

## Recent Developments in Regulatory Investigations

Federal and state regulators are investigating the practices of various participants in the subprime mortgage market. State regulators have so far been responsible for the vast majority of subprime-related enforcement actions, prompting members of Congress to criticize the Securities and Exchange Commission (SEC) for failing to identify “who was asleep at the switch” and to take action to respond to the mortgage crisis.<sup>1</sup>

The collapse of Bear Stearns will likely lead to increased regulatory oversight of hedge funds and investment banks.<sup>2</sup> In a January 2008 report, the Government Accountability Office (GAO) called for continued vigilance over hedge fund activities. The GAO described self-regulation as challenging for the hedge fund market, in part because the funds use multiple prime brokers as service providers and no single provider has independent information about a fund’s total leverage.<sup>3</sup> In the week following the collapse of Bear Stearns, the SEC began investigating a dramatic increase in trading on option contracts which would benefit buyers if the company’s stock declined quickly and dramatically.<sup>4</sup>

Examples of recent federal and state investigations involving subprime mortgages and investments include:

### Securities and Exchange Commission Investigations:

The SEC formed a subprime working group in the spring of 2007 and has approximately three dozen open investigations.<sup>5</sup> “The investigations cover a broad range of possible misconduct ranging from the origination process, to the securitization and retail sales of mortgage-backed securities, as well as insider trading.”<sup>6</sup> Other areas of focus include fraud and breaches of fiduciary duty in connection with collateralized debt obligations, valuation issues and transfers of ownership.<sup>7</sup>

The SEC has also begun scrutinizing how hedge funds account for illiquid assets. When hedge fund managers are unable to value assets, they have the option of moving them to “side pockets,” where they are not included in calculations of the fund’s net asset value. Side pockets allegedly may be used to hide hedge fund losses from investors, a special

<sup>1</sup> Nicholas Rummell, *SEC drift said to prevent action on credit crunch: With two empty seats, agency deemed more process than product*, 12 INVESTMENT NEWS 8 (Feb. 25, 2008).

<sup>2</sup> Bob Davis, Greg Ip and Damian Paletta, *U.S. Mulls Next Step in Crisis: Further Bailouts, Stimulus Likely; Markets Still Edgy*, THE WALL STREET JOURNAL, March 18, 2008, at A1.

<sup>3</sup> United States Government Accountability Office, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed* (Jan. 2008); see also Edward Hayes, *Regulators Eye Hedge Fund Brokers*, Wolters Kluwer Financial Services (March 5, 2008), available at <http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=03-05-08>.

<sup>4</sup> Kara Scannell, *SEC’s Bear Stearns Probe Zeroes In on ‘Put’ Trades*, THE WALL STREET JOURNAL, March 20, 2008, at C2.

<sup>5</sup> Yael Bizouati, *CDOs and Cities: Merrill’s legal issues in Springfield may lead to more suits. Acknowledging liability?*, INVESTMENT DEALERS’ DIGEST (Feb. 18, 2008).

<sup>6</sup> The Bureau of National Affairs, Inc., *In Three Dozen Subprime Investigations SEC Is Asking ‘Who Knew What, When’*, 40 SECURITIES REGULATION & LAW 7 (Feb. 18, 2008).

<sup>7</sup> *Id.*

danger if a manager does not disclose the percentage of the fund's portfolio in a pocket or the standards used to determine whether an asset will be placed there.<sup>8</sup>

The SEC's investigations of Merrill Lynch & Co. and UBS may lead it to issue subpoenas to both companies. According to newspaper reports, the Commission is also conducting probes of Bear Stearns, Morgan Stanley, Goldman Sachs Group, Inc., Regions Financial Corporation, the Royal Bank of Scotland's Greenwich Capital unit, and MBIA.<sup>9</sup> The SEC has been coordinating efforts with the Federal Bureau of Investigation, which has more than a dozen open criminal probes of subprime lenders.<sup>10</sup>

### **Financial Industry Regulatory Authority Investigations:**

The Financial Industry Regulatory Authority (FINRA) was created in July 2007 through the merger of the National Association of Securities Dealers and certain functions of the New York Stock Exchange.<sup>11</sup> FINRA has authority to fine, suspend or expel from the industry companies which violate FINRA rules, federal securities laws, or rules enacted by the Municipal Securities Rulemaking Board.<sup>12</sup>

FINRA, which has focused on the sale of investment products to seniors, recently sent letters to as many as two dozen companies that sell collateralized mortgage obligations requesting detailed information about sales, marketing, review processes, and consumer complaints.<sup>13</sup> The regulator may be investigating these products because they are widely marketed, but difficult to understand, and because the products could appeal to seniors.<sup>14</sup>

### **State Investigations:**

State regulators have aggressively investigated allegations of subprime-related fraud.<sup>15</sup> For example, Massachusetts Secretary of State William Galvin has alleged that Bear Stearns failed to disclose its conflict of interest in trading with hedge funds it managed,

<sup>8</sup> Edward Hayes, *SEC Focuses on Hedge Fund Valuations*, Wolters Kluwer Financial Services (March 12, 2008), available at <http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=03-12-08>.

<sup>9</sup> Reuters News Agency, *U.S. officials probing UBS over subprime bank crisis, paper says*, TORONTO STAR, Feb. 3, 2008, at A12; David Flaum, *Morgan Keegan CEO is leaving – SEC seeks facts on losing mutual funds*, MEMPHIS COMMERCIAL APPEAL, Feb. 28, 2008, at C1; *FBI Joins SEC In Probing Subprime Loan Problems*, CONGRESS DAILY, Jan. 30, 2008; Mark Ginocchio, *RBS unit involved in SEC inquiry; Greenwich Capital plans to cooperate in probe*, THE ADVOCATE, Feb. 8, 2008; Alan Zibel, *Federal Probe of Subprime Mortgage Mess Likely to Focus on Whether Banks Duped Investors*, CANADIAN BUSINESS ONLINE, Feb. 1, 2008, available at [http://www.canadianbusiness.com/markets/market\\_news/article.jsp?content=D8UHPJNO0](http://www.canadianbusiness.com/markets/market_news/article.jsp?content=D8UHPJNO0).

<sup>10</sup> *SEC Probes Dozens of Subprime Lenders*, CFO MAG. FOR SENIOR FIN. EXECUTIVES, Feb. 14, 2008; *SEC Turns Spotlight on Countrywide CEO Mozilo*, MORTGAGE NEWS DAILY, available at [http://www.mortgagenewsdaily.com/10182007\\_Mozilo\\_Investigation.asp](http://www.mortgagenewsdaily.com/10182007_Mozilo_Investigation.asp).

<sup>11</sup> Financial Industry Regulatory Authority, *About the Financial Industry Regulatory Authority*, available at <http://www.finra.org/AboutFINRA/index.htm>.

<sup>12</sup> Financial Industry Regulatory Authority, *FINRA Enforcement & Market Regulation*, available at <http://www.finra.org/RegulatoryEnforcement/FINRAEnforcementMarketRegulation/index.htm>.

<sup>13</sup> David Scheer and Jesse Westbrook, *Brokers Probed by Finra on Mortgage Security Sales, Person Says*, Bloomberg.com (Jan. 4, 2008).

<sup>14</sup> Edward Hayes, *FINRA Joins Mortgage Storm*, Wolters Kluwer Financial Services (Feb. 4, 2008), available at <http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=02-04-08>.

<sup>15</sup> For information about state Attorney General investigations, see *Recent Developments in Attorney General Investigations*.

and has subpoenaed MBIA, Inc. and Ambac Financial Group, Inc. for information about disclosures the firms made to cities and towns regarding their subprime exposure.<sup>16</sup>

Early this year, the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth filed an administrative complaint against Merrill Lynch & Co., alleging that the company sold the city of Springfield collateralized debt obligations which were unsuitable investments and quickly lost almost all of their value. The Securities Division is seeking an injunction, an administrative fine, disgorgement of any profits Merrill Lynch made on the sale of the CDOs, and the appointment of a consultant to review conditions at Merrill Lynch that enabled the alleged wrongdoing.<sup>17</sup> The complaint was filed only one day after Merrill Lynch agreed to reimburse the city almost \$14 million to compensate it for the CDOs' loss in value, and is part of a larger investigation into Merrill's transactions with other Massachusetts towns and cities.<sup>18</sup>

#### **Additional Regulatory Agency Investigations:**

Federal and state regulatory agencies, including the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Conference of State Bank Supervisors, and the American Association of Residential Mortgage Regulators, announced last summer that they would begin a project "to conduct targeted consumer-protection compliance reviews of selected non-depository lenders with significant subprime mortgage operations."

The project, which was slated to begin in the fourth quarter of 2007, was intended to focus on underwriting standards, risk-management oversight, and methods of ensuring compliance with consumer protection regulations, such as the Equal Credit Opportunity Act, the Truth in Lending Act, and the Home Ownership and Equity Protection Act.<sup>19</sup>

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<sup>16</sup> Associated Press, *Regulators' Subprime Mortgage Cases*, Feb. 18, 2008.

<sup>17</sup> *In the Matter of: Merrill Lynch, Pierce, Fenner & Smith Inc., Carl Kipper and Manuel Choy*, Docket No. 2008-0001 (Feb. 1, 2008).

<sup>18</sup> Yael Bizouati, *supra* note 5.

<sup>19</sup> Press Release, Board of Governors of the Federal Reserve System, Federal and State Agencies Announce Pilot Project to Improve Supervision of Subprime Mortgage Lenders (July 17, 2007), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/20070717a.htm>.