. *Id.* at ¶ 45.

168. *Id.* at ¶¶ 57–68.

169. *Cf. Zornow, supra* note 133, at S10 (arguing that valuation issues will make prosecutions difficult unless other factors are present, such as clear evidence of manipulated valuations). Jury selection in the trial is scheduled to begin in September 2009, but delays may arise due to two lead prosecutors leaving the U.S. Attorney's Office and defense counsel complaints that they are being buried in documents by the prosecution. *See* Kate Kelly & Dionne Searcey, *For J.P. Morgan, Legal Headaches*, WALL ST. J., Mar. 15, 2009, at B2 (noting prosecutors' leaving Attorney's Office); Tom Hays, *Defense Digs out of Documents in Bear Stearns Case*, YAHOO!FINANCE, Mar. 16, 2009, <http://finance.yahoo.com/news/Defense-digs-out-of-documents-apf-14658479.html> (last visited Mar. 20, 2009).

edged the complicated nature of valuation and disclosure cases, noting that the SEC does not want to be in “the business of second-guessing business decisions that were appropriate business judgments at the time.”¹⁷⁰ In the words of one senior SEC staffer, “[t]here is no question that this was an extremely volatile period, that the world was coming down on these companies, they were throwing up their hands and really didn’t know what to do.”¹⁷¹ As the staffer concluded, “[t]o the extent that people made mistakes in an environment like that, that’s not where we’re really heading.”¹⁷²

C. Legal and Illegal Short Selling

Illegal short-selling practices have been another area of federal law enforcement focus during the credit crisis. Following the sharp decline in Bear Stearns’ stock price in March 2008 and concerns about deteriorating stock prices at other major financial institutions later in the summer, federal regulators introduced a series of restrictions on short sales and stepped up investigatory activity of illegal sales. Numerous public statements that illegal short selling would be closely monitored notwithstanding, difficulties in proving illegal conduct have contributed to prosecutors bringing very few cases involving illegal short sales. Similarly, the regulatory curbs did not have the desired effect, and fears of chilling legal short-selling have led regulators to retreat from these restrictions. Thus, aside from punishing readily identifiable instances of illegal market manipulation in connection with short sales, continued aggressive law enforcement in this area is unlikely.

Ordinary short selling (“short selling”)¹⁷³ is a long-established practice,¹⁷⁴ which allows traders who believe the price of a stock is too high, and accordingly will decline over some period of time, to profit from that prediction. To “short” the stock, the trader enters an order to sell stock that the trader does not own at the current market price. The trader then borrows the shorted stock from a broker-dealer to deliver to the purchaser, with the expectation of covering the transaction at a later date by buying back the stock at a lower price and pocketing the difference.¹⁷⁵ As long as certain SEC, Federal Reserve Bank, and Financial Industry Regulatory Authority (“FINRA”) regulations are satisfied, short selling is

170. See Richard Hill, *Economic Conditions Have SEC Staff Bracing for Fraud, Whistle-Blower Cases*, 40 BNA SEC. REG. & L. REP. 1990 (2008) (quoting Scott Friestad, Deputy Director, SEC Division of Enforcement).

171. Wilczek, *supra* note 116, at 1603 (quoting SEC’s New York Associate Regional Director).

172. *Id.* Similarly, the DOJ likely will steer clear of valuation cases and focus on straightforward fraud and misrepresentations. See *id.* (quoting unnamed DOJ official that “misrepresentations will be the focus of the DOJ’s prosecutions” and not the . . . rather than the “‘tricky’ issue of trying to prove which valuation method is more appropriate,” because misrepresentations are “where the rubber really hits the road, that’s where you make a clear case for fraud”).

173. The SEC defines a short sale as “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.” SEC Rule 3b-3, 17 C.F.R. § 242.200(a) (2008).

174. See 5 HAZEN, *supra* note 124, § 14.22[3].

175. See *id.* § 14.22.

perfectly legal.¹⁷⁶ Indeed, short sellers perform an important salutary function, since legitimate short sales convey negative information to the market by suggesting that the shorted stock's price is overvalued. In the words of the Second Circuit, "[a]side from providing market liquidity, short selling enhances pricing efficiency by helping to move the prices of overvalued securities toward their intrinsic values."¹⁷⁷

However, short sales coupled with manipulative practices—for example, taking short positions while spreading false market rumors with the intent of profiting from the resulting decline in share price—are illegal. Section 10(b) of the Securities Exchange Act prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security in contravention of SEC regulations.¹⁷⁸ As the Supreme Court has stated, the term "manipulative" is "virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."¹⁷⁹ Thus, the key question in manipulation cases is whether the defendant's specific intent was to affect the stock price: absent scienter, conduct that merely affects the price of a security is not sufficient to demonstrate manipulation.¹⁸⁰

"Naked" short selling is also illegal in many circumstances.¹⁸¹ In a naked sale, the short seller sells stock to a purchaser but fails to actually borrow the security to be sold. Since the seller is not constrained by the number of a company's shares available to be borrowed, naked short sales may potentially result in a "fail to

176. *See id.*

177. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 101 (2d Cir. 2007) (internal citations omitted); *see also* *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 209 (3d Cir. 2001) ("[S]hort selling can help move an overvalued stock's market price toward its true value, thus creating a more efficient marketplace in which stock prices reflect all available relevant information about the stock's economic value."); Press Release, Sec. and Exch. Comm'n, Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases (Oct. 1, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-235.htm> (noting that "short selling plays an important role in the market for a variety of reasons, including contributing to efficient price discovery, mitigating market bubbles, increasing market liquidity, promoting capital formation, facilitating hedging and other risk management activities, and importantly, limiting upward market manipulations").

178. 15 U.S.C. § 78j(b) (2006). Similarly, Section 9(a), Manipulation of Security Prices, makes it illegal "to induce the purchase or sale" of securities registered on a national securities exchange "by the circulation or dissemination . . . of information to the effect that the price of any such security will or is likely to rise or fall" that is "conducted for the purpose of raising or depressing the price of such security" when the statement was "at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact," and which the defendant "knew or had reasonable grounds to believe" was false or misleading. 15 U.S.C. § 78i(a)(4) (2006). More generally, Section 17(a) makes it unlawful for any person "to employ any device, scheme, or artifice to defraud," or "to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact" in the offer or sale of any securities. 15 U.S.C. § 77q(a) (2006).

179. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

180. *See* 3 *HAZEN*, *supra* note 124, § 12.1[2][A]. Whether aggressive short-selling conducted with the purpose of affecting the price of securities, but not accompanied by other deceptive conduct (so-called "open-market manipulation"), counts as market manipulation is an open question. *See generally* Brian A. Ochs, *When Does Short Selling Become Manipulation?*, 40 *BNA SEC. REG. & L. REP.* 1951 (2008).

181. *See* 5 *HAZEN*, *supra* note 124, § 14.22[3][D].

deliver” securities to the buyer.¹⁸² Thus, naked short selling has been characterized as selling “counterfeit shares.”¹⁸³ Critics also complain that naked short selling can artificially depress a company’s market valuation by creating sustained downward pressure on the stock price.¹⁸⁴ Accordingly, Rule 203(b) of SEC Regulation SHO requires that, prior to shorting an equity security, the seller must “locate” securities available for borrowing.¹⁸⁵

In 2008, reacting to credit crisis events, federal regulators imposed a succession of new restrictions on short-selling and announced their intention to crack down on manipulative short sales. In March 2008, Bear Stearns’ stock price deteriorated precipitously in the weeks prior to the company’s collapse and sale to JPMorgan Chase,¹⁸⁶ leading regulators to suspect that improper manipulation of the market had occurred.¹⁸⁷ On July 13, the SEC Office of Compliance, Inspections, and Examinations (“OCIE”), FINRA and NYSE Regulation Inc. announced that they would immediately begin conducting investigations aimed at preventing “the intentional spread of false information intended to manipulate securities prices” by focusing on the adequacy of the supervisory and compliance controls of broker-

182. *See id.*

183. *See id.* § 14.22[3][D] & n.107 (citing *Jag Media Holdings Inc. v. A.G. Edwards & Sons Inc.*, 387 F. Supp. 2d 691, 695 (S.D. Tex. 2004)); *see also* *In re Eagletech Commc’ns, Inc.*, Exchange Act Release No. 34-54095 (June 5, 2006).

184. *See* Christopher Twarowski, *SEC Order On Naked Short Selling Takes Effect*, WASH. POST, July 22, 2008, at D1.

185. 17 C.F.R. § 242.203(b) (2008). The SEC has explained that “locate” means that a broker-dealer is prohibited from accepting a short sale order for its own account unless it has (1) borrowed, or entered into an arrangement to borrow, the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the due date. *See* 5 HAZEN, *supra* note 124, § 14.22[3][B] & n.51 (citing *Short Sales*, Exchange Act Release No. 34-50103 (July 28, 2004)).

186. *See* Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58166 (July 15, 2008) (“During the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns, which eroded confidence in the firm. As Bear Stearns’ stock price fell, its counterparties became concerned, and a crisis of confidence occurred late in the week.”). These counterparties became unwilling to make secured funding available to Bear Stearns on customary terms. *See id.*

187. *See* Brian Wingfield, *What Killed Bear?*, FORBES.COM, Apr. 3, 2008, http://www.forbes.com/2008/04/03/banking-bear-bernanke-biz-wall-cx_bw_0403bear2.html (last visited Mar. 20, 2009); David Scheer, *SEC Opens Bear Stearns Stock Manipulation Inquiry*, BLOOMBERG.COM, Mar. 18, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a3K784kZkB1Q&refer=home> (last visited Mar. 20, 2009). Following Bear’s resulting collapse and sale to JPMorgan Chase, several self-regulatory organizations announced a coordinated effort to heighten the monitoring and investigation of trading activity in “issuers that may be subject to credit market-related volatility.” *See* Press Release, Fin. Indus. Regulatory Auth., *Self-Regulators Warn Against Spreading False Rumors and Other Abusive Market Activity* (Mar. 31, 2008), *available at* <http://www.finra.org/Newsroom/NewsReleases/2008/P038211>. To emphasize the gravity of the concern over rumors and short selling, the SROs admonished market participants to be “especially aware that intentionally spreading false rumors or engaging in collusive activity to impact the financial condition of an issuer will not be tolerated and will be vigorously and aggressively investigated,” and added that, “[t]his type of activity is highly detrimental both to the investing public and to companies constituting important components of the U.S. financial system.” *Id.*

dealers and investment advisors.¹⁸⁸ On July 15, in light of growing concerns about runs on the stock prices of other major financial institutions, the SEC announced a temporary order¹⁸⁹ that aimed to protect 19 financial institutions against naked short selling by requiring traders to obtain a commitment from a lender to supply shorted securities of the named institutions prior to conducting a short sale.¹⁹⁰ A little over a month after the expiration of the July 15 order, following Lehman Brothers' bankruptcy, the SEC went farther by temporarily prohibiting all short sales in the publicly traded securities of almost 800 financial institutions.¹⁹¹ Justifying the drastic expansion of its earlier order, the SEC argued that "short selling . . . may be causing sudden and excessive fluctuations of the prices of [the securities of financial institutions] in such a manner so as to threaten fair and orderly markets."¹⁹² The SEC also announced that it was intensifying its scrutiny of investigating improper short selling, particularly when accompanied by fraudulent market rumors.¹⁹³

Notwithstanding the SEC's stated intention to attack manipulative short selling, regulatory actions involving improper short sales have been rare. In these cases, law enforcement faces a difficult hurdle in proving that there was the requisite intent on the part of market actors. Disseminating incorrect information about a company, even if it has an impact on the company's stock price, is not illegal unless accompanied by manipulative intent. Market actors may circulate rumors without any such intent, as speculating about companies lies at the heart of what traders and other financial players do. In the words of former SEC Chairman

188. See Press Release, Sec. and Exch. Comm'n, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (July 13, 2008), available at <http://www.sec.gov/news/press/2008/2008-140.htm>; see also Jenny Anderson, *S.E.C. Unveils Measures to Limit Short-Selling*, N.Y. TIMES, July 16, 2008, at C1.

189. See David Scheer and Edgar Ortega, *SEC Extends Limit on Short Sale of Fannie, Freddie*, BLOOMBERG.COM, July 30, 2008, <http://www.bloomberg.com/apps/news?pid=20601103&refer=news&sid=a2TrS9t34oao> (last visited Mar. 20, 2009).

190. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58166 (July 15, 2008) (imposing ban on naked short selling). The order thereby went beyond Rule SHO, which requires traders only to locate or identify available shares before effecting a short sale. *Id.* Among the 19 companies were Goldman Sachs, Merrill Lynch, Lehman Brothers, Fannie Mae, and Freddie Mac. *Id.* at App. A.

191. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 34-58592 (Sept. 18, 2008).

192. *Id.*

193. See Press Release, Sec. and Exch. Comm'n, SEC Expands Sweeping Investigation of Market Manipulation (Sept. 19, 2008), available at <http://sec.gov/news/press/2008/2008-214.htm> ("Abusive short selling, market manipulation and false rumor mongering for profit by any entity cuts to the heart of investor confidence in our markets. Such behavior will not be tolerated. We will root it out, expose it, and subject the guilty parties to the full force of the law.") (quoting Linda Thomsen, Director of SEC Enforcement Division). At the same time, the New York Attorney General's Office announced a "wide-ranging investigation into short selling" following from complaints about false rumors being spread by short sellers. See Aaron Lucchetti et al., *Cuomo Plans Short-Selling Probe*, WSJ.COM, Sept. 18, 2008, <http://online.wsj.com/article/SB122176389889653245.html> (last visited Mar. 20, 2009).

Arthur Levitt, “[t]alking about differing ideas and opinions [about companies] . . . is ‘the food of the market.’”¹⁹⁴ As Levitt suggests, market speculation often involves ideas and opinions that are difficult to label objectively “false,” unless it can be shown that the speaker had no reasonable basis for the statement or that she deliberately misrepresented her actual opinion.¹⁹⁵ Federal regulators have acknowledged this further difficulty: at a recent forum of the American Bar Association, senior staff members of the SEC’s Enforcement Division commented that, while the SEC has “a number” of open investigations, such cases are “challenging and difficult” because “oftentimes the rumors are about things that can be portrayed as opinions as opposed to fact,” which “makes them harder to pursue.”¹⁹⁶

The fraudulent intent of the person originating the rumor is easier to demonstrate than the intent of those who merely pass on fraudulent information that has already been released into the market. Proving that a rumor has originated with a particular market actor, however, is difficult to establish in a media age. As then Director of the SEC’s Division of Enforcement, Gary Lynch, reportedly said in February 1986, in response to an increase in market rumors at the time,¹⁹⁷ “[i]f you have ever tried to track a rumor to its source, it is almost impossible to do so.”¹⁹⁸ Today’s electronic communication devices, such as cell phones, BlackBerries, and ultra portable laptops, make the task of tracing rumors exponentially more difficult now than in 1986. Once a rumor starts circulating, it is very difficult for the SEC to trace its source.¹⁹⁹

These obstacles may help explain why to date the SEC has brought only one case charging improper short selling that involved the dissemination of false market rumors.²⁰⁰ In April 2008, the SEC charged an individual trader at Schottenfeld Group LLP with securities fraud and market manipulation for intentionally spreading a false rumor concerning the Blackstone Group’s acquisi-

194. Jonathan D. Glater, *Whispering With Intent*, N.Y. TIMES, July 20, 2008, at A4 (quoting Arthur Levitt); cf. Richard D. Marshall, *Rumor-Mongering in the Crosshairs*, N.Y. L.J., Feb. 9, 2009, at S8, S11 (arguing that efficient markets require free dissemination of information and that SEC drive to prevent gossip may implicate First Amendment considerations).

195. See *In re Salomon Analyst AT&T Litig.*, 350 F. Supp. 2d 455, 465–66 (S.D.N.Y. 2004) (citing *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095–96 (1991)).

196. Hill, *supra* note 170, at 1990.

197. See Peter Behr & David A. Vise, *Wall Street Rumors: Experts See Rise of Stock-Price Manipulation Through Planted Tips*, WASH. POST, Feb. 16, 1986, at G1 (describing a “growing trend of rumors that have triggered sharp, speculative swings in stock prices in the past year, particularly among companies that are targets, or likely targets, of mergers and takeovers”).

198. David A. Vise, *SEC Forum Fails to Find Solutions to Rumors*, WASH. POST, Feb. 20, 1986, at E1 (quoting Gary Lynch).

199. See *id.* (“Furthermore, once a rumor starts circulating, the SEC may not be able to trace the initial source of the rumor.”) (quoting Gary Lynch).

200. As then SEC Chairman Christopher Cox testified at a Congressional hearing in the summer of 2008: “For the entirety of its 74-year-history until 2008, the Commission had never brought an enforcement action of this kind.” Glater, *supra* note 194 (quoting Christopher Cox).

tion of Alliance Data Systems Corp (“ADS”) while selling ADS short.²⁰¹ On November 29, 2007, the Schottenfeld trader allegedly sent instant messages to thirty-one securities professionals in a five minute period from 1:10pm to 1:15pm, claiming that the ADS board was in the process of meeting to consider a reduced buyout offer from Blackstone.²⁰² The false rumor spread extremely quickly and was picked up by the media: within 30 minutes, the price of ADS stock dropped 17 percent from \$77 to \$63.65.²⁰³ From 1:11pm to 1:17pm, the trader sold short 10,000 ADS shares; at 1:19pm, he began covering the entire short position, allegedly making a profit of \$25,509 before the New York Stock Exchange temporarily halted trading in the company and ADS issued a press release rejecting the rumor, leading the ADS stock price to close the day at near its pre-rumor price.²⁰⁴

The Schottenfeld trader quickly settled with the SEC. Just as the Bear Stearns fund manager prosecution involves allegations that may help circumvent the obstacles typically confronting valuation cases,²⁰⁵ the Schottenfeld case featured circumstances that reduced the normal hurdles in manipulative short-selling cases. The SEC’s claim that the trader had intentionally made false statements was made more credible by both the black & white, factual statements in the traders’ instant messages and the virtual concurrence of these messages and the trader’s entering and covering his short position with the decline in the ADS stock price. Similarly, the extremely short gap in time between the sending of the messages and the drop in the stock price undoubtedly reduced the SEC’s difficulty in tracing the rumor’s alleged origin. These factors likely played a role in the trader’s agreeing, without admitting or denying the allegations, to disgorge \$26,129 in profits and interest and pay a penalty of \$130,000.²⁰⁶

As for naked short selling, the SEC historically has brought very few cases involving violations of Regulation SHO.²⁰⁷ Moreover, it now seems clear that the

201. See Press Release, Sec. and Exch. Comm’n, *SEC Charges Wall Street Short-Seller with Spreading False Rumors* (Apr. 24, 2008), available at <http://www.sec.gov/news/press/2008/2008-64.htm>. The SEC cited violations of Section 17(a) of the Securities Act of 1933, Sections 9(a)(4) and 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5, promulgated under Section 10(b).

202. See Complaint at 4, Sec. and Exch. Comm’n v. Berliner, No. 08-CV-3859 (S.D.N.Y. Apr. 24, 2008).

203. See *id.*

204. See *id.* at 5–6.

205. See *supra* notes 159–169 and accompanying text (discussing Cioffi and Tannin case).

206. See Press Release, Sec. and Exch. Comm’n, *supra* note 201.

207. See, e.g., In Re Sandell Asset Mgmt. Corp., Exchange Act Release No. 33-8857 (Oct. 10, 2007) (settled enforcement action against Sandell Asset Management for, inter alia, allegedly shorting stocks in 2005 while misrepresenting to counterparties that it had located stocks to borrow); In Re Goldman Sachs Execution & Clearing, Exchange Act Release No. 34-55465 (Mar. 14, 2007) (censuring Goldman for facilitating illegal short sales from 2000 to 2002 by unreasonably relying on customer representations that sales were “long” orders). According to the SEC Inspector General, of 5000 complaints of naked short-selling the SEC received between January 1, 2007 and June 30, 2008, only 123 were forwarded for investigation, and none resulted in an enforcement action. See Zachary Goldfarb, *SEC Faults its Handling of Tips on Short Sales*, WASH. POST, Mar. 19, 2009, at D1.

succession of restrictions the SEC placed on naked and legal short selling in the summer of 2008 did not have the desired effect. Within weeks of the expiration of the temporary ban on shorting stocks, global markets began to drop sharply.²⁰⁸ Preliminary analysis by the SEC's Office of Economic Analysis has suggested that the short-selling ban may have contributed to this slide by reducing market liquidity and producing other unintended consequences.²⁰⁹ It is thus unlikely that the SEC will repeat these curbs. As then SEC Chairman Christopher Cox concluded in December 2008, "While the actual effects of [the restrictions] will not be fully understood for many more months, if not years, knowing what we know now, I believe on balance the commission would not do it again [. . .] The costs appear to outweigh the benefits."²¹⁰

In sum, while the federal investigations into illegal short sales, mortgage lender fraud, and financial institutions' valuation of complex securities are ongoing, it seems likely that law enforcement in many of these investigations may not reveal intentional or reckless wrongdoing. Successful prosecutions may focus on clear-cut cases like evident misrepresentations or obviously fraudulent rumors (or, for mortgage fraud in the wider market, to straightforward cases with relatively low impact). To be clear, this does not mean that federal law enforcement's efforts are misguided or unnecessary: far from it. If wrongdoing occurred, it should be subjected to criminal liability. Moreover, the continued threat of criminal liability provides an important deterrent to future crime. But in regard to conduct during the credit crisis, given all the obstacles discussed above, federal law enforcement may well fail to find much criminal wrongdoing.

PART III: STATE REGULATORY INVESTIGATIONS

In addition to the federal investigations discussed above, the credit crisis also has attracted intense scrutiny at the state level and has generated spirited, often behind the scenes, competition between state and federal law enforcement agencies. A look at some of the state regulatory investigations relating to the credit crisis provides an interesting contrast in tactics, goals, and results to date. Historically, states have played a key role in overseeing the financial system, including the regulation of securities. In the late nineteenth century, a number of questionable practices prompted legislators in various states to regulate the marketing of fraudulently valued securities.²¹¹ These "blue sky" laws²¹² generally

208. See Rachele Younglai, *SEC Chief Has Regrets Over Short-Selling Ban*, REUTERS.COM, Dec. 31, 2008, <http://www.reuters.com/article/ousivMolt/idUSTRE4BU3FL20081231?pageNumber=1&virtualBrandChannel=0> (last visited Mar. 20, 2009).

209. See *id.*

210. *Id.*

211. In 1911, Kansas was the first state to promulgate a securities statutory regulatory regime. A number of states quickly followed Kansas's lead, and today all states have blue sky laws. See 2 HAZEN, *supra* note 124, § 8.1[1][A] & n.4. See generally ROBERT N. RAPP, BLUE SKY LEGISLATION (2d ed. 2008).

provided for the registration of securities and sellers of securities, required a permit from the state before securities can be sold, and gave state regulators the power to investigate firms.²¹³ In passing federal securities legislation after the stock market crash of 1929, Congress preserved the states' oversight role.²¹⁴ Over the ensuing years much of the states' authority has been preempted under federal law, in response to criticism that the various state approaches to securities regulation had led to a "balkanized" patchwork of unwieldy regulations.²¹⁵ Nevertheless, Congress has retained state authority concerning the anti-fraud provisions of the securities laws, and state law enforcement agencies have remained active in this area.²¹⁶ For Attorneys General and other state regulators who must seek reelection, responding to financial fraud has brought massive positive media attention as white collar crime has become a high profile area of public concern.

The credit crisis has been no exception, as various troubled areas of the financial services industry have attracted significant state attention. A number of the state credit-crisis investigations have yielded some visible results. A key aspect of these investigations has been the goals adopted by state law enforcement agencies. Unlike the federal investigations, which appear focused on punishing individual

212. The "blue sky" appellation may have originated from the Kansas statute, which was intended to protect Kansas farmers from industrialists' selling "a piece of the blue sky." See 2 HAZEN, *supra* note 124, § 8.1[1][A].

213. See Christopher R. Lane, *Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators*, 39 NEW ENG. L. REV. 317, 321 (2005).

214. See Lane, *supra* note 213, at 325 (concluding that Congress envisioned "a dual system of regulation"). Section 18 of the Securities Act of 1933 originally provided in pertinent part: "[n]othing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person." Securities Act of 1933, ch. 38, 48 Stat. 85 (codified as amended at 15 U.S.C. § 77r (2006)). The National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416, substituted and amended this provision, which now reads: "Fraud authority. Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." 15 U.S.C. § 77r(c)(1) (2006).

Section 28(a) of the Securities Exchange Act of 1934 originally provided in pertinent part: "Except as otherwise specifically provided in this chapter, nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder." Securities Act of 1934, ch. 404, 48 Stat. 903 (codified as amended at 15 U.S.C. § 78bb (2006)).

215. Jonathan Mathiesen, *Dr. Spitzlove Or: How I Learned To Stop Worrying and Love "Balkanization"*, 2006 COLUM. BUS. L. REV. 311, 313 ("Recently, the term "balkanization" has arisen in the context of securities regulation, in reference to the wave of activism by select state attorneys general in prosecuting cases of securities fraud.").

216. States' actions have been facilitated by the fact that blue sky laws may have less stringent scienter requirements than their federal counterparts. See RAPP, *supra* note 211, §§ 14.08[2]–[3] (discussing various scienter requirements); see also 25A STEINBERG & FERRARA, *supra* note 125, §§ 13:22–13:23 (2001) (same). For example, New York's blue sky statute, the Martin Act, does not require scienter for criminal misdemeanor convictions or for civil enforcement actions. See Barry Kamins, *The Martin Act: A Sleeping Giant*, N.Y.L.J., Dec. 13, 2007, at 3. The Martin Act's robust enforcement authority has contributed to New York becoming a leader in prosecuting securities fraud.

wrongdoers, state regulatory actions regarding predatory lending, the auction rate securities market, and credit rating agencies have been more focused on obtaining consumer relief and systemic reform. This shift in focus, as well as the tactics regulators have brought to bear and business considerations at targeted companies, has allowed states to sidestep the problems of proving criminal intent or recklessness that currently confront federal investigations and to resolve investigations and enforcement actions quickly. At the same time, the state focus on pursuing remedies rather than investigating past conduct had led to companies being pressured to agree to settlements that may be broader than the facts would justify.

A. *Predatory Lending Practices*

State securities regulators have taken a leading role investigating and prosecuting alleged predatory lending practices, including, most prominently, those at Countrywide Financial, one of the nation's leading mortgage lenders, which led to a significant settlement between the company and eleven states in October 2008. Several factors facilitated this result. For one, business considerations at Countrywide and the opportunity to obtain closure with multiple regulators provided considerable incentives for the company to enter the settlement. In addition, rather than focus on demonstrating individual wrongdoing, the state law enforcement agencies concentrated on obtaining relief for distressed loan holders, thereby avoiding the need to prove that intentional or criminally reckless misconduct had occurred at the company.

The label "predatory lending" involves a number of deceptive and fraudulent lending practices,²¹⁷ but has come to be identified most closely in the credit crisis with subprime mortgage loans made to the elderly, minorities, and individuals with lower incomes and less education. One of the more common complaints throughout this period concerns homeowners confronted with "payment shock" regarding adjustable rate mortgages ("ARMs"). Often these loans were originated with very low "teaser" rates (in some cases as low as 1% p.a.) during the first few months of the mortgage; at the end of the low interest-paying period, however, the rates reset at substantially higher rates, leaving homeowners unable to afford monthly payments and placing them at risk of foreclosure.²¹⁸ Many borrowers claimed that the costs and higher interest rate mechanisms of these loans were not adequately disclosed and that they were persuaded to borrow or refinance after being

217. See DEP'T OF HOUS. AND URBAN DEV. AND DEP'T OF THE TREASURY, REPORT OF THE JOINT TASK FORCE ON PREDATORY LENDING 1-2, 17-18 (2001).

218. See MORRIS, *supra* note 69, at 69-71 (describing "viciously predatory" underbelly of mortgage industry); Gretchen Morgenson, *Cruel Jokes, and No One Is Laughing*, N.Y. TIMES.COM, Jan 13, 2008, <http://www.nytimes.com/2008/01/13/business/13gret.html?pagewanted=2&emc=eta1> (last visited Mar. 20, 2009) (describing functioning of ARMs).

subjected to deceptive or high-pressure sales tactics.²¹⁹

While federal authorities had investigated predatory lending practices in earlier years,²²⁰ state attorneys general and securities regulators have played the leading role in investigating and prosecuting predatory lending practices during the credit crisis. The prime example was the action against Countrywide Financial. In December 2007, following consumer complaints, the Illinois Attorney General announced an investigation of the company's alleged predatory lending practices.²²¹ In June 2008, both the Illinois Attorney General and the California Attorney General sued the company and its chief executive officer and president for engaging in deceptive advertising and unfair competition in "pushing homeowners into mass-produced risky loans for the sole purpose of reselling the mortgages on the secondary market."²²²

Nine other states subsequently joined California and Illinois, and by early October 2008, the California and Illinois Attorneys General announced that an agreement had been reached with Bank of America Corp., which had acquired Countrywide Financial in July, settling the fraud complaints.²²³ The settlement, described as likely to "become the largest predatory lending settlement in history," was valued at about \$8.7 billion, including loan modifications for those facing foreclosure valued at up to \$3.4 billion, as well as financial compensation for victims of predatory lending abuses.²²⁴

Several factors led to the settlement being achieved relatively quickly. The first were the business considerations facing Bank of America. Following the acquisition of Countrywide, Bank of America faced considerable regulatory pressure to modify the mortgages that had been issued, in addition to public scrutiny due to sympathetic portrayals of bilked lenders in the popular press.²²⁵ The settlement

219. See Christina Crapanzano, *Countrywide Is Assailed in Protest of Policies*, N.Y. TIMES.COM, Oct. 12, 2007, <http://www.nytimes.com/2007/10/12/business/12mortgage.html?emc=eta1> (last visited Mar. 20, 2009); see also Gretchen Morgenson, *Illinois to Sue Countrywide*, N.Y. TIMES.COM, June 25, 2008, <http://www.nytimes.com/2008/06/25/business/25mortgage.html> (last visited Mar. 20, 2009) ("People were put into loans they did not understand, could not afford and could not get out of.") (quoting Lisa Madigan, Illinois Attorney General).

220. See, e.g., DEP'T OF HOUS. AND URBAN DEV. AND DEP'T OF THE TREASURY, *supra* note 217.

221. Gretchen Morgenson, *Countrywide Subpoenaed by Illinois*, N.Y. TIMES, Dec. 13, 2007, at C1.

222. Press Release, Office of the Att'y Gen. of Cal., *Brown Sues Countrywide for Mortgage Deception* (June 25, 2008), available at http://ag.ca.gov/newsalerts/print_release.php?id=1582; see also Reuters, *California Sues Countrywide over Lending*, N.Y. TIMES.COM, June 26, 2008, <http://www.nytimes.com/2008/06/26/business/26lend.html> (last visited Mar. 20, 2009); Gretchen Morgenson, *supra* note 219.

223. See Andrew Harris, *Countrywide Settles Fraud Cases for \$8.4 Billion*, BLOOMBERG.COM, Oct. 6, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aWdK8sUCOLf0&refer=home> (last visited Mar. 20, 2009) (listing California, Illinois, Connecticut, Florida, Texas, Arizona, Washington, Iowa, Ohio, Michigan, and North Carolina as participating in settlement).

224. Press Release, Office of the Attorney General of California, *Attorney General Brown Announces Landmark \$8.68 Billion Settlement with Countrywide* (Oct. 6, 2008), available at <http://ag.ca.gov/newsalerts/release.php?id=1618> (last visited Feb. 26, 2009).

225. See, e.g., Morgenson, *supra* note 221 (describing home owner's problems with Countrywide pay option loan); see also MORRIS, *supra* note 69, at 70–71 (describing similar situation involving Countrywide).

thus presented the bank an opportunity to resolve the issue cleanly and protect the value of its acquisition.²²⁶ Moreover, modifying the loans made better financial sense for Bank of America than foreclosing on distressed loans and taking significant losses.²²⁷

In addition to these business considerations, the approach pursued by the state agencies facilitated the settlement. By cooperating in negotiating a single settlement, the eleven states were able to increase the pressure on Bank of America, while at the same time allowing the company the opportunity to resolve the complaints from multiple states, including many of those hit hardest by mortgage foreclosures, at once. Moreover, rather than focus on uncovering corporate criminal conduct, the states concentrated on obtaining relief for distressed mortgage loan holders. The civil lawsuits filed by Illinois and California alleged that Countrywide had engaged in unfair and deceptive practices in marketing and servicing their loans and requested that Countrywide be required to pay civil fines for violating state laws, in addition to modifying loans and providing other assistance to distressed mortgage holders.²²⁸ In the settlement, however, Bank of America did not admit wrongdoing and was not required to pay any fines.²²⁹ In other words, by foregoing any attempt to prove wrongdoing, the states were able to obtain a sizeable settlement for the benefit of distressed loan holders in comparatively short order. At the same time, to the extent that Countrywide cannot be held solely responsible for all the loans consumers agreed to enter, the settlement likely swept more broadly than the company's lending practices may have justified.

B. Rating Agency Investigations

State regulators also have been active in investigating the role of the credit rating agencies in contributing to the credit crisis. In July 2007, the leading credit rating agencies announced downgrades on securities backed by subprime mortgages that caused a steep drop in stock prices; state law enforcement agencies, particularly the New York State Attorney General's Office, responded by investigating the procedures agencies had used to rate these securities. Rather than focus on past wrongdoing, however, the New York State Attorney General's Office pushed for significant changes in the business practices of credit rating agencies, again avoiding the proof problems involved in proving criminal wrongdoing.

Credit agencies have long played a role in monitoring financial markets; in fact,

226. Accordingly, Bank of America had accounted for the cost of a potential settlement when acquiring Countrywide. According to a statement of the bank's CFO, the cost of restructuring the loans and the other provisions of the settlement were within the bank's pre-acquisition estimate. Dina ElBoghady, *Bank of America to Modify Mortgages from Countrywide*, WASH. POST, Oct. 7, 2008, at D03.

227. See *id.* (noting that settlement made financial sense for Bank of America because if 20% of troubled loans went into foreclosure—the industry rate at the time—the bank would be hit with \$22 billion in losses).

228. See Complaint at 72–81, *People v. Countrywide Fin. Corp.*, (Ill. Cir. Ct. June 25, 2008); Complaint at 42–46, *People v. Countrywide Fin. Corp.* (Cal. Super. Ct. June 24, 2008).

229. See ElBoghady, *supra* note 226.

2009 marks the hundredth anniversary of John Moody's publication of the first credit rating, in the form of an opinion on the creditworthiness of corporate debt issued by railroad companies.²³⁰ The modern role that credit agencies play in financial markets can be traced to a U.S. Treasury Department decision in 1931 to adopt credit ratings as the appropriate measure of quality for the bond accounts of nationally regulated banks.²³¹ Until the 1970s, the rating agencies made their money from subscription fees paid by investors for conducting research and rating the creditworthiness of issuers of debt securities;²³² during the 1970s recession, increased investor demand for reliable, independent credit ratings allowed the rating agencies to adopt their current business model of charging issuers of securities in order to make ratings available to the public free of charge.²³³

Calls for reform of this and other rating agency practices were voiced by many investors in the wake of the corporate scandals involving Enron, WorldCom, Global Crossing and other companies, where the agencies maintained investment-grade ratings on these companies within a few months of—and in the case of Enron, until four days before—their respective bankruptcies.²³⁴ The scandals and public outcry led to the passage of the Sarbanes-Oxley Act of 2002, which contained a provision requiring the SEC to investigate and review the rating agencies.²³⁵ In compliance with Sarbanes-Oxley, the SEC submitted its findings to Congress in January 2003;²³⁶ three years later, Congress passed the Credit Agency Reform Act.²³⁷ This Act gave the SEC authority to regulate competition within the credit-ratings industry and monitor conflicts of interest.²³⁸

230. See Ruth Rudden, *EVOLUTION OF CREDIT RATINGS – PART I*, CARICRIS (2005), <http://www.caricris.com/pdfs/article/evolutionpart1.pdf> (last visited Mar. 20, 2009).

231. See *id.*

232. See *id.*

233. See *id.*; see also SEC. AND EXCH. COMM'N, *REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS, AS REQUIRED BY SECTION 702(B) OF THE SARBANES-OXLEY ACT OF 2002*, at 41 & n.110 (2003) (noting that 90% of Moody's and Fitch's revenues come from issuers who pay fees for ratings).

234. See *id.* at 3–4, 16–17.

235. See *Rating the Rating Agencies: The State of Transparency and Competition: Hearing Before the Subcomm. on Capital Markets of the H. Comm. on Financial Services*, 108th Cong. (2003) (opening statement of Chairman Michael G. Oxley), available at <http://financialservices.house.gov/media/pdf/040203ox.pdf> (noting that Sarbanes-Oxley required SEC to submit report on rating agencies).

236. SEC. AND EXCH. COMM'N, *supra* note 233.

237. Pub. L. No. 109–291, 120 Stat. 1327 (2006).

238. The Act also abolished the SEC's authority to create Nationally Recognized Statistical Rating Organizations ("NRSROs"). See Marie Leone, *Senate Passes Credit Agency Reform Act*, CFO.COM, Sept. 22, 2006, <http://www.cfo.com/article.cfm/7959117?f=related> (last visited Mar. 20, 2009). In thirty years of using the appellation, the SEC had granted NRSRO status to only five firms: A.M. Best, Dominion Bond Rating Service, Fitch Ratings, Moody's Investors Service, and Standard & Poor's. See *id.* This led to concerns that the SEC had fostered an oligopoly in the rating agency market. See *Rating the Rating Agencies: The State of Transparency and Competition: Hearing Before the Subcomm. on Capital Markets of the H. Comm. on Financial Services*, 108th Cong. (2003) (opening statement of Michael G. Oxley, Chairman, Committee on Financial Services); see also Leone, *supra* (noting that Moody's and S&P controlled 80% of the market). While the act was intended to open up

Despite these reforms, similar criticism of ratings agencies has emerged during the current credit crisis, which superheated in July 2007, when the largest agencies announced plans to downgrade hundreds of bonds backed by subprime residential mortgages.²³⁹ S&P's ratings downgrade numbered 612 such bonds, valued at \$12 billion, while Moody's downgrade numbered 399 mortgage-backed securities, valued at an additional \$5.2 billion.²⁴⁰ Within days of the S&P and Moody's statements, Fitch Ratings also announced downgrades of bonds valued at \$7.1 billion because of rising delinquencies and defaults on subprime mortgages.²⁴¹ The ratings downgrades spooked an already nervous market, as investors fled stocks and low-quality bonds.²⁴²

Investors complained bitterly that delinquencies in residential mortgages had been rising for months prior to the ratings downgrades, and that S&P and Moody's were too slow in correcting the excessively high ratings that had been placed on many classes of bonds backed by subprime mortgages during the housing boom.²⁴³ Critics noted that the rating agencies were not paid during the initial review of loan pools or the negotiations with investment banking underwriters about the structuring of the loan pools.²⁴⁴ Underwriters thus were able to make data available to all three agencies, effectively getting a free preview of each agency's evaluation of the proposed deals, enabling them to shop for the best rating being offered.²⁴⁵ In addition, industry practice was to give the rating agencies only limited information, while the most detailed data concerning loan pools were not disclosed.²⁴⁶

This criticism, and the impact of the downgrades on the financial markets, was not lost on securities regulators. Shortly after the downgrades, the SEC announced that it had initiated an investigation into whether credit-rating agencies had followed proper procedures for rating mortgage-backed securities and managing conflicts of interest or whether they had been improperly influenced by security issuers and underwriters to publish high ratings.²⁴⁷ On June 11, 2008, the SEC

the market, the dominance of the top agencies continued throughout the credit crisis. *See Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Government Reform*, 111th Cong. (2008) (testimony of Sean J. Egan, Managing Director, Egan-Jones Rating Co.) (listing same market share for Moody's and S&P).

239. *See* Serena Ng & Ruth Simon, *Rating Cuts By S&P, Moody's Rattle Investors*, WALL ST. J., July 11, 2007, at A1.

240. *See id.*

241. *See* Bloomberg News, *Fitch May Downgrade Bonds Tied to Subprime Mortgages*, N.Y. TIMES, July 13, 2007, at C7.

242. *See id.*

243. *See* Ng & Simon, *supra* note 239.

244. *See id.*

245. *See id.*

246. *See id.*

247. *See* Robert Schroeder, *SEC Probing Rating Agencies' Subprime Role*, MARKETWATCH, Sept. 26, 2007, <http://www.marketwatch.com/news/story/sec-probing-ratings-agencies-subprime/story.asp> (last visited Mar. 20, 2009).

voted to propose a comprehensive series of credit rating agency reforms.²⁴⁸

State securities regulators, particularly in New York, also acted aggressively to reshape ratings industry practice. On June 5, 2008, a week before the SEC publicized its proposed rulemaking, New York Attorney General Andrew Cuomo announced that he had reached agreements with Standard & Poor's, Moody's Investor Services Inc., and Fitch Inc., providing for fee reform and other measures designed to "dramatically" boost credit rating agency independence.²⁴⁹ According to Mr. Cuomo's announcement, the agreement "fundamentally alter[ed]" the way the top three credit-rating agencies would do business going forward.²⁵⁰ Among the reforms effected were a new fee-for-service structure intended to address how the leading three credit rating agencies and investment banks chose which agency would rate an issue of residential mortgage-backed securities.²⁵¹ Under the agreement, the rating agencies will now be compensated for performing credit evaluations regardless of whether they are chosen to ultimately rate the issue. The rating agencies will also henceforth disclose all deals submitted to them for review, so that investors will know when issuers sought, but ultimately decided not to use, the ratings from a particular credit-rating agency, and develop criteria for the due diligence information required to rate mortgage-backed securities.²⁵² Finally, the credit rating agencies must conduct an annual review of their mortgage-backed securities practices to identify any that could compromise their ability to give independent ratings.²⁵³

Facilitating the rapidity of the New York State Attorney General's action was its focus on regulatory reform; comparing this approach with the SEC investigation provides an interesting contrast. As with other state credit-crisis investigations, the New York action focused on prospective regulatory changes. By contrast, the SEC's investigation initially focused on the past conduct of the rating agencies, particularly whether they had followed internal procedures on managing conflicts of interest or had been improperly influenced by security issuers and underwriters. This resource-intensive focus likely slowed the SEC response, even as the thorough investigation likely helped ensure that reform proposals were targeted closely at past abuses. For its part, shortly after the New York Attorney General's announcement, the SEC issued a brief statement supporting the reforms, describing the action "as an excellent example of how state and federal authorities can

248. See Press Release, Sec. and Exch. Comm'n, SEC Proposes Comprehensive Reforms to Bring Increased Transparency to Credit Rating Process (June 11, 2008), available at <http://www.sec.gov/news/press/2008/2008-110.htm>.

249. Press Release, Office of the Att'y Gen. of N.Y., Attorney General Cuomo Announces Landmark Reform Agreements With The Nation's Three Principal Credit Rating Agencies (June 5, 2008), available at http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html.

250. *Id.*

251. *See id.*

252. *See id.*

253. *See id.*

work together in a complementary manner,” and praising the state’s efforts to consult with the SEC and to “coordinate their efforts” with the SEC’s pending rulemaking for credit rating agencies.²⁵⁴ The SEC announced comprehensive amendments to its rules governing credit-rating agencies in December 2008, including a series of steps to curb potential conflicts of interest at bond-trading firms and stepped up disclosure requirements around the rating process.²⁵⁵ Coming six months after the New York agreement was reached, the SEC measures were addressed to the same fundamental issues of conflicts of interest and transparency that New York had targeted.

C. Auction Rate Securities

In responding to the credit crisis, states’ involvement has been especially evident in investigating the ARS market. Following the collapse of the market in early 2008, state law enforcement agencies, in conjunction with the SEC, moved promptly to investigate ARS issuers. Because of business considerations facing these companies, the formidable pressure state regulators and the SEC brought to bear, and the states’ primary focus on providing investor relief, sizeable settlements were quickly secured with a number of banks that underwrote and distributed ARS.

ARS are long-term taxable or tax-exempt securities issued by various corporate, non-profit and municipal entities.²⁵⁶ Before the market collapsed, interest rates paid by ARS were reset periodically in a process known as a “modified Dutch auction.”²⁵⁷ In this process (normally held at regular intervals of seven, fourteen, thirty-five and forty-nine days, depending on the ARS) investors placed bids with broker-dealers for the amount of ARS they wished to purchase and the minimum interest rate they were willing to accept; simultaneously, holders of ARS placed orders (which could be conditioned on interest rates falling below a certain level) to hold or sell their ARS.²⁵⁸ The broker-dealers passed the bid and sell orders to a designated auction agent, often a third-party bank selected by the issuer, that

254. Press Release, Sec. and Exch. Comm’n, Statement from SEC Chairman Cox Regarding New York Attorney General Agreement with Credit Rating Agencies (June 5, 2008), available at <http://www.sec.gov/news/press/2008/2008-109.htm>.

255. See Press Release, Sec. and Exch. Comm’n, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies (Dec. 3, 2008), available at <http://www.sec.gov/news/press/2008/2008-284.htm>; see also Kara Scannell & Aaron Lucchetti, *SEC Tightens Rules for Ratings Firms*, WALL ST. J., Dec. 4, 2008, at C3.

256. See STEPHANIE LEE, NERA ECONOMIC CONSULTING, AUCTION-RATE SECURITIES: BIDDER’S REMORSE? A PRIMER 1–2 (2008), available at http://www.nera.com/image/PUB_Auction_Rate_Securities_0708.pdf [hereinafter ARS Primer]. Closed-end mutual funds also issued ARS in the form of auction preferred stock. See *id.* at 3 (explaining closed-end mutual funds are investment companies that issue fixed number of shares, typically preferred stock to take advantage of leverage requirements under the Investment Company Act of 1940).

257. See *id.* at 5.

258. See *id.* at 5–9; see also Adrian D’Silva et al., Fed. Reserve Bank of Chi., *Explaining the Decline in the Auction Rate Securities Market*, ESSAY ON ISSUES NO. 256, at 1–2 (Nov. 2008), available at http://www.chicagofed.org/publications/fedletter/cflnovember2008_256.pdf (describing auction process).

determined the lowest interest rate that would result in the sale of the full ARS supply. The lowest bid rate at which all ARS shares could be sold at par established the “clearing rate,” i.e., the interest rate applicable to the issue until the next auction date.²⁵⁹

The ARS market functioned without major disruption since ARS were first issued in the mid-1980s until late 2007. ARS enabled their issuers to enjoy the benefits of paying short-term, typically lower interest rates while issuing long-term debt securities, making these securities an attractive alternative variable-rate financing vehicle.²⁶⁰ When the ARS market was functioning as designed, the periodic auction resets gave ARS a degree of liquidity comparable to very short-term assets,²⁶¹ leading many investors to regard them as “cash-like.”²⁶² Bank broker-dealers would often bid in their own auctions to ensure their smooth functioning and to prevent a failed auction or off-market interest rate.²⁶³ By 2008, there were approximately \$330 billion of ARS outstanding.²⁶⁴

By the fall of 2007, however, disruptions in the credit markets, including the woes of monoline insurance companies (many of which had backstopped ARS by providing guarantees or credit enhancements) led to a dramatic decrease in demand for ARS.²⁶⁵ Broker-dealers, who continued to perform their role as bidder of last resort,²⁶⁶ had to step in with increasing frequency to prevent failed auctions, resulting in their taking more ARS onto their balance sheets at a time when they were under considerable financial pressure due to write-downs from their exposure

259. See ARS Primer, *supra* note 256, 5–9.

260. See D’Silva et al., *supra* note 258, at 1–2.

261. See ARS Primer, *supra* note 256, at 5; D’Silva et al., *supra* note 258, at 1.

262. See ARS Primer, *supra* note 256, at 1.

263. See Liz Rappaport, *Auction-Rate Crackdown Widens—UBS Faces New Charges in New York, As Scrutiny of Wall Street’s Role Intensifies*, WALL ST. J., July 25, 2008, at A1.

264. See Thomsen Testimony, *supra* note 50, at 11 (describing broker-dealers functioning in both capacities); Jacqueline Doherty, *The Sad Story of Auction-Rate Securities*, BARRONS.COM, May 26, 2008, http://online.barrons.com/article/SB121159302439419325.html?mod=b_hpp_9_0002_b_this_weeks_magazine_home_right (last visited Mar. 20, 2009).

This is not to say that the ARS market was entirely without hiccups prior to the credit crisis. In 2004, the SEC initiated an investigation, reaching a settlement with 15 broker dealer firms for \$13 million. See Press Release, Sec. and Exch. Comm’n, 15 Broker-Dealer Firms Settle SEC Charges Involving Violative Practices in the Auction Rate Securities Market (May 31, 2006), available at <http://www.sec.gov/news/press/2006/2006-83.htm>. The SEC found that the settling firms had not adequately disclosed to investors certain auction practices, some of which had the effect of favoring certain customers over others or the issuer of the securities over the customer (or vice versa). The investigation concluded that, because “firms were under no obligation to guarantee against a failed auction, investors may not have been aware of the liquidity and credit risks associated with certain securities.” *Id.* A central condition of the settlement was that broker-dealers would disclose ARS liquidity risk, their input to the auctions, and their potential conflicts with current clients. See *id.*

265. See Dakin Campbell et. al, *Auction Rate Market Turmoil Continues*, BOND BUYER, Feb. 15, 2008, at 1; Liz Rappaport, *New Hitches in Markets May Widen Credit Woes*, WALL ST. J., Feb. 11, 2008, at A1 (describing decline in investor interest in ARS market in early 2008); see also Thomsen Testimony, *supra* note 50, at 37 (describing role of monoline insurance companies).

266. See *supra* note 263 and accompanying text.

to subprime securities.²⁶⁷ In late January 2008, some broker-dealers stopped providing support bids to make up for the declining demand in their Dutch auctions, resulting in a number of failed auctions: available bids were insufficient to cover the available supply of shares, leaving would-be ARS sellers stuck with the securities because of the gap between supply and demand.²⁶⁸ By mid-February, every broker-dealer had stopped supporting the auctions, leading the ARS market to seize up completely, rendering the previously liquid securities illiquid.²⁶⁹

Reacting to the ARS auction failures, state Attorneys General and other state securities regulators, as well as the SEC,²⁷⁰ launched investigations into the ARS market.²⁷¹ ARS investors, many of whom were individuals, alleged they had relied on broker statements that misleadingly represented that ARS were liquid securities, equivalent to money market instruments, and were not warned of the liquidity risk inherent in the ARS auction process.²⁷² These allegations had echoes of prior state regulatory investigations involving conflicts of interest: a number of banks functioned as both underwriters and as broker-dealers in the ARS market.²⁷³

As in other areas of the credit crisis that have come under scrutiny, state law enforcement agencies—working closely with the SEC—were able to obtain settlements from issuers of ARS relatively quickly. Beginning in early May 2008

267. See John Carney, *What Happened to the ARS Market Anyway?*, DEALBREAKER, Feb. 21, 2008, http://www.dealbreaker.com/2008/02/what_happened_to_the_ars_marke.php (last visited May. 20, 2009); see also Thomsen Testimony, *supra* note 50, at 37 (describing actions of broker-dealers); Doherty, *supra* note 264 (same).

268. See Thomsen Testimony, *supra* note 50, at 33–34 (describing mechanics of auction failure); Fin. Indus. Regulatory Auth., *Auction Rate Securities: What Happens When Auctions Fail*, <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P038207> (last visited Mar. 20, 2009). In the event of a failed auction, in order to provide an incentive for issuers to restructure the ARS and improve the potential for a later successful auction, the interest rate reverts to a fail rate that is often set higher than the market rate. See Anna Pinedo, *US Auction-Rate Securities: A Market Being Replaced*, INT'L FIN. L. REV., Nov. 2008, at 1, available at <http://www.mofo.com/docs/pdf/081106MarketReplaced.pdf>. In early 2008, however, this mechanism did not succeed in kickstarting the ARS market.

269. See Joan Gralla, *Failed U.S. Muni Auctions Attract Investors*, REUTERS.COM, Feb. 14, 2008, <http://www.reuters.com/article/companyNews/idUSN1446747120080214> (last visited Mar. 20, 2009); see also Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, N.Y. TIMES, February 15, 2008, at C6.

270. See Thomsen Testimony, *supra* note 50, at 11.

271. See Press Release, Ala. Sec. Comm'n, *Alabama Investors to Participate in Settlements over the Sale of Auction Rate Securities* (Sept. 26, 2008), available at <http://www.asc.state.al.us/Auction%20Rate%20Securities%20Settlements/Investors%20to%20Participate%20in%20Settlements.pdf> (describing Alabama's involvement in ARS investigation); Press Release, Office of Ill. Sec'y of State Jesse White, *Secretary of State Jesse White Investigates Auction Rate Securities Complaints* (Apr. 18, 2008), available at <http://www.cyberdriveillinois.com/press/2008/april/080418d2.html> (describing involvement of Illinois, Massachusetts, Florida, Georgia, Missouri, New Hampshire, New Jersey, Texas and Washington).

272. See Press Release, Ala. Sec. Comm'n, *supra* note 271 (describing investors); Press Release, Office of Ill. Sec'y of State Jesse White, *supra* note 271 (same); Press Release, Office of Mo. Sec'y of State Robin Carnahan, *Carnahan Launches Investigation into Auction Rate Securities Sales* (Apr. 10, 2008), available at <http://www.sos.mo.gov/news.asp?id=695> (same).

273. See Thomsen Testimony, *supra* note 50, at 35 (describing potentially conflicting incentives for broker-dealers functioning in both capacities).

and continuing into the following months, the Massachusetts Attorney General's office announced several agreements with broker-dealers over allegations that they impermissibly sold ARS to various Massachusetts municipalities and other government entities that were not statutorily permitted to purchase these securities.²⁷⁴ Other large global settlements between a number of financial institutions—including Citigroup, Merrill Lynch, UBS, Wachovia and other banks—and multiple regulators—including the SEC, the New York State Attorney General, and members of the North American Securities Administrators Association (an organization of state securities regulators)—soon followed.²⁷⁵ As part of these settlements, regulators alleged, among other things, that the companies had marketed and sold ARS as safe “cash equivalent” products, without disclosing the increasing liquidity risk in 2007 and 2008.²⁷⁶ The settling firms neither admitted nor denied these allegations, but agreed, among other things, to repurchase ARS at par from

274. See, e.g., Press Release, Office of the Att’y Gen. of Mass., Citigroup Agrees to Purchase Auction Rate Securities from Massachusetts Water Pollution Abatement Trust (Sept. 12, 2008), available at http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2008_09_12_citigroup_mwpat&csid=Cago; Press Release, Office of the Att’y Gen. of Mass., Morgan Stanley & Company Agrees to Repay Massachusetts Municipalities for Auction Rate Securities Investments (Aug. 7, 2008), available at http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2008_08_07_morgan_stanley_agreement&csid=Cago; Press Release, Office of the Att’y Gen. of Mass., UBS Financial Services Agrees to Return Over \$35 Million from Impermissible Municipal Investments to Massachusetts Towns and Cities (May 7, 2008), available at http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2008_05_07_ubs_agreement&csid=Cago; see also *Auction Rate Securities Market: A Review of Problems and Potential Resolutions: Hearing Before the H. Comm. On Financial Servs.*, 110th Cong. (2008) (statement of Martha Coakley, Att’y Gen. of Mass.), available at http://www.mass.gov/Cagof/docs/press/testimony_ag_sept19_auction_rate_securities_hearing.pdf (describing Massachusetts actions regarding ARS market).

275. See, e.g., Press Release, Office of the Att’y Gen. of N.Y., Attorney General Cuomo Announces Settlement with Wachovia to Recover Billions for Investors in Auction Rate Securities (Aug. 15, 2008), available at http://www.oag.state.ny.us/media_center/2008/aug/aug15a_08.html (describing Wachovia settlement); Press Release, Office of the Att’y Gen. of N.Y., Attorney General Cuomo Announces Settlements with JP Morgan and Morgan Stanley to Recover Billions for Investors in Auction Rate Securities (Aug. 14, 2008), available at http://www.oag.state.ny.us/media_center/2008/aug/aug14a_08.html (describing JPMorgan and Morgan Stanley settlements); Press Release, Office of the Att’y Gen. of N.Y., Attorney General Cuomo Announces Settlement with UBS to Recover Billions for Investors in Auction Rate Securities (Aug. 8, 2008), available at http://www.oag.state.ny.us/media_center/2008/aug/aug8a_08.html (describing UBS Settlement); Press Release, Office of the Att’y Gen. of N.Y., Attorney General Cuomo Announces Landmark Settlement with Citigroup To Recover Billions in Auction Rate Securities for Investors Nationwide (Aug. 7, 2008), available at http://www.oag.state.ny.us/media_center/2008/aug/aug7a_08.html (describing Citigroup settlement); see also Eric Dash, *Three Banks Settle Cases over Bonds*, N.Y. TIMES, Aug. 22, 2008, at C3 (describing ARS settlements with Merrill Lynch, Goldman Sachs, Deutsche Bank, Citigroup, JPMorgan Chase, Morgan Stanley, UBS, and Wachovia).

276. See sources cited *supra* note 275; see also Liz Rappaport & Randall Smith, *UBS to Pay \$19 Billion as Auction Mess Hits Wall Street*, WALL ST. J., Aug. 9, 2008, at A1 (describing regulators allegations that firms, among other things, “secretly propped up failed auctions” and “misled investors on the safety of the securities”). Some firms also were alleged to have allowed executives to trade in ARS for their own benefit. See, e.g., Evan Weinberger, *Ex-UBS Counsel Settles Cuomo’s ARS Claims*, LAW360, Oct. 7, 2008 (describing New York settlement with former general counsel of UBS) (on file with authors). One firm was alleged to have improperly influenced one of its research analysts to write a favorable piece on ARS to prop up the market price. See *infra* note 288 (discussing Massachusetts complaint against Merrill Lynch).

retail investors, charities, municipalities and small businesses on varying time-tables.²⁷⁷ Some banks, including UBS and Wachovia, also agreed to repurchase ARS at par from institutional customers.²⁷⁸ The firms also agreed to other measures, such as a special arbitration procedure to determine whether customers suffered consequential damages as a result of the lack of liquidity of their ARS.²⁷⁹ By year-end 2008, the ARS investigations had resulted in the banks agreeing to repurchase over \$61 billion from investors.²⁸⁰

The settlements were remarkable not only for their scope and the dollar amounts involved, but also for the speed with which they were reached with so many banks. Why did these investigations lead so quickly to settlements? Business considerations at the banks were one important factor. Many of the investors complaining about the firms' misrepresentations and lack of disclosure were still clients that the banks were anxious to retain.²⁸¹ As competitors made agreements to reimburse their clients, remaining firms faced increasing market pressure to follow suit.²⁸² Since the credit quality of the ARS remained relatively strong, despite the lack of liquidity in the market,²⁸³ the firms were better able to afford to repurchase the securities in order to assuage clients, match their competitors, and end regulatory scrutiny.²⁸⁴

The tactics that state regulators and the SEC employed and the enforcement options available to them were another important factor. A number of state regulators increased the pressure on targeted companies by publicizing their view of the facts, sometimes by filing complaints early in their investigations, even where companies were already cooperating with regulators.²⁸⁵ Prosecutors in a

277. See sources cited *supra* note 275.

278. See Press Release, Office of the Att'y Gen. of N.Y., Attorney General Cuomo Announces Settlement with Wachovia to Recover Billions for Investors in Auction Rate Securities, *supra* note 275; Press Release, Office of the Att'y Gen. of N.Y., Attorney General Cuomo Announces Settlement with UBS to Recover Billions for Investors in Auction Rate Securities, *supra* note 275.

279. See sources cited *supra* note 275.

280. Press Release, Office of the Att'y Gen. of N.Y., Attorney General Cuomo Announces the Release of Assurances of Discontinuance in Auction Rate Securities Settlements with Citigroup and UBS (Dec. 11, 2008), available at http://www.oag.state.ny.us/media_center/2008/dec/dec11a_08.html (calling the settlement the "largest consumer recovery in history").

281. Cf. Daisy Maxey, *Lingering Scars: Advisers' Job Records and Client Relationships May Long Be Tarred by the Auction-Rate Blowup*, WALL ST. J., Dec. 1, 2008, at R4 (discussing positive effect of settlements on financial advisers' client relations and retention).

282. See David Mildenberg, *Merrill, Goldman Pressured by Cuomo on Auction-Rate Debt*, BLOOMBERG.COM, Aug. 16, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a4XnkdnmMJQ&refer=home> (last visited Mar. 20, 2009).

283. See Dan Jamieson, *Reps Angry Over ARS Payback Delay*, INVESTMENT NEWS, Aug. 18, 2008, <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080818/REG/518129496/1009/TOC> (quoting Morgan Stanley employee that repurchases posed "no risk" because of high quality of ARS) (last visited Mar. 20, 2009).

284. Cf. Mildenberg, *supra* note 282 ("All the banks want to put these things behind them quickly so they can move on.") (quoting Duke University Law School professor).

285. See, e.g., Rappaport, *supra* note 263 ("It is frustrating that the New York Attorney General has filed this complaint while we have been fully engaged in good-faith negotiations with his office") (quoting UBS

number of states also had the power to seek revocation of the firms' state operating licenses, in addition to seeking monetary penalties.²⁸⁶ Next to these sticks, state regulators offered firms the carrot of entering global settlements that would end the investigations being independently conducted by different states' regulators, and with them the risk of incurring increasing penalties from successive regulators looking to distinguish their investigation from the previous ones. Similarly, the SEC played a highly important role in achieving these settlements, as many parties may have been less willing to settle without the SEC's participation. Indeed, the SEC accelerated its own internal processes to ensure many of these global settlements were achieved on the same time frame as the states. Finally, states focused on pursuing consumer relief: while many of the states' allegations involved claims of wrongdoing, the underlying purpose of the settlements was to unfreeze the assets of investors stuck with illiquid ARS.²⁸⁷ Settling firms did not admit to wrongdoing but instead agreed to repurchase ARS from investors.²⁸⁸ At the same time, the settlements likely were broader and more over-inclusive than the corporations' conduct justified: many sophisticated customers who were familiar with the risks of ARS were nonetheless covered by the settlements, and even firms with robust point-of-sale risk disclosures were required to repurchase ARS from their customers.

In all three areas in which states have achieved resolutions of their investigations, it remains too early to tell how significant the long-term impact of these actions will be. Broader, more meaningful reforms may be better achieved via a regulatory or legislative process that involves industry experts and brings all

spokesperson). This tactic is not one normally employed by federal prosecutors, who are typically bound by grand jury secrecy rules during the course of an investigation, generally wait until an investigation is completed to release information and file complaints, and often provide formal processes for contesting allegations prior to the commencement of an enforcement action. In addition, under the Martin Act, the New York Attorney General did not have to prove any intent to defraud for a criminal misdemeanor. *See supra* note 216.

286. *See* 25A STEINBERG & FERRARA, *supra* note 125, § 13:14.

287. *See, e.g.*, Press Release, Office of the Att'y Gen. of N.Y., Attorney General Cuomo Announces Settlement with Wachovia to Recover Billions for Investors in Auction Rate Securities, *supra* note 275 ("From the beginning of his investigation into the auction rate market, the Attorney General's objective has been to bring relief to investors stuck with illiquid auction rate securities . . . The settlements with Citigroup, UBS, JP Morgan, Morgan Stanley, and Wachovia accomplish precisely the kind of relief investors have demanded . . .").

288. For some firms, the facts underlying the allegations also were not auspicious. The Massachusetts complaint against Merrill Lynch provides a good illustration. The bank allegedly had permitted its sales and trading managers, including the auction desk managers, to inappropriately influence and pressure the bank's research department. These managers allegedly were allowed to push the research department to publish pieces endorsing the stability and quality of all types of ARS. For example, a research department piece comparing Variable Rate Demand Obligations ("VRDOs") and ARS noted that VRDOs have a protective put option feature that ARS lack. The complaint alleges that the ARS manager demanded a retraction; when the research analyst refused, the ARS manager escalated the complaint. The research department ultimately retracted and rewrote the piece with a markedly different focus and scope, concluding with a glowing endorsement of ARS "as a buying opportunity for investors who are looking for short-term instruments." *See* Office of the Sec'y of the Comm. Of Mass. Sec. Div., Administrative Complaint, In Re Merrill Lynch, Pierce, Fenner, & Smith, Inc., No. 2008-0058 (July 31, 2008).

stakeholders to the table, not just the parties to the lawsuit. Nonetheless, the states' focus on obtaining consumer relief and promoting regulatory reform, combined with state tactics that have encouraged settlement, has paid immediately visible dividends and avoided the difficulties of proof that confront many ongoing federal investigations.

PART IV: CONCLUSION

Senator Patrick Leahy, D-Vt., summed up the public mood recently when he reportedly said that U.S. taxpayers will want to see heads roll in return for their bailout of the financial sector.²⁸⁹ In the midst of populist rhetoric combined with the worst recession in recent times, record blue and white collar unemployment,²⁹⁰ and continued publicity about outsized compensation packages for Wall Street and corporate executives,²⁹¹ prosecutors and regulators will undoubtedly feel enormous pressure to find wrongdoers to hold responsible.²⁹²

It is critical, however, that law enforcement and prosecutors not allow intense public pressure to lead them to bring cases that should not be brought. Many institutional failures in the credit crisis were the result of human errors in judgment—in some cases, massive errors—but not intentional wrongdoing. This is not to say that law enforcement's search for villains is misguided or unnecessary. Where wrongdoing occurred, it should be subjected to criminal liability, and the continuing threat of criminal liability may provide an important deterrent to future crime. Moreover, law enforcement can play a significant role in obtaining consumer relief and promoting regulatory reform. It is to say, however, that in this overheated political climate, prosecutors and regulators must constantly keep in mind that their overriding goal should be to do justice, and not fall victim to the temptation of satisfying the public's desire for catharsis if wrongdoing has not occurred.

289. Evan Weinberger, *Heads May Roll in Wake of Financial Collapse*, LAW360, Oct. 3, 2008 (on file with authors).

290. Sudeep Reddy et al., *Job Losses Worst Since '74: 533,000 Shed in November*, WSJ.COM, Dec. 6, 2008, <http://online.wsj.com/article/SB122848262764182657.html> (last visited Mar. 20, 2009).

291. See, e.g., Andrew Ross Sorkin, *Outcry Builds for Recovery of A.I.G. Bonuses*, DEALBOOK, Mar. 17, 2009, <http://dealbook.blogs.nytimes.com/2009/03/17/outcry-builds-for-recovery-of-aig-bonuses/?scp=5&sq=a.i.g.&st=cse> (last visited Mar. 20, 2009) (noting congressional reaction to announcement that A.I.G. had paid out \$165 million in bonuses after receiving more than \$170 billion in federal bailout money).

292. Cf. David Segal, *Financial Fraud Is Focus of Attack by Prosecutors*, N.Y. TIMES, Mar. 11, 2009, at A1 (describing state and federal plans for "a surge of prosecutions of financial fraud").