SEC HISTORICAL SOCIETY
WEBCAST TRANSCRIPT
"The Best of NERA V"

July 29, 2008 with Elaine Buckberg, Theresa Gabaldon, Stephanie Lee and Chudozie Okongwu

THERESA GABALDON: Good afternoon and welcome to The Best of NERA broadcast on www.sechistorical.org. I am Theresa Gabaldon, Lyle T. Alverson Professor of law at The George Washington University School of Law and moderator of today's program. The Best of NERA programs, celebrating their fifth anniversary with today's broadcast, are made possible through an ongoing partnership between NERA Economic Consulting and the Securities and Exchange Commission Historical Society. Since 2004 The Best of NERA has highlighted some of the top presentations from NERA Economic Consulting's annual Finance, Law and Securities Litigation Conference**.** I made my debut as an online program moderator for the SEC Historical Society with the first Best of NERA four years ago and I am delighted to return for today's broadcast.

The SEC Historical Society preserves and shares the history of securities regulation from the early 20th century to the present through its virtual museum and archive at www.sechistorical.org. The museum's collections are free and accessible worldwide at all times and welcome more than 8,000 visitors each month. The Society and the virtual museum and archive are separate from and independent of the U.S. Securities and Exchange Commission; they receive no government funding. Today's program is also part of the Society's ongoing commemoration of the upcoming 75th anniversary of the SEC in 2009.

All four previous The Best of NERA programs can be accessed again in podcast, transcript and audio formats in the Online Programs section of the virtual museum and archive. Over the past years, the programs have discussed a variety of topics in securities regulation, including assessing financial conditions and anticipating financial distress, fraudulent conveyance and restatements in light of Sarbanes-Oxley in the first Best of NERA in 2004; hedging restricted funds, analysis of the diversification of investment funds and economies of scale in mutual funds in the 2005 program; disgorgement, options backdating and mutual fund advisory fees in the 2006 program; and regulatory and legal risks in market manipulation, specialist trading and commodity market manipulation in last year's program. I am very happy to introduce today's panelists who will present their topics and add to this rich treasury of insights in current regulation. Dr. Elaine Buckberg, NERA's Senior Vice-President, is a veteran of past The Best of NERA programs. Welcome back. Elaine was a panelist in both the 2004 and 2006 programs. Today she will discuss SEC enforcement actions. Stephanie Lee, a NERA Senior Consultant, who will look at auction rate securities, and Dr. Chudozie Okongwu, also a NERA Senior Vice-President, who will talk to us about sub-prime issues. Our very sincere thanks go to NERA Economic Consulting for continuing its generous sponsorship of the program, as well as to Dr. Vinita Juneja, NERA Senior Vice-President and Chair of Global Securities and Finance Practice for overseeing the planning of today's program.

I would also like to commend the two persons who first envisioned The Best of NERA, Dr. Andrew Carron, now President of NERA Economic Consulting and a member of the Society's Board of Trustees, and Carla Rosati, the Society's Executive Director. At their first meeting in November 2003 they conceived an online program bringing together and recognizing the annual seminar's top presentations. Five years later, The Best of NERA is still going strong.

Before Elaine, Stephanie and Chu begin their presentations, I would like to remind our audience that the remarks made today are solely those of the speakers and do not represent the opinions of the Society. Our speakers cannot give legal or investment advice.

Elaine, Stephanie and Chu, welcome. Elaine, as our veteran, I would like you to kick off. Please do fill us in on the subject of SEC settlements post Sarbanes-Oxley Act.

ELAINE BUCKBERG: Thank you Theresa. Today I am going to be presenting some new NERA research on settlements in SEC enforcement actions since the passage of Sarbanes-Oxley in July 2002. The fifth anniversary of Sarbanes-Oxley was just last week. The findings I will present today rest on the new proprietary database of all SEC enforcement settlements that were announced on the SEC website between July 31, 2002 and December 31, 2007 and let me also note that we will soon be making all this data available to the public via a new website.

Since Sarbanes-Oxley, the SEC has imposed penalties of unprecedented size in its enforcement actions. Prior to Sarbanes-Oxley, the largest penalty imposed against a publicly traded company was $10 million against Xerox in April 2002. Our research finds that since Sarbanes-Oxley the SEC has imposed 111 penalties of $10 million or more, including 14 of $100 million dollars or more. The largest penalty was a February 2006 settlement at AIG with a penalty of $800 million.

Prior to 1990, the SEC was allowed to levy monetary penalties only in insider trading cases. This changed with the Securities Enforcement Remedies Act of 1990, which allowed the SEC to bring civil cases in federal court for any securities law violation. However according to former SEC staff members this authority was used sparingly before Sarbanes-Oxley, because extracting financial penalties from publicly traded companies was viewed as imposing additional harm on already aggrieved shareholders.

Sarbanes-Oxley changed that. The Fair Funds provision allows that monetary penalties collected in enforcement actions can be distributed to shareholders who may have been harmed as a result of the violation; previously the fines had gone to the U.S. Treasury.

The surge in high value settlements created uncertainty for defendants. Recognizing this, on January 4, 2006, the SEC published its Statement Concerning Financial Penalties in which it described nine factors that the Commission considers in determining monetary penalties. Without listing them all, let me highlight five themes. One is whether the company itself benefited as a result of the violation. Secondly, whether the penalty, if collected, could be used to compensate injured shareholders or if it further harmed the same shareholders. Third, the need and the difficulty of deterring the particular kind of offense. Fourth, how widespread and intentional were the acts, and fifth, the quality of the company's co-operation with the SEC and other law enforcement. In addition to laying out these principles to guide settlements, effective January 1, 2007, SEC staff are required to obtain Commission pre-approval for penalty amounts in settlements with public companies.

At this point let me note that we can only observe the outcome of those SEC investigations that resulted in an enforcement action, whether in federal court or administrative proceedings. SEC investigations are generally conducted privately and many investigations end without any punitive actions. Therefore we don't observe those SEC actions or investigations that end without an enforcement action.

Now let me begin to present our findings using the settlement data. We have looked at settlements for both companies and for individual defendants. Since Sarbanes-Oxley the SEC has reached 1,127 settlements with companies or corporations and 3,081 settlements with individual defendants. Federal court cases are a majority of both company and individual settlements, 55% of company settlements and 63% of individual settlements in federal court. Many federal court cases begin and end with a settlement. The SEC will file a complaint and the settlement simultaneously.

Although the SEC does not publicize active investigations, management of a public company under investigation must decide whether the securities laws require that the company itself publicly disclose the investigation if this information would be material. Of 162 public companies with SEC settlements related to company misstatements and omissions, 145 or fully 98% disclose the fact of an investigation prior to the settlement. The average time between the investigation announcement and a settlement was two years and two months.

Now let us look at the most frequent types of allegations resulting in a settlement. Micro cap fraud alone results in almost twice as many settlements as any other two kinds of allegations both in terms of company and individual settlements. Micro cap fraud includes boiler room operations, pump and dump schemes and fraudulent offerings. The next three categories, all with similar numbers of company settlements, are misstatements and omissions by public companies, misappropriation of investor funds by financial service companies and misrepresentations to investors by financial service companies. Insider trading has resulted in hundreds of settlements with individuals and is the most common allegation against individuals, yet insider trading has resulted in only 24 settlements with companies.

In 2003, the first year after Sarbanes-Oxley, there was a total of 899 SEC settlements. This includes individuals and companies, federal court and administrative settlements and, unless stated otherwise, that will be true of all the other statistics I will present. Settlements then declined in each year from 2004 through 2006 when the total number of settlements bottomed at 663. In 2007 the number of settlements increased again to 709.

The decline from 2003 to 2006 and then the rebound in 2007 are all driven by variation in the number of settlements with individuals. The number of settlements with companies has fluctuated in a relatively modest range of 188 to 240. There were 209 company settlements in 2007.

As I mentioned before, the SEC does not require monetary payment in all settlements. About 55% of company settlements involved monetary payments both for court and administrative settlements. Individual settlements, however, involved monetary payments and 81% of court cases, yet only 18% of administrative cases. The median individual settlement has been stable at around $100,000.

I will talk about company settlement values in a moment, but first let me compare company and individual settlements in terms of the breakdown between disgorgement and penalties. Individual settlements are 85% disgorgement in terms of dollars. Disgorgement is supposed to be an equitable remedy that equals the alleged ill-gotten gain by the settling party. Disgorgement represents 42% of company settlements where the remaining 58% is due to penalties. In other words the typical company settlement involves a penalty that's about 40% larger than the disgorgement amount.

Company settlements vary widely in amount. The typical or median settlement rose steadily from 2002 to 2006 from 400,000 to 1.5 million. These calculations and the others I will present exclude any settlements that involve no monetary payments. But in 2007 the median settlement then fell by nearly half to $800,000.

Average settlements are considerably higher. Average settlements peaked in 2005 at 15 million and fell to $8 million in 2007. But to give you a sense of how high settlements can go, let's also consider settlements at the 90th percentile. If we ranked non-zero settlements by amount, the 90th percentile would be a settlement that's larger than 90% of the other settlements. In 2003 the 90th percentile settlement was $80 million as compared to the $15 million average. In 2007 the 90th percentile settlement was $25 million as compared to the average $8 million. In terms of the upper bound, the top 10 largest settlements since Sarbanes-Oxley all exceed $250 million.

Last, let me focus with you on settlements in misstatement cases, which involve allegations similar to those in securities class actions. These account for the majority of cases brought by the SEC against publicly traded companies. There have been 162 company settlements of misstatement cases since Sarbanes-Oxley, of which 17 or 10% involved foreign issuers. The number of company settlements has fluctuated between 24 and 35 per year since 2003. Individual settlements in misstatement cases typically outnumber company settlements by a factor of about three to one. 2007 was typical: there were 142 settlements in misstatement cases in 2007, a post Sarbanes-Oxley high. Of these 34 settlements were with companies and the remaining 108 were with individual defendants. Company settlements in misstatement cases are typically less than 1% of the company's market capitalization. Of the 162 company settlements, only one was for more than 4% of market capitalization and all but four or 87% were for 1% of market cap or less. One interpretation is that the SEC is using market cap as a proxy of ability to pay where this capacity to pay is a factor that is acknowledged in the settlement with Applix.

This past Friday was the sixth anniversary of the passage of Sarbanes-Oxley, and with its approval the SEC won the right to distribute enforcement action penalties to injured shareholders. With the possibility of using penalties to compensate shareholders, the SEC imposed record penalties against issuers. Then, realizing that the sharp increase and large variations in company penalties was causing uncertainty among defendants, in 2006 the SEC articulated the factors it considers when setting settlement amounts. In addition, as of January 2007, the Commission itself must pre-approve penalties in settlements with public companies. In 2007 there were 209 settlements with companies with the median value of $800,000. But the median settlement in the 34 public company misstatement cases, which carry allegations similar to those in shareholder class actions, was over $26 million. In future research we plan to continue following SEC settlement trends and delve further into the characteristics of settling companies to better explain variation in settlements.

THERESA GABALDON: Thank you Elaine, your presentation raises a lot of interesting questions but I will hold them until Stephanie and Chu are done. Chu, I think that your topic logically precedes Stephanie's so I am very much looking forward to hearing from you about the timely topic of issues related to sub-prime offerings.

CHUDOZIE OKONGWU: Thanks Theresa. Today I would like to speak briefly about some aspects of the credit crisis or as it is more commonly called the sub-prime mortgage crisis. I will spend some time discussing how we got here and also would like to touch on key areas of dispute that we are seeing and we are likely to continue to see in litigations formed by the events of the past year or so. In the past decade and most especially in the period after 2001 we have seen an unprecedented growth in credit. Sub-prime mortgage lending is only one example of this large increase in lending. The stock of consumer finance receivables outstanding which includes auto loans and leases, student loans, revolving credit and other consumer finance loans grew from about $567 billion to around $825 billion or by more than 45% in the period between 2001 and 2006. Sub-prime mortgages, which are home loans given to individuals with poor credit histories and a high loan-to-value ratio, also grew substantially during this period. A related category is Alt A mortgages, a category that generally includes borrowers without sufficient documentation of their ability to repay or documentation that puts them at a level somewhere between prime and sub-prime. The annual dollar amount of sub-prime and Alt A mortgages originated grew from $215 billion in 2001 to $1 trillion in 2006. However by way of comparison in total over that same period there was $3.6 trillion sub-prime mortgage origination and more than $8.7 trillion in conforming loan origination. Put another way, sub-prime and Alt A mortgage origination was only 41% of conforming loan origination over that six year period. As sub-prime mortgages by definition have a higher likelihood of delinquency and/or default, it is not surprising that underlying problems in the credit markets first became apparent in that market. While the approximate causes of the increases in sub-prime delinquencies and defaults are still the subject of some debate contributing factors include the increase in mortgage rates that accompanied the increases in the Federal Funds target rate after July 2004, the decline in housing prices that began in July 2006 and the fact that the demands of debt service on U.S. households had grown to record levels.

Briefly I would like to speak about these factors in some more detail. After keeping the Fed funds target rate at 1% between July 2003 and July 2004 to cushion the economy from the effects of the bursting of the dotcom technology and telecom bubbles, the Federal Reserve began to increase the Fed funds rate in July 2004. Mortgage rates followed. The effective interest rate on an adjustable rate mortgage rose from 5.41% in July 2004 to 6.58% in July 2006; unsurprisingly, July 2006 also marked the peak for home prices. The S&P Case-Shiller Home Price Index which had increased by about 107% between January 2000 and July 2006 began to decline. It is presently 18% down from that peak. Also in the period since 2000 U.S. households have had to devote a larger proportion of their disposable income to debt service. The Financial Obligations Ratio, which measures the share of disposable income that households devote to payments of outstanding mortgage debt, consumer debt, automobile lease payments, rental payments of occupied property, home owner's insurance and property tax payments, rose from 17.67% in the first quarter of 2000 to 19.46% in the fourth quarter of 2006; that was the highest level ever. It presently stands at 19.15%. As home prices fell homeowners' equity was eroded. Those home owners who earlier in the face of difficulty making payments were able to sell or refinance their houses found this route more difficult as home prices and equity declined. Some home owners found that they had negative equity or were upside down, meaning that their mortgage debt exceeded the current value of their homes. Similarly, declining equity limited the households' ability to engage in cash out refinancing in order to purchase goods and services or to service debt. This had been a major source of cash to households. A study by James Kennedy and Alan Greenspan estimated that equity extraction from homes rose from $389 billion in the year 2000 to $915 billion in 2005. These pressures on households manifested most immediately among the riskiest sub-prime borrowers. Delinquencies and foreclosures for adjustable rate sub-prime mortgages rose from 15 3/4% in the first quarter of 2006 to more than 39% in the first quarter of this year. This is the highest rate ever recorded. Analyses by the rating agencies have shown that sub-prime mortgages originated in 2006 and 2007 are more likely to default than are sub-prime mortgages from other years and that this trend is evident from inception. This has caused some to speculate that changes in the loan origination process such as the development of exotic loan structures and increasing the acceptance of low and no documentation loans may have contributed to the high delinquency rates. The problems affecting sub-prime borrowers quickly spread to investors in the secondary market because of the way the market for mortgages and other types of credit products is organized.

An individual sub-prime mortgage is a risky asset to hold as there is a significant probability that the borrower will not be able to repay the full amount of the loan and therefore that the investor may be left with only the recovery value of the home. However to the extent that the likelihoods of individual delinquencies or defaults are not positively correlated, pooling mortgages diversifies and hence lessens the risk. Financial engineers pool mortgage loans to take advantage of this fact. The securitized rights to the cash flows for these pooled sub-prime mortgages were sold to investors. Securitization allows investors to choose varying levels of the risks and returns associated with a mortgage pool. Investors looking for a safer investment receive a lower yield and have priority to the cash flows from the pool of mortgages. Investors with lower priority have higher potential returns. The financial engineers that structured these securities did so with certain assumptions about among other things the likelihood of defaults, the correlation of defaults and the loss severities in case of default. In retrospect it appears that some of these assumptions were not correct. Sub-prime lending and some of the structured finance securities associated with it have become the target of much criticism. However a range of credit products, including conforming home loans, credit card loans, auto loans, are all seeing increasing credit deterioration. As an illustration in March 2005 2.56 of prime adjustable rate mortgages were delinquent or in foreclosure. That figure was more than 10.2% by March 2008. Securities values derived from the cash flows of these troubled credit products who suffered, asset backed securities whose collateral or sub-prime mortgages and CDOs that invested in these securities are perhaps the most famous causalities. Losses in these types of securities have been substantial. For example, the ABX Index which is administered by Markit Partners tracks the pricing on a basket of 20 home equity asset backed securities. The index of Triple B tranches originated in the second half of 2006 and that's the lowest level that is still considered investment grade. The price has fallen from 98.3 at inception to around $5 today. Adequate trading losses and write downs of financial institutions have to date been far in access of $300 billion. These difficulties have prompted a number of lawsuits alleging all sorts of improprieties. An interesting feature of this litigation is that many of the plaintiffs and defendants play multiple and in some cases overlapping roles in the markets for the structured finance and derivative products which have been the focus of many of these disputes.

Two of the key areas of dispute in current and I expect prospective litigation that will come in the aftermath of the credit crisis are valuation and risk management. I will discuss these in turn though they are of course related. Valuation is the focus of a number of the disputes that are already in the courts. This is not surprising as securities have become increasingly complex. Many securities are mainly valued using models and models as well as model inputs can differ leading to differing estimates of value. Valuation of securities contributes to the calculation of profits which are of keen interest to investors, in banks and hedge funds for example. Some cases that have been filed have alleged that asset valuations were overstated, leading to inflated earnings in stock prices. Valuation is also the basis for margin calls and to the extent that two counter parties differ on the valuation of a security, differences about the fact or the magnitude of margin calls can and have arisen. Risk management which is related to valuation has also been the focus of a number of past, present and I expect future disputes. Some questions that have arisen from the current crisis are: whether hedge funds and bank disclosure about the efficacy of hedges were accurate and complete; whether banks took sufficient care to manage the risks associated with their contingent liabilities; and whether banks adequately managed the risks associated with their proprietary trading and their commitments to private equity.

In conclusion as I hope I have made clear the present crisis is not confined to the sub-prime mortgage sector but is manifest in a variety of areas in the credit markets, the rapid growth of borrowing in many sectors and a financial innovation that is left in its wake, and a great number of complex securities that have deteriorating fundamentals. Disputes in how to evaluate these products and to quantify managerial risks associated with holding them are and will continue to be the focus of litigation.

THERESA GABALDON: Chu, thank you. Again questions for further discussions will wait while we hear from Stephanie on the subject of auction rate securities and recent auction failures.

STEPHANIE LEE: Thank you, Theresa. Auction rate securities have been in the news a great deal recently. After widespread auction failures earlier this year many investors have been surprised they could not easily exit positions they wanted to liquidate. Much litigation activity has followed. There has been a strong response from both federal and state regulators over the last several months. Until recently even many financial professionals were not familiar with auction rate securities so I will start by discussing what these are, how an auction works and what it means for an auction to fail. Then I will turn to recent events and describe some developments since the market dislocation earlier this year.

What are auction rate securities? They are variable rate debt or preferred stock instruments with interest rates reset at regular auctions. These auctions typically take place anywhere from every seven to every 49 days. Traditional variable rate debt has its rate set in relation to some benchmark rate, for example 20 basis points above Fed funds. But with auction rate securities the variable rate is set at an auction. Because these frequent auctions rarely failed, auction rate securities were generally viewed as highly liquid. Historically they were often marketed to issuers as an alternative variable rate financing vehicle. For investors, typically corporations or high net worth individuals, auction rate securities were a higher yield alternative to money market funds. Many recent news stories have portrayed the auction rate market as a single homogeneous market but there is significant variation among auction rate securities, about half of these are issued by municipalities. Most municipal auction rates are tax exempt. They carry the same tax benefit as many other municipal bonds. About 25% of auction rate securities are backed by student loans. These student loan auction rate securities are fully structured products with types of credit enhancements, you may be familiar with from mortgage backed securities, features like tranching and over collateralization. Almost 20% of the auction rate market is preferred stock issued by closed end mutual funds. The remaining 5% of the market is comprised of other issuer types like CDOs and corporations.

How does an auction work and what does it mean for an auction to fail? Prior to an auction potential investors and current holders submit bids to a broker dealer, for example Bank of America or Merrill Lynch. Investors submit bids which can be bids to buy, sell or hold. These bids will include information on the investors' desired quantities and interest rates. At this point the broker dealer also has the option but not the obligation to enter a bid for its own account. The auction agent consolidates the bids and determines the auction clearing rate. The clearing rate is the lowest rate at which the amount up for sale can be placed with potential buyers. One typically thinks of auctions clearing at the highest price but in this case we are dealing with interest rates. Rates have an inverse relationship with prices so these auctions clear at the lowest rate. An auction fails when the amount for sale exceeds the amount that potential investors wish to purchase. Basically, if more people want to sell than there are people who want to buy, the auction fails. Prior to the recent market disruption, while auction failures were rare, they certainly did occur. Historically if an auction was going to fail due to lack of buyer demand the broker dealer running the auction might participate in the auction itself, purchasing auction rate securities to hold on its own books. This fact of broker dealer intervention became widely known in 2006 after the SEC settled with 15 broker dealers and banks. The settlement related to a variety of auction practices including inadequate disclosure of broker dealers own participation in auctions.

What happens after an auction fails? After a failure the security's penalty or maximum rate kicks in and everyone who owns the security will receive this rate. Typically these maximum rates are fixed numbers for municipal auction rates, such as 12% or 15%. For closed end fund auction rates the maximum rates are generally a spread over Libor or a small multiple of Libor, something like three month Libor plus 30 basis points or 150% of one month Libor. As I mentioned earlier student loan auction rates securities are structured products which are generally more complex and their maximum rate formulas can be quite involved. The maximum rate on a student loan auction rate security could be fixed or floating, it might depend on the credit rating of the security itself and it might include a cap on the total interest paid during a given period. After an auction fails everyone who owns the security receives the maximum rate. Holders continue to earn this rate until the auction starts clearing again, the security is refinanced, the holder sells to another investor outside of the auction process or an investor could continue holding until maturity.

Now I will turn to some responses to recent market events. Since widespread auction failures earlier this year there have been a number of reactions from different parties. In some cases high penalty rates attracted new investors, some auction rate securities experienced failed auctions and subsequently had auctions start clearing again. For example many news stories have cited the 20% maximum rate on one bond issued by the Port Authority of New York and New Jersey. Just prior to auction failure in mid February this bond cleared at a tax exempt rate of 5% so the Port Authority experienced a sharp increase in interest payments after this auction failed. Within a week however auctions for this bond started clearing again at an average rate of over 8% for the month of March. A couple of months later the Port Authority called this bond to be redeemed at par.

Many issuers of auction rate securities have either refinanced or restructured their auction rates. Sometimes, this has involved changing the interest rate mode of a bond from auction mode to variable rate mode. And some issuers have replaced auction rate securities with another type of instrument entirely. According to news reports, municipalities have either completed or announced over $75 billion in re-financing or re-structuring of auction-rate securities. This is about half of the municipal auction rate market. Beyond issuer responses we also know that some broker dealers have offered loans to their customers for part or all of par value of their auction rate holdings. In addition some broker dealers are reportedly marking auction rate securities at a discount to par on retail customer account statements. This is in line with discounts they may be taking for auction rates held on their own balance sheets. We have also seen many corporate holders taking write downs on auction rate holdings. And of course, the SEC and several states are conducting regulatory investigations. To date, at least 16 broker dealers have been subject to class action lawsuits with 10b-5 claims. More than 20 broker dealers are involved in regulatory investigations or subpoenas. Massachusetts filed a civil suit against UBS at the end of June. Two weeks ago, we heard about the onsite inspection at Wachovia where Missouri is taking the lead. And last week we heard about the Texas State Securities Board and Cuomo, the New York Attorney General, each filing separate actions against UBS. There have also been many lawsuits filed, including class actions as well as hundreds of arbitration claims. These lawsuits have allegations about broker dealers misrepresenting auction rate securities as equivalent to cash or money market funds. They also allege that broker dealers knew but failed to disclose material facts about auction rate securities. They allege that broker dealers were artificially supporting and manipulating the auction market. Arbitration complaints also relate to the suitability of auction rate securities given a particular investor's profile. In these class action suits the classes are very different from typical security classes. Courts require commonality to certify a class. A conventional class has holders of one or maybe more than one security issued by a single entity. In these suits however the auction rate securities classes consist of investors in all different kinds of auction rate securities purchased from a particular broker dealer. So the securities at issue in these cases will differ in many ways. They may differ in patterns of auction failure. Penalty rates may differ substantially among securities and with issuer redemptions some investors may have had their auction rate holdings redeemed while others hold securities with auctions that continue to fail. Along these lines in a conventional class action suit, the class is alleged to have experienced an identical and documented omission or misstatement. This might be something from an SEC filing or a press release. With these auction rate class auctions, the assumed class members will have had many different discussions with their own financial advisers, of course these types of discussions are generally not documented in the same way as something like a corporate earnings announcement. Investors who experienced failed auctions owned illiquid securities. In some cases investors became liquid when the auction started clearing again. In other cases an investor may have sold the security outside the auction process in the secondary market. Investors may not have needed liquidity or they may have accessed funds by borrowing. Some investors received high penalty rates during a period of the illiquidity like the investors who owned the Port Authority bond I mentioned earlier. In other words potential costs and benefits following a failed auction may greatly differ from one investor to another.

So to wrap up this freeze in the auction rate market is another facet of the credit crunch that as Chu described continues to unfold. For over two decades this market functioned well in a way that normal financial markets operate. Historically auctions rarely failed but they had failed. Returns on auction rate securities were consistent with a risk of failure.

This current situation in the auction rate market was not anticipated and is truly exceptional.

THERESA GABALDON: Stephanie, I think a lot of it. Very enlightening presentation. Luckily we do now have time for a few questions and a bit of a discussion and I would like to back up to start with a question raised I think by Elaine's paper. Elaine, presumably observations about SEC settlement trends have utility for the subjects and prospective subjects of investigation and enforcement actions. With respect to those who have become subjects do you think this information actually will facilitate settlement?

ELAINE BUCKBERG: One thing I think that this data will do is to add to the understanding that was already created by the SEC laying out these guidelines in January of 2006. So there they have said, here are the principles that guide us in coming up with a number but with this data individuals or corporations, we'll be able to look at settlements that are similar, same set of allegations, company of similar size and get a sense of what's the range of settlements. Now they won't necessarily have the information to assess how the SEC would have looked at the other company in terms of the quality of its cooperation or where the company's offense stood on the pervasiveness through the company. But I think it will certainly be helpful in giving expectations and a range as I mentioned we will be making all this data public.

THERESA GABALDON: It seemed to me that the corporate settlement amounts that you mentioned were not eye popping especially vis-à-vis the issuers' bottom-line. Would you agree with that assessment that most of the penalties that are assessed are not all that material to the bottom-line?

ELAINE BUCKBERG: I think, first of all, you can't just look at the number, you have to look at the number in relation to the company's capacity to pay and that's why we looked at these market cap statistics. That's going to depend on the company, so you know at the upper end some penalties approach or are 1% of market cap. So think of one of the higher numbers, 1% of market cap, and let's imagine a company with a PE ratio of 15. So 1% of market cap is 15% of their annual earnings; that can be tough to pay. It's going to vary on the offense and it's going to vary with the company's capacity to pay, rather than just looking at that bottom line number.

THERESA GABALDON: Do any of you think that perhaps the greater significance of the penalties may lie in their signaling function, that is, it might be a form of saying, "hey, look over here" and suggest to private plaintiffs that there is something to be investigated?"

ELAINE BUCKBERG: One thing that we are doing research on right now is looking at instances of these misstatements cases where there is both a class action and an SEC investigation and in many cases the first public information about the SEC investigation will come later than the shareholder class action filing by some months. In other instances where the SEC action becomes public first, it is generally by a company announcement rather than settlement itself. So there will be plenty of time for plaintiffs to have filed somewhere between the company announcing that we are under investigation and we need to let you know this because we believe its material and the settlement.

THERESA GABALDON: Chu, your paper also raised some very interesting questions. I guess one of the most interesting to my mind has to do with what might happen next. Do you have any guesses as to how many shoes are left to drop?

CHUDOZIE OKONGWU: I think that depends on large part on the trajectory that the economy and the housing market which of course are interlinked, take from here on end, if we continue to see weakening in both of those then there are some fairly ominous developments, specifically as I alluded to my talk with prime customers. You may have heard that J.P. Morgan in their most recent earnings announcement was very negative about the prospect for credit deterioration among prime mortgages. I think another area where there is the prospect of significant problems involves leveraged loans. These were loans that were made in many cases to private equity groups to assist them with borrowing enough money to buy companies. Many of these transactions were done at very high multiples to EBITDA. So to the extent that highly leveraged companies, going into a weakening economic environment, many of these loans, furthermore, had very loose covenants. It may well be that troubled companies will get far into trouble before they are reeled in by their bankers and there is a substantial amount of this paper out there and the banks have been working hard to get it off their books. Another area is credit cards. Ominously, American Express said that even their best customers are having problems now. And there is also the indication of the beginnings of problems with auto loan credit deteriorating.

THERESA GABALDON: Stephanie, Elaine, do you have any crystal ball observations about what might happen next in this area?

ELAINE BUCKBERG: I guess the only thing we can say is that it doesn't look like the trends have played out yet and there will be more to discuss.

CHUDOZIE OKONGWU: Housing prices are still declining double digits year on year so until inventories start to come down and the rate of decline significantly stops you are going to see these feedback effects and of course the problem here is that all these potential problems feed back into the financial sector forcing the banks to continue this process of de-levering and raising capital.

ELAINE BUCKBERG: You see increasing indications of tightening of bank credit to businesses which will affect businesses' ability to do business and affect incomes and will affect employment, which will have feedback on consumer finances and consumer debt.

THERESA GABALDON: Stephanie, let me compliment you again on how helpful your explanation of auction rate securities was. I do however have a few questions. One of them is this, you are the author of a paper titled 'Auction Rate Securities: Bidder's Remorse?' Do you think that purchasers of auction rate securities generally do have the information necessary to let them fairly evaluate the risks of their investments or do they need something more?

STEPHANIE LEE: The short answer is yes. I do think that purchasers had information available to them discussing the risks of the investments, with closed end fund auction rate preferreds they have a traditional prospectus available to them which is freely available on EDGAR on the Web. For purchasers of fixed income auction rate securities, bonds issued by municipalities or backed by student loans, they have bond offering documents. While these may or may not have been provided to them by brokers, every time they purchased auction rate securities they were always available. In many cases the issuers published these on their websites, in other cases a broker could easily obtain one from a service like Bloomberg. Brokers also provide price talk, which would be an indication ahead of an auction of a likely range of clearing rates which very relevant to determining possible information about the auction rate securities from failed auctions in the past, while they were not extremely frequent they did happen and they were certainly news surrounding those events. For example the first auction failure in 1987 was M-Corp which filed for bankruptcy two years later; it was certainly widely publicized. SIFMA has best practices published for broker dealers on auction rate securities so that's out there and available for people to see. And then there was the SEC settlement in 2006 that I mentioned relating to broker dealers practices in auctions and that certainly had a lot of news surrounding it. So for anyone purchasing auction rate securities that was interested in finding out more there was a lot out there for them to find.

THERESA GABALDON: I suppose that you also suggested that in some circumstances having an auction fail isn't the worst possible outcome from the holder's standpoint anyhow?

STEPHANIE LEE: There is a Port Authority bond that I mentioned; it went from clearing at a rate of 5%, tax exempt 5% rate to just a few weeks later clearing above 8% for a whole month and that's a very big difference in yield and many holders might have been very pleased to obtain a higher rate like that.

THERESA GABALDON: So if anyone would be unhappy in that same point it would clearly be the issuer?

STEPHANIE LEE: Yes, which is why they refinanced that bond.

THERESA GABALDON: Elaine, it seemed to me that you may have been suggesting that penalties are more likely to be imposed on corporations than on individuals that, individuals a larger part of the announced represented by settlements represent disgorgement of ill-gotten gains whereas corporations pay somewhat less in disgorgement and somewhat more in penalties. What do you think the explanation for that might be?

ELAINE BUCKBERG: I would say that in most but not all settlements, there will be a disgorgement component. There are exceptions, but in most cases the disgorgement component comes first and that says, “Give back any ill-gotten gains.” Now one place there would be no disgorgement component would be when there are no alleged ill-gotten gains and an example of that would be an insider trader who managed to lose money doing it. There are certain examples of that, there are some famous court cases involving such examples. There may be no company gains so there would be no disgorgement and there you could have a penalty, but the typical ratio is again about 140%. With individuals often the focus is on, “Let’s get back any alleged ill-gotten gains,” because for deterrence we do not want to let people keep the benefits of any fraud. But then penalties will be set both as a function of the nature of the case, the nature of the offense and capacity to pay. And so if you look at insider trading cases they are allowed to have… with the penalties three to one… maximum penalty is three times disgorgement or maybe it’s a total of three. But if you look at the cases the judge says, “Well, you don’t have the money to pay a penalty beyond an extra 25%, so penalties will be low.” Corporations in many instances may be more able to come up with the penalty; also the deterrence concern may be greater with corporations.

THERESA GABALDON: That makes sense. Chu, I am interested in terms of what if anything might have prevented some of the crisis that is said to have taken place. In terms of regulatory structures is there anything that might have prevented or moderated what’s happened thus far?

CHUDOZIE OKONGWU: One area that a number of people have looked at concerns the regulation of mortgage brokers. It actually turns out that mortgage brokers do not have a uniform manner in which they are regulated and there have some concerns that have been raised about the origination of a lot of mortgages particularly in areas such as Southern California and Florida. So I believe that right now that is something that the regulators are looking at which is instituting a sort of a more uniform structure for mortgage brokers.

THERESA GABALDON: Do you attribute any fall out to the liberalization of banking regulations in the 1990s?

CHUDOZIE OKONGWU: What aspect of the liberalization do you have in mind?

THERESA GABALDON: The eroding lines between investment and commercial banking.

CHUDOZIE OKONGWU: I think that’s certainly plausible. I would note that the bank that eventually had to be saved by the Fed was not a bank that in any way participated in commercial banking, as a matter of fact it was rescued with the Fed’s help, courtesy of one of those banks that is a broker dealer and a commercial bank. The two banks with the most write downs to date, one is Merrill Lynch which doesn’t participate in any commercial banking; one is UBS, which does, so it’s not clear to me that this liberalization contributed materially because there is not really a difference in the performance of the players.

ELAINE BUCKBERG: I will also add there that if you look at the J.P. Morgan Bear Stearns deal it would appear that the regulators aren't troubled by this sort of universal banking diversified company concept which is part of the reason Bear Stearns was attractive to J.P. Morgan, in certain businesses it was deeper, it gives it additional prime brokerage operations, and it actually helps diversity J.P. Morgan's portfolio as a finance company.

CHUDOZIE OKONGWU: In terms of regulation, I think one thing that's particularly interesting and that it is worthy of examination, is the fact that the most lightly-regulated sector arguably, which is hedge funds, did not have losses anywhere near as large as those that have been publicly declared by the banks.

THERESA GABALDON: I've heard people say around the water cooler that it's all a attributable to the repeal of Glass-Steagall, and you've given the perfect ammunition to respond.

ELAINE BUCKBERG: If there's any regulator changes, it's changes that may have made it easier to issue mortgages with a high loan to value ratio instead of moving away from that old minimum 20% down and allowing loans that were larger and larger in terms of the value. So the risk of getting into that upside down position that Chu mentioned, where declining house prices puts buyers with no equity or negative equity in their home. In that position, it's a much easier decision to be delinquent in your mortgage or to walk away from it.

CHUDOZIE OKONGWU: Interestingly enough, deregulations that have been instituted in the past year, a lot of them go to regulating the types of mortgages that can be offered to arguably less sophisticated or unsophisticated mortgage borrowers.

THERESA GABALDON: Continuing on the theme of barn doors after the herd has stampeded, Stephanie, would you say that there should have or could have been any sort of structural regulation in place that would have prevented auction rate failures?

STEPHANIE LEE: I think there are already a lot of regulations in place, such as suitability requirements for individual investors. Clearly that framework is already there, so if someone were to find that an auction rate security was not a suitable investment given a particular investor's profile, that's already in place.

THERESA GABALDON: How about limit on the ability of issuers to engage in or issue this kind of instrument?

STEPHANIE LEE: Issuers have many different options available to them, depending on market conditions at a particular time, or depending on the types of credit enhancements that they feel they might need and the cost of these different credit enhancements. In the past, they might have chosen an auction rate security or another instrument, like a variable rate demand obligation, which is closely related but does have a liquidity wrap. I think that, to maintain efficient and vibrant capital markets, we would want issuers to have that choice available to them.

THERESA GABALDON: Some states actually limited the ability of municipal issuers to engage in issuances of auction rate securities, or perhaps it was a cap on maximum default rates.

STEPHANIE LEE: Many states, using their usury laws, do have a cap on the maximum rate that an auction rate security can bear.

ELAINE BUCKBERG: I just want to say that, in the context of the data I have been discussing, we have a great new paper coming out shortly by my colleague, Jan Larsen, that will cover everything I have covered and more. It's called *SEC Settlements in a New Era, Post-SOX.* It will be posted on our Web site, but we will also be launching a new Web site – www.seclitigationtrends.com – sometime in September for this and related research.

THERESA GABALDON: I will try to be your first visitor. Elaine, Stephanie and Chu, thank you for sharing your insights with us. It's clear to me why your presentations were deemed the "top" at NERA Economic Consulting's recent Finance, Law and Securities Litigation seminar.

Our audience may be interested to know that this "Best of NERA" broadcast is now archived in audio format in the SEC Historical Society's virtual museum, so you can listen again to the discussion at any time. A transcript of the discussion, as well as the chat in MP3 format, will be added to the Online Programs section in the coming months. I encourage you also to access any of the four previous "The Best of NERA" programs, which are available in Online Programs at any time.

Again, I'd like to thank NERA Economic Consulting for its continuing, generous support of this program series.

Please join me again online on Tuesday, September 23rd for another Fireside Chat. Our next chat will look at the development and work of the SEC Division of Enforcement, as part of the SEC Historical Society's commemoration of the upcoming 75th anniversary of the U. S. Securities and Exchange Commission. My guests will be Irving Pollack and Stephen Cutler, the first and most-recently-retired directors of the division.

Thank you again for being with us today.