Securities Regulation Daily Wrap Up, TOP STORY—S.D.N.Y.: Federal judge finds Nomura, RBS liable in RMBS case, (May 11, 2015)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

The Federal Housing Finance Agency (FHFA) won its federal case against the purveyors of residential asset-backed securities during the housing boom years of the mid-2000s. Manhattan District Court Judge Denise Cote said that while the "[t]he magnitude of falsity, conservatively measured, is enormous," the case turned on just one question: did those who sold and marketed the securities do enough to accurately describe them to investors? Today's opinion is the culmination of the bench trial that was held during a three-week span in March and April of this year (*Federal Housing Finance Agency v. Nomura Holding America, Inc.*, May 11, 2015, Cote, D.).

The FHFA, on behalf of the government-sponsored entities (GSEs), the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (Freddie Mac), sued Nomura Holding America, Inc. (Nomura) and RBS Securities Inc. (RBS) for securities violations based on Nomura's and RBS's alleged roles in the sale of residential mortgage-backed securities (RMBS) to the GSEs during the run-up to the 2008 financial crisis. Nomura and RBS were found liable under Securities Act Section 12(a)(2) and related Blue Sky laws.

Section 12(a)(2) liability. The court quickly found that Nomura and RBS were statutory sellers who either solicited or passed title to the RMBS certificates at issue for value by providing data about collateral and supplying preliminary offering materials as part of the public offerings of the certificates. While reciting the various ways a defendant can be held liable under Securities Act Section 12(a)(2), the court noted that the Supreme Court's *Omnicare* opinion clarified two of these modes, but all of the parties turned down a chance to tell the court how that ruling might impact this case.

As for the falsity element of the FHFA's case, Judge Cote found that the agency had proven the falsity of four sets of related representations included in all seven disputed prospectuses. The court noted that as many as 45 to 59 percent of the loans at issue did not follow applicable underwriting guidelines.

Judge Cote singled out Nomura's practice of doing only pre-acquisition due diligence (typically without relating the results to supporting loan groups) and often making its decisions based on how it could cut due diligence costs or placate mortgage loan sellers. The judge also took issue with the narrow view of one of the defendants' expert witnesses. Moreover, the defendants' theories about "generally" meeting the guidelines, or that the use of "believed" in a prospectus supplement required proof greater than what the Supreme Court required in *Omnicare* for an opinion fell short because the defendants' lacked any basis for their statements, and had even contradicted their representations.

FHFA made its case regarding loan-to-value (LTV) ratios and appraisals by proving these items to have been objectively and subjectively false (Judge Cote also said the defendants could be liable under *Omnicare*'s omissions doctrine). Likewise, FHFA also proved that the defendants' representations about owner occupancy tables and credit ratings were false.

On the issue of materiality, the court found ample reason to use a five percent threshold based on Second Circuit law, SEC rules, the offering documents at issue, and industry practice. Key qualitative features that could alter the total mix of information available to a reasonable investor included data on LTV ratios, compliance with underwriting guidelines, owner occupancy rates (a rare miss for FHFA since the rate was just 3.09 percent when isolated from other data), and credit ratings. The court rejected the defendants' six lines of attack on FHFA's case, while noting the major significance of credit ratings leading up to the financial crisis.

Section 12(a)(2) provides for a statutory calculation of damages or for a plaintiff to obtain rescission if it still owns the securities. The parties did not dispute the amount of consideration paid or the income received, but they disagreed about the tender date and the amount of prejudgment interest.

Judge Cote held that the tender date is the judgment date. As a result, she rejected the FHFA's constructive tender argument that would have set the tender date at September 2, 2011 (when the FHFA initially filed suit) on the ground that this earlier date would give the FHFA a windfall that is barred by the underlying purpose of Section 12(a)(2). Moreover, the prejudgment interest rate will be the coupon rate, an outcome all of the parties said was one of the possibilities, despite each of them having argued for a different rate.

Judge Cote also rejected the defendants' negative loss causation defense under Section 12(a)(2). The defendants had argued that the FHFA's losses were the result of macroeconomic factors beyond the representations in the offering documents. But Judge Cote noted that the defendants never affirmatively proved that any part of the FHFA's loss was due to macroeconomic factors, and the judge noted that the facts in this case made it clear that the defective representations were inseparable from the financial crisis.

On this last point, the court mentioned a decision by a Second Circuit panel last month in which the appeals court noted that misrepresentations often can blur into macroeconomic events in a manner that strengthens a defendant's negative loss causation defense. But Judge Cote also said that same decision noted that conduct alleged to have caused a plaintiff's loss may in some cases be the thing that caused the market-wide crisis (See footnote two in *Financial Guarantee Insurance Company v. The Putnam Advisory Company, LLC*).

Moreover, Judge Cote noted the Second Circuit's use of the Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States in discussing how some alleged securities violations can be linked to larger economic phenomena. But Judge Cote never considered that report in making her factual findings because the parties did not offer it as an exhibit. Still, the judge said the Second Circuit's prior citation to the report helped to confirm the trial record in the FHFA's case against Nomura and RBS.

Lastly, Judge Cote also dealt with questions of controlling person liability under Securities Act Section 15. In a 23-page section of her 361-page opinion, she found that Nomura, Nomura Credit & Capital, Inc., and five individual defendants were liable as controlling persons.

Blue Sky laws. The court also rejected Nomura's and RBS's arguments aimed at short-circuiting FHFA's state securities law claims. FHFA sued RBS under Virginia's Blue Sky law in its role as underwriter of three of the seven disputed securitizations. Likewise, FHFA sued Nomura Asset Acceptance Corp. (NAAC) and Nomura under the District of Columbia's (D.C.'s) Blue Sky law for NAAC's role as depositor, Nomura's role in underwriting one of the seven securitizations, and for the controlling role played by some of Nomura's officers and directors (similar claims under Virginia law were time-barred).

According to Judge Cote, the D.C. and Virginia laws are closely modeled after the Securities Act and the Uniform Securities Act of 1956, with only minor differences that did not play a significant role in the outcome of this case. She also rejected claims that the transactions at issue did not occur in D.C. or Virginia. RBS's argument that one Freddie Mac trader used a Blackberry phone indicated he was away from the office was unavailing because the phone message at issue was for a certificate not involved in this case, and no evidence showed Freddie Mac traders lived outside Virginia.

Judge Cote also said the defendants' "last-minute" effort to invoke the dormant commerce clause was inapt. The defendants had argued that the Supreme Court's 2010 *Morrison* opinion and the Second Circuit's *Absolute Activist* ruling had redefined the meaning of where a transaction can occur. But judge Cote said the time-honored rule that state Blue Sky laws cannot run afoul of the dormant commerce clause because they target solely intrastate transactions applied, and that *Morrison* and *Absolute Activist* did not change that legal landscape.

The case is No. 11cv6201.

Attorneys: Philippe Z. Selendy (Quinn Emanuel Urquart & Sullivan, LLP) for Federal Housing Finance Agency. David B. Tulchin (Sullivan & Cromwell LLP) for Nomura Holding America, Inc., Nomura Asset Acceptance Corp., Nomura Home Equity Loan, Inc., Nomura Credit & Capital, Inc., Nomura Securities International, Inc.,

David Findlay, John McCarthy, John P. Graham, Nathan Gorin, and Dante LaRocca. Thomas C. Rice (Simpson Thacher & Bartlett LLP) for RBS Securities Inc.

Companies: Federal Housing Finance Agency; Nomura Holding America, Inc.; Nomura Asset Acceptance Corp.; Nomura Home Equity Loan, Inc.; Nomura Credit & Capital, Inc.; Nomura Securities International, Inc.; RBS Securities Inc.

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