

LESSONS FROM THE FCIC FINAL REPORT IN FHFA V. NOMURA

The ruling of Judge Denise Cotes in *Federal Housing Finance Administration v. Nomura Holding America, Inc.*, is a 361 page description of the fraud and corruption that went into just one group of real estate mortgage-backed securities. FHFA was formed after the Great Crash to oversee Fannie Mae and Freddie Mac. These two entities were the actual buyers of the RMBSs offered by Nomura Securities International, Inc., and RBS Securities, Inc., then known as Greenwich Capital Markets, Inc. The Court finds that a number of statements in the offering materials were false at the time of the offering, in violation of Section 12 of the Securities Act of 1933. It awarded a judgment in the amount of \$806 million, and required FHFA to tender return of the securities.

This Reuters story is typical of the coverage of the decision, in the “we knew that” mold. Peter Eavis of the New York Times wrote a clearer explanation, pointing out that this decision undercuts any argument that Wall Street banks did not break the law in the sale of RMBSs. This is the first paragraph of the decision:

This case is complex from almost any angle, but at its core there is a single, simple question. Did defendants accurately describe the home mortgages in the Offering Documents for the securities they sold that were backed by those mortgages? Following trial, the answer to that question is clear. The Offering Documents did not correctly describe the mortgage loans. The magnitude of falsity, conservatively measured, is enormous.

In this post, I’ll look at several aspects of

the case: 1) the legal framework; 2) the discussion of the due diligence tracks the findings of the Financial Crisis Inquiry Commission in its Final Report; 3) the individual liability holdings; 4) the role of the Credit Rating Agencies; and 5) loss causation.

!. The Legal Framework.

The main theory of liability in this case is the Securities Act of 1933, 15 USC § 77a et seq., specifically Section 12. The operative language says that a person who

offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission

is liable to the purchaser for any loss arising from the misrepresentations. The plaintiff has to prove that the offering materials contained an untrue statement of a material fact, and that the purchaser did not know about the falsehood. Sellers can defend by proving that they did not know and “in the exercise of reasonable care could not have known” of the falsehood. Sellers can also reduce their damages to the extent they bear the burden of proving that the losses of the buyer were not caused by the falsehood. The

defendants did not claim that Fannie Mae and Freddie Mac knew that the offering materials were full of falsehoods. Thus, the main focus of the decision is the falsehoods in the offering materials.

2. The Due Diligence Defense and The Final Report of the FCIC

If the Defendants exercise reasonable care in preparing the offering materials, they are protected from liability. In fact, the risks of failing to exercise due care are so great that investors believe that financially strong sellers of securities wouldn't take the risk of selling unless they had done good due diligence. Of course, our dominant ideology, neoliberalism, preaches that markets, whatever they might be, police themselves, and securities laws are unnecessary. Here's a lovely example from John Spindler, now a business law professor at the University of Texas (it's not on his CV). The Final Report also calls out this bizarre idea, beginning at P. 171 (.pdf page 198).

The Final Report looks at the due diligence across the universe of securitizers in Chapter 9, page 156 (.pdf page 184). It says that the securitizers did little or no due diligence themselves. Instead, they farmed it out to third parties. These vendors examined a sample of loans from a pool, and reported whether the loans met the guidelines that the originators claimed to follow, whether they complied with federal and state laws, and whether the valuations of collateral were reasonably accurate. They also looked for compensating features that might outweigh the defects. The sample loans were graded, and the securitizers could use these grades to kick out loans, or they could waive the defects, and in either case, they could use the information to negotiate the purchase price for the pool.

The Final Report says that vendors reported very high defect rates, and that securitizers waived in a high percentage of the defective loans. The originators then put the kicked-out loans into

other pools proposed for sale. Disqualifying defects were discovered in 28% of the loans examined by one vendor, Clayton Holdings, for the 18 months ending June 30, 2007. Of those, 39% were waived in, so that 11% of defective loans were included in purchased pools. The samples were small, as low as 2 or 3%. There seems to be little effort to find the defective loans in the non-sampled portion, so it's reasonable to assume that a similar or higher percentage of loans in the entire pool are defective.

Judge Cote follows a similar pattern. Nomura had no written procedures for evaluating loans. P. 48. After it won a bid for a pool, it conducted a review of the loans, relying on the information contained on the loan tape provided by the originator of the loans in the pool. The loan tape is actually a spread sheet containing information about the loans, including FICO scores, debt to income ratios, loan to value ratios, owner-occupancy status and other important data. P. 31. Nomura sent the loan tape to its vendors to conduct reviews for credit, compliance with originator's stated underwriting guidelines, and valuation. The due diligence was done on a sample, in the range of 25-30%, but it was not a random sample, so the results could not be extended to the entire loan pool.

Of the loans submitted beginning in 2006 and the first quarter of 2007, one vendor graded 38% as failing to meet the originator guidelines. Nomura waived in 58% of those. It also had very high kickout rates for the pools it purchased. That means that of the examined loans, about 22% had major defects, again not counting the unexamined loans. With high kick-out rates, the number of defective loans remaining would be much higher.

The offering materials for these RMBSs all claimed that the loans met the originator guidelines with some exceptions. Judge Cote says this was a false statement, and that there was no showing that the defendants had done the kind

of investigation required to avoid liability.

3. Individual Liability.

The Judge looks at the liability of the five individual defendants in part IV.b.3. P. 234. These are the officers, directors and signatories of the entities responsible for the filing of the offering materials. The ruling is harsh:

All five Individual Defendants testified at trial. The general picture was one of limited, if any, sense of accountability and responsibility. They claimed to rely on what they assumed were robust diligence processes to ensure the accuracy of the statements Nomura made, even if they did not understand, or, worse, misunderstood, the nature of those processes. Not one of them actually understood the limited role that due diligence played in Nomura's securitization process, and some of them actually had strong reason to know of the problems with the diligence process and of the red flags that even that problematic process raised.

Each Individual Defendant made a point of highlighting the aspects of Nomura's RMBS business for which he claimed to have no responsibility. None of them identified who was responsible for ensuring the accuracy of the contents of the Prospectus Supplements relevant to this lawsuit, and, as this group of Individual Defendants furnished the most likely candidates, the only logical conclusion is that no one held that responsibility.

A detailed explanation of this summary follows. Apparently securitizers have terrible memories.

4. Misleading The Credit Rating Agencies

FHFA did not claim the ratings were false, but

that the ratings were not based on accurate information about the actual collateral for the RMBSs. The Court found that the defendants gamed the credit rating agencies models by submitting only the loan tapes prepared by the originators, even when they knew that the loan tapes were full of errors that would affect the final rating. Page 202. The Court found that the ratings depended on factors like the loan to value ratio and the debt to income ratio. The Court found that the LTV ratios were lower than represented by Nomura in 18-36% of the loans, and that many LTV ratios were above 100%, which skewed the models of the credit rating agencies and bought Nomura undeserved AAA ratings. This is a nice piece of lawyering by the legal team at Quinn Emanuel.

The FCIC is not so forgiving towards the Credit Rating Agencies:

The Commission concludes that the credit rating agencies abysmally failed in their central mission to provide quality ratings on securities for the benefit of investors. They did not heed many warning signs indicating significant problems in the housing and mortgage sector. Conclusion to Ch. 10 at .pdf 240

But there's no point in shooting at the credit rating agencies. They have a get out of jail free card from the judiciary, which says that they are just giving opinions and are protected by the First Amendment.

5. Loss Causation.

The defendants argued that they didn't cause the loss. They claimed that it was the housing market crash. Judge Cote cites a recent decision from the Second Circuit, *Fin. Guar. Ins. Co. v. Putnam Advisory Co., LLC*, – F.3d –, 2015 WL 1654120 at 8 n.2

... there may be circumstances under which a marketwide economic collapse is itself caused by the conduct alleged to have

caused a plaintiff's loss, although the link between any particular defendant's alleged misconduct and the downturn may be difficult to establish.

Judge Cote tells us that the Second Circuit cited the Final Report of the FCIC for the proposition that the housing crash was linked to the "shoddy origination practices concealed by the misrepresentations" in the Nomura offering materials. Those shoddy practices contributed to the housing bubble, and were factors in the Great Crash. Crucially, she writes at 332:

Defendants do not dispute this. They do not deny that there is a link between the securitization frenzy associated with those shoddy practices and the very macroeconomic factors that they say caused the losses to the Certificates. This lack of contest, standing alone, dooms defendants' loss causation defense, which, again, requires them to affirmatively prove that something other than the alleged defects caused the losses.

6. Conclusions

The legal team at Quinn Emanuel did a nice job of preparation. The people who prepared the testimony of the expert Dr. William Schwert deserve a special mention: that was really smart. See page 204 and previous material.

It looks like the Quinn Emanuel team and the Judge were deeply informed by the Final Report, and used it as a road map to digging up and presenting evidence of the fraud and corruption in the securitization process. It's a terrible shame the spineless prosecutors at the Department of Justice couldn't grasp the point of the Final Report. That is, unless the prosecutors did understand, and the decision was made by the neoliberals at the top, Lanny Breuer and Eric Holder, and the banker's best friend,

Barack Obama.