

THE BEST OF NERA 2010

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Lisa Fairfax: Good afternoon, and welcome to the Best of NERA 2010 broadcast by the SEC Historical Society on www.sec-historical.org. My name is Lisa Fairfax and I am the Leroy Sorensen Merrifield Research Professor of Law at The George Washington University School of Law, and moderator of today's program.

The SEC Historical Society shares, preserves and advances knowledge of the history of financial regulation through its virtual museum and archive at www.sechistorical.org. The museum is the authoritative online source on the history of financial regulation from the 20th century to the present. It is free and accessible world-wide at all times. The virtual museum and archive, as well as the Society, is a separate and independent body from the U.S. Securities and Exchange Commission and receives no government funding. We therefore thank the gifts and grants from many institutions and individuals who make possible the growth and outreach of the museum to over 15,000 visitors each month.

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I am especially delighted to welcome to you to today's program. First let me introduce to you our speakers for today. Christopher Laursen, Senior Consultant who will be discussing structured finance issues. We welcome Chris to the program. Dr. Chudozie Okongwu, Senior Vice President, with his

insights on disclosure in regards to the sale of structured products. Chu also presented in the 2008 program. And then finally, Dr. Elaine Buckberg, Senior Vice President, who will be looking at quantifying SEC settlements since the Sarbanes-Oxley Act. This is Elaine's fourth appearance in this series. She was also part of the 2004, 2006 and 2008 broadcast.

So now we're going to start our program and we're going to first hear from Chris. Chris, welcome to the program and please tell us about structured products.

Christopher Laursen: Thanks, Lisa. My talk today is going to be on structured finance and what I want to do is lay some ground work in the area. I think there has been a lot of sound bite-based characterizations of structured finance which as a broad class can mischaracterize some of the realities. What I want to do is talk about some misconceptions and try to provide some background that hopefully provide a trail to more of a subjective truth. I'm going to do that by way of some factual items, and then I'm also going to compare structured finance to corporate issuances.

So, first of all I think it's important to know what is structured finance and what are we talking about today. There are various types of structured finance. Structured finance might be a bank deposit whose return is linked to the S&P 500 or some other index. It may be a subordinated corporate bond that may have a payment in-kind provision, or it could be an asset-backed security that has underlines of aircraft leases or some other asset class. The structured finance I'm going to talk about today is essentially the asset-backed securities brand. So what do we mean when we say asset-backed security? In asset-backed securities, you typically have groups of financial assets, which often are relatively small denominations or less liquid. They are pooled together, typically by a trust or other special purpose corporation which issues various securities to fund that pool. The interest of the structured finance securities comes from the interest and principle and sometimes the collateral liquidation of the underlying loans leases or other financial assets. So asset-backed securities can be used as a very broad term; you could have auto loans underlying, or credit cards, but there are many

other sub-types depending on the financial assets in the pool. Ideally, a mortgage-backed security is going to have underlying mortgages.

A CDO is actually just an asset-backed security with a single or mixed type of collateral pool underlying it. So I think the first misconception..... with structured finance or asset-backed securities, does it really make sense or, for the big financial institutions, was it just a ploy all along? The background on that is pretty simple. When you pool different type of assets and divide them up into different classes of securities, you end up with securities that have different risk and return characteristics. So what that does, it creates different diversification opportunities for someone that has a desired risk tolerance. So say you're an investor with a very low risk tolerance, and you want high credit quality, triple A type of credit quality, but not U.S. government debt. If you don't have structured finance, there are only five or six traditional corporations in the U.S. whose debt is rated triple A. So you are very limited in the type of positions you can purchase.

Structured finance broadens that. You can buy high quality credit in mortgages, autos, ship leases and other types of assets class and that diversification allows you to reduce your risk. So there is an investor-driven purpose for these types of positions. Even more broadly, the supply of credit to these underlying asset classes reduces the cost to the ultimate borrower. So whether you're an consumer or business, there are many, many more classes of investors who are investing in your underlying class that reduces the borrowing cost, which is also good broadly. So there's a real rationale and positive economic impact for asset-backed securities to exist. That's the general background what I wanted to start off.

In terms of some other labeling and misconceptions, I thought it would be interesting to talk about the idea that structured finances are toxic. No matter what underlying asset class or what level in the capital structure or tranche you might have owned, you can find someplace that labels these securities as toxic. It's no secret that the performance on many asset-backed securities issuances has been much worse than expected by many investors or analysts. That's not really at issue here. The

question I have is, why isn't U.S. corporate debt issuances labeled as toxic? So the background I want to talk about is just that U.S. corporate issuances were such better performing issues versus asset-backed securities.

Let's think about this in terms of the credit crisis. In 2007, about 25% of the Lehman high yield corporate bond index was comprised of financial company issues. As we all know, most of the large financial corporations, and by extension the securities they issued, were supported by the U.S. government. Beyond the financial institutions we know the Federal Reserve, the Treasury and other government entities instituted numerous unprecedented programs to support corporate America. So you can think about the target Fed fund rate going down to zero which reduces floating rate borrowing cost, but then there are specific programs like the commercial paperback stop, which allowed corporations to sell their commercial paper directly to the Federal Reserve to allow them to roll that paper where as otherwise they might have a problem with their liquidity.

The same issue is with money market bailouts. Money market funds were effectively guaranteed that allowed the money markets to roll the short term debt that they were purchasing. Without those types of programs, a lot of corporate America could have become ill-liquid quite quickly and led to many more defaults or poor performance on those issuances. Of course we know about the massive infusion into the government sponsored entities Fannie Mae and Freddie Mac, and those had issued many, many bonds as well. So the point of the matter is that if we start labeling one class toxic, I think we need to think broadly and understand the weaknesses throughout the economy that were prevalent back prior to the credit crisis and what actually happened.

A few other misconceptions that I've heard out there in the press is structured finance was new, untested and designed to fail. Asset-backed securities have been around a long time. CDOs were created around the same time high yield corporate debt issuances started to be issued in the U.S. in the 1980s. CMO tranches have been a prevalent part of community bank investment portfolios since the 1990s, if not before. So the idea that these products are new simply isn't founded. Were they

untested? Well, if you go back to the 1980s clearly through that time until now, we've gone through recessions. We've gone through significant regional real estate declines. The Long Term Capital Management issues, dot com bubble, 9/11, Enron and WorldCom. So it's not really fair to say the structured finance is untested. Was it designed to fail? Again the decades of experience with this product and even in late 2006 structured finance was essentially endorsed by the U.S. inter-agency group of regulators from the SEC to the Fed to the OCC that stated that structured finance had a well established track record. It was an essential part of U.S. and international capital markets. I think that those facts speak for themselves with respect to structured finance.

The final thing I want to talk about is complexity issue with structured finance. Are the structured finance issuances really uniquely complex and difficult to analyze? And we can think about three terms that are applied a lot of times to structured finance: tranches, implicit leverage and correlation. I just need to explain these concepts and compare them a little bit to the corporate issuances. All the tranches are securities within a capital structure. Each tranche is a separate security. Debt and equity within a corporate capital structure is also tranced if you will. Pieces that are at the top of the capital structure and equity being the residual being at the bottom of the capital structure. So this idea of tranching is a 50 cent word but really it's been in corporate finance for a long time. Implicit leverage just reflects this level in the capital structure, or the subordination. So a piece of security that's issued that is senior to another security, that creates implicit leverage. Within the lower class security there's implicit leverage. At least that's what the term that's been used on Wall Street. But this isn't different within structured finance. A subordinated piece of debt issued by a traditional corporation like Ford or Best Buy, those also would have implicit leverage under that concept. Finally, correlation. This is the idea that the underlying assets or activities within a pool of assets or within a business matters with respect to the cash flows. With the underlying assets in asset-backed securities, you've got mortgages, you got auto loans. If all of those tend not to pay at the same time, then the performance on the various securities or tranches will not

do so well. But the same is true with businesses within a corporation or legal entities under a holding company.

It's important how all those activities perform in relation to one another and the timing. So, the concept is pretty simple. As long as Ford sells enough cars or GM sells enough cars, all the capital structure components and all the liabilities and debt and equity are going to get paid; if you don't sell enough cars, they won't all get paid. The same is true in asset-backed securities. If people pay their mortgages as expected, everyone gets paid. If not, you're going to have a different result. And so, whether you're talking about General Motors, or certain asset-backed securities, at the end of the day not enough people paid their mortgages or purchased enough cars.

Lisa Fairfax: Absolutely. Thank you. We're going to do a Q&A after we hear from all of the speakers. But I would like to thank you. I think you are exactly right. I think there is a lot of negative press about structured finance in general and asset-backed securities in particular. So I thank you for that discussion and some of the key misconceptions around those issues. Now we're will turn it over to Chu whose going to talk to us about structured products.

Chudozie Okongwu: Thank you. I am going to be speaking about CDOs and structured financed securities and some of the issues that have arisen with them as a result of the credit crisis. Now such securities played a pivotal role in the credit crisis and this is a result of a plethora of litigation concerning them. At issue is often the question of whether the problem of such securities have had were do to exogenous factors or the result of the fact that certain entities did not perform the role expected of them, or even in some cases acted in a manner that was counter to the way they should have acted. I'll discuss some such cases and the role that economic analysis can play in the absence of factual evidence such as emails, meeting minutes and alike.

In many cases economic analysis of the data can help identify and quantify patterns that can answer key questions about the roles played by certain entities in specific transactions. In many of the structured finance transactions that are now in dispute, a key issue is that of the alleged conflict of

interest among various agents involved in the deals. However, such conflicts are part of many economic transactions. Agents are typically aware of them and make decisions accordingly. Unanticipated losses due to such conflicts should only result in cases where there is asymmetrical information and the ability to control the performance of some aspect of the deals.

Now in your typical CDO transaction, for example, there are many parties that play various roles: originators, servicers, underwriters, collateral managers, rating agencies and many others. Certain parties can play multiple roles. An economist would think of some of these entities as principal and some as agents. For example, you might think about the servicer as an agent of the investor in the deal. The fact that certain entities play multiple roles in CDO transactions is alleged to have led to instances in which asymmetrical information was able to be used to these parties advantage. Key questions in such cases are: What could they know? When could they know it? And what could they have done about it? An economist approaches such a problem by gathering data and subjecting it to thorough analysis. One could do this by comparing the performance of similar functions and dissimilar structures.

Academics have actually done this and have obtained some interesting and suggestive results. For example, one academic study found that mortgages and asset backed securities have a 50% higher delinquency rates if the originators and the underwriters are different. Another story examines servicers. Servicing can either be performed by affiliates of the underwriter or by others. The study found that asset-backed securities issued by underwriters with the servicer under the same parent company retained their initial rating for 17% longer than asset-backed securities with third-party servicers. Now these are interesting because they're suggestive both of asymmetrical information in the first case, and in the second case the ability to control an outcome. Again we see the key concepts here.

Distinguishing instances, as opposed to exogenous factors, is often our task. Now we can think of other instance of asymmetrical information and ability to control outcome. So under asymmetrical

information, studies have found low quality borrowers disproportionately choose not to provide documentation of income and assets. We know that there have been some instances which collateral characteristics have been knowingly misrepresented. It's alleged that some instances the level of detail available to certain investors was different than that available to other investors. And it's alleged in some deals collateral had been overvalued. All these instances of asymmetrical information can result in bad outcomes.

When one thinks about control one can think about instances in which it's alleged that loans were not modified as could reasonably be expected, or were not foreclosed promptly, or were improperly subsumed into deals. Now, our task is to figure out when such instances occur versus when collateral performs badly merely due to macro- economic factors.

Such issues are at the heart of the recently settled SEC case against Goldman Sachs. You may recall that the SEC sued Goldman Sachs for failing to disclose to investors that securities underlying a synthetic CDO transaction were selected with the assistance of a party shorting the deal. In the transaction Paulson and Company, a major hedge fund, paid Goldman Sachs \$15 million to structure and market a CDO secured by mortgage collateral. A third party firm, ACA, agreed to become the portfolio selection agent and ultimately approved the selection of 55 of 123 mortgage-backed securities picked by Paulson. Paulson then shorted the CDO by entering into a credit default swap with Goldman Sachs. Within 9 months after the deal closed, 99% of the CDO had been down-graded. Investors lost a little over one billion. The biggest loser was ABN AMRO; it lost \$841 million. The bank ING lost \$150 million. Most of that money went to Paulson to settle the credit default swap transaction.

Goldman Sachs and Paulson initially contended that the nature of the deal and the sophistication of the investors rendered the disclosure of Paulson's role in selecting the portfolio as well as his position unnecessary. However on July 15th Goldman Sachs and the SEC agreed to a \$550 million settlement Goldman Sachs acknowledged that its marketing materials for the transaction were

incomplete, that it was a mistake to state that the portfolio was selected by ACA without disclosing Paulson's role in the selection process, and that Paulson's economic interest were adverse to those of the CDO investors. In other words, it acknowledged that the asymmetrical information was a problem. Now the CDO portfolio contained 90 securities rated BAA by Moody's. One could tease out of the data is that the SEC complaint stated that by October 24, 2007 83% of the securities in the portfolio had been downgraded. I'd note that by contrast that Moody states that by October 22, 2007 91% of all BAA rated sub-prime mortgages had been downgraded. This suggests that at least in one dimension the CDO collateral performed better than average.

Another interesting case is the investigation of the hedge fund Magnetar Capital by the SEC. Magnetar invested in the equity tranche of CDOs. It also bought protection via CDS on the deals. These yielded large profits when the deals performed badly. Key issues being examined are Magnetar role, if any, in the portfolio selection process. Magnetar told investors that it did not control the selection but did communicate with the bank asset managers when the deals were being structured. Other issues being examined are how the assets in the CDOs were being valued when the deal was structured, what triggers were put into place to determine how certain investors would incur losses, and at what point the firms involved in the deals decided to bet against the deals.

Now an interesting observation is that, as Magnetar held both the equity tranche of the deal as well as CDS that would short the deals, it would have made money if the deal done very well, in which case the equity investment would have paid off, or if the deals would have done very badly via the short CDS positions. Its position was a bet on volatility. And to make large profits, Magnetar needed the portfolio to do really well or really badly. As such it would be in its interest to select highly correlated assets. One way in which to examine its claim that it did not control the asset selection process in the CDOs in which it participated might be to analyze the correlation of the portfolio assets relative to the market. And this brings me back to where I started. Because like the Goldman case, and by the way the SEC is investigating a second deal by Goldman, where Goldman selected the

assets for the deal and also bought credit protection on the deal. The key issues here in the Magnetar case concerned asymmetrical information and control. In other words, what did they know, when did they know, and what could they do about it? Because often the answers to such questions are not directly observable, economic analysis can be a valuable tool because it can allow us to infer the answers to the questions, by looking at the data.

Lisa Fairfax: Thank you very much. It's very intriguing conversation particularly with respect to asymmetrical information. We will certainly get back to that discussion in our Q&A. Next we are going to have Elaine talk to us about settlements.

Elaine Buckberg: Thank you Lisa. SEC settlements have been in renewed focus since the SEC first filed its complaint against Goldman, when the press began to speculate about how large the settlement would be. Today I'll discuss SEC settlements since Sarbanes-Oxley, focusing on settlements with companies and then, following on some of Chu's discussion of the Goldman case, we'll talk a little bit about the settlement.

Sarbanes-Oxley was a major turning point in SECs settlements. Prior to Sarbanes-Oxley the single largest penalty against a public company was a \$10 million settlement earlier in 2002. Since then, the settlements have run in the hundreds of millions. Indeed we had three settlements in excess of \$100 million his year. The Goldman Sachs settlement, of course, at \$550 million, the State Street Bank and Trust settlement at \$314 million, and the Bank of America-Merrill settlement at \$150 million.

But prior to 1990, the SEC had authority to levy penalties only for insider trading. The Securities Enforcement Remedies Act of 1990 changed that, giving the SEC penalty authority for any securities law violation. However, penalties were deposited in the U.S. Treasury, so they became government revenue. Section 308 of Sarbanes-Oxley enabled the SEC to use penalties to create so-called Fair Funds which could then be distributed to harmed investors. With the ability to use penalties to compensate investors rather than to add to government revenue, the SEC began to levy

much larger penalties. Compared to that then-record-setting \$10 million Xerox settlement the top settlements now range from \$800 million down to \$250 million. All of these top ten settlements are with public financial companies or their subsidiaries. That \$550 million settlement with Goldman ranks third after an \$850 million settlement with AIG and a \$750 million settlement with WorldCom.

On January 4, 2006, the SEC issued guidance of about how it thought about arriving at settlement amounts with public companies. The guidance came on a day when the SEC was announcing settlements with two public companies: a settlement with McAfee for \$50 million and a settlement with Aflac which carried no financial settlement component. The SEC stated, “Our view of the appropriateness of a penalty on a corporation in a particular case turns principally on two considerations, the presence or absence of a direct benefit to the corporation as a result of the violation, and the degree to which the penalty will recompense or further harm the injured shareholders”.

The SEC also named a number of additional considerations which I will summarize as the magnitude of the harm to investors, the need for deterrence, the egregiousness of the fraudulent activity, and the cooperation of the corporation with the SEC once the investigation began. Many settlements still have no financial component like that Applix settlement. Of post-Sarbanes-Oxley settlements, 44% of company settlements involved no financial penalty. Here I’m speaking of both public and private companies. If we look a group of settlements that are all with public companies, settlements with public companies involving misstatements which would be the parallel to 10b-5 shareholder or securities class actions. Fully 72% of those settlements since Sarbanes-Oxley involve no financial component. So those huge headline-making settlements are still a small proportion of the approximately 750 settlements the SEC reaches every year on average.

The number of settlements is up thus far in fiscal year 2010, but still below the post-Sarbanes-Oxley average of 750 approximately, and based on the settlement in the first 9 months, of the fiscal year,

this year is likely to yield 676 settlements, up from the post-Sarbanes-Oxley low of 616 in 2009. On average about one-quarter of the settlements are with companies. The remaining three-quarters are with individuals.

Now the SEC brings cases and reaches settlements in both federal court and administrative proceedings, with about 54% in federal court. Whether the SEC will opt for administrative proceedings versus a federal court action depends on the kind of case, the penalty sought, and tactical issues. An administrative proceeding is the only way the SEC can address the failure of an SEC-regulated entity to properly supervise its employees, for example. On the other hand only in federal court can the SEC bring a case against entities or individuals it does not regulate. Another advantage of administrative proceedings is to give the SEC nationwide subpoena power, as opposed to the 100-mile rule that applies in the federal court.

In terms of settlement size, the annual average company settlement ranges from \$5 million to \$25 million since Sarbanes-Oxley. For the fiscal year to date from October 1, 2009 to mid-June, the average settlement was \$11 million. But median company settlements, your 50th percentile settlements, are typically much lower, generally in about the \$1 million range. With respect to settlements with public companies we find that non-zero settlements are increasing in the company's market capitalization. That is if we have a settlement that involves a financial amount we find that there is a statistically significantly positive relationship between the settlement size and the market capitalization of the company. As I said before, over 70 percent of settlements with public companies involving misstatements involve no financial penalty. Another 21% are still under \$50 million. So, only about 7% of public companies misstatement settlements are for more than \$50 million.

Another important consideration, if you're looking at SEC settlements, is the composition between disgorgement which is designed to be an equitable remedy that would be essentially the give up of gains due to the alleged fraud, and civil penalties. And the higher the ratio of civil penalties to

disgorgement, especially when you are looking a company, generally signals a more egregious problem. Companies pay somewhat more in civil penalties than disgorgement. An average company settlement is composed of 40% disgorgement, 52% civil penalties, and 2% pre-judgment interest .

Now for the remainder of my talk, I'd like to analyze the Goldman settlement in terms of its size and allocations in relations to the statistics and practices we know the SEC follows. As I already mentioned this is the third largest SEC settlement ever. And one of the ways the SEC evaluates settlements with public companies is as a percentage of market capitalization, which it looks at the measure or capacity to repay. So that positive statistically significant relationship between market cap and settlement size is no coincidence. The Goldman settlement at \$550 million came out to 0.7% of the Goldman \$75 billion market cap on the eve of settlement. So that's quite large, but not up at the one percent threshold that the SEC has indicated it considers extraordinary. But Goldman stock rose over 4% on the day the settlement was announced. It was announced after the closing, but there was anticipation of a settlement that day. The stock rise was over six times the value of the settlement, so by reaching that settlement Goldman was still able to add 5 times that amount to its market cap, after subtracting the value of the settlement.

Now the distribution of the settlement is interesting. The \$550 million payment is going to be split between government revenue and the Fair Fund to compensate participants in the deal. So the largest share, \$300 million goes to the U.S. Treasury as government revenue and the remaining \$250 million will be split between two participants in the Abacus 2007 AC1 deal. There were only four participants and the remaining two were involved in the structuring of the deal: Goldman itself and ACA which selected the penalty with input from Paulson. German bank ING will receive \$150 million; this is equal to its entire investment in the Abacus deal, which is now reported to be valueless. The Royal Bank of Scotland will receive the remaining \$100 million compared to the reported losses of \$841 million. RBS acquired ABN AMRO, an original participant in the super

senior tranche of the Abacus deal. So RBS is receiving about 12 cents on the dollar compared to its loss, while ING gets full compensation.

Now I'm certainly not privy to the SEC thinking on this matter but I will note a difference between the nature of the two investments that may have affected the SEC's decision. And to understand this, we need to briefly discuss the structure of the synthetic CDOs such as the Abacus deal, because synthetic CDOs have two kinds of investors. There is the funded class of investors who, just like any other bond investors, make an up front payment to invest in the security, then to expect to receive a return. A synthetic CDO also sells credit protection to other investors by selling credit default swaps. And it needs to be prepared to make contingent payments if there are losses on the reference bonds underlying those credit defaults swaps.

In the case of Abacus, ultimately the protection buyer was Paulson. IKB invested in the funded class of the deal. It made an upfront payment of \$150 million for notes that then loss value. In contrast ABN AMRO was an unfunded class investor. So it made no upfront payment at purchase, but it had to be prepared to make contingent payments at a later date. So if the Abacus structure had to make contingent payments in excess of the value of the funds that had been put up by the funded class investors plus any interest or returns that had been earned on that, then unfunded investors like ABN AMRO would need to put up money to pay the CDS protection buyers. ABN AMRO ultimately paid over \$840 million to Goldman to exit its position and avoid future contingent payments. So because an unfunded class investor hopes to get a return without laying out any cash out up front, the SEC may have viewed this as a more aggressive or more speculative investment as it is essentially a leveraged investment and determined a lower rate of compensation to be appropriate.

Clearly under that \$550 million settlement, after compensating ING, there were \$400 million left. There was the potential to have compensated almost 50 cents on the dollar to ABN AMRO. But instead it chose a lower rate of compensation and gave the remainder to the Treasury. Let me close by noting that all the data I cited today comes from NERA's proprietary database on SEC

settlements. We've gathered data on all SEC settlements since Sarbanes-Oxley - over 5,800 such settlements - and we make much of this data publicly available on www.securitieslitigationtrends.com. So if you found this interesting you can refer to the website for more information to review the data and for our semi-annual papers on SEC settlement trends. Thanks very much, Lisa.

Lisa Fairfax: Thank you. It was very interesting to hear about those settlement trends. Let me now take a moment to ask some of your questions. I'll start with Chris, who talked about some interesting issues with regards to asset backed securities, I think in particular in talking about this notion of them being toxic. One of the questions I had was given the kind of really negative view that people have of securities and this notion that that they're "toxic". What do you think is the future there was at some point perhaps really exaggerated claims that perhaps we shouldn't use these type of securities anymore and certainly some discussions about minimizing their use in a variety of different ways? What is your take of how they should be used? Or kind of going forward?

Christopher Laursen: I think there has been more rational talk of late that considered the virtues of securitization and how it actually helps consumers and has a rational purpose for investors and so clearly for a trend towards more transparency and less reliance on perhaps on the credit rating agencies is perhaps is important and is getting written into rules. I think Reg AB is one that would require significant amount of additional disclosure and provide underlying assets within and asset back security not just provide the assets on a list but also provide sort of a cash flow model and so that's going to provide a lot more detail to investors that want to take a closer look and have a better understanding of the position.

Lisa Fairfax: Speaking of new rules, we have the new Dodd- Frank Act the President has just signed into law. I don't know if you had a chance to take a look at it. I understand that there are some provisions that deal with asset back securities if you have seen it do you have any kind of overall impression about what you think it means for asset backed securities. What type of impact the reform will have in that area?

Christopher Laursen: I think one part of it is has to do with the reliance on the credit ratings and basically that's being removed from banking regulation. The bank regulators traditionally have relied on credit rating from NSROs nationally recognized statistically rated organizations like Moody and Standard and Poor's and Fitch. They are being asked to study where reference to their ratings are in the banking regulation and remove it. With respect to asset back securities regional or community bank that normally could purchase an asset-backed security of a certain rating and know that it's within the law, with in the regulation, of what it might hold in a investment portfolio. Now it's going to be faced with some other, potentially more nebulous task of asserting what the credit worthiness of an issue is and convincing its regulators that it's ok. So that will be interesting to see how that plays out.

Lisa Fairfax: And that segues into a question I wanted to ask Chu, which was there are both in the new act but also kind of in general there was a lot of discussion about the role of credit rating agencies in connection with potentially creating inaccuracies related to structured products. So I wanted to get your sense about whether you think the description of that role the potential negative impact of rating agencies is accurate and kind of whether or not you think there's anything can be done. Do you think rating agencies are part of the problem, if you will, creating inaccuracies with respect to those products?

Chudozie Okongwu: I think the background here is that there are allegations in certain cases the underwriters or structures rating shopped essentially played the rating agencies off against one another in an effort to get the most lenient treatment for a deal. I think before we talk about that it's worthy of note that some of the more recent deals have much more higher quality collateral than the deals that came out before the crisis, and far more over collateralization, because that is the only way people are really interested in them at this point.

Going back to your question about the rating agencies, I think this harkens back to something I talked about briefly, which was the whole principal problem. The rating agencies are meant to be

agents for investors. The problem that leads to a perceived conflict of interest on their part is that they are paid by other agents to the deal. It's a sticky problem because according to the rating agencies their business model as set up currently is the only one that is really going to work for them. Essentially the investor doesn't want to pay the rating agencies. It's a difficult problem, and I'm not sure how it's going to be dealt with.

Lisa Fairfax: I agree with that assessment that it's something that is difficult to get your hands around. I also wanted to follow up I said we were going to talk a lot about asymmetrical information in that being one of the kind of critical problems in this area. I wondered in light of the comment you just made about the kind of newer deals and the nature of the collateral there. Should we be as concerned about problems associated with asymmetrical information in this kind of tightening environment with respect credit?

Chudozie Okongwu: Yes, we should be concerned. I think that you are going to see efforts to minimize the potential for it. I don't you can ever completely eliminate it. I think Chris touched upon that when he mentioned greater transparency. I think investors are going to demand greater transparency, into what they are investing, as the only way they are going to part with their capital.

Lisa Fairfax: Certainly I think a lot of the issues surrounding the crisis were that people were talking about opaqueness. So I think that transparency is a counter to that we will likely to see in the future.

Let me turn to Elaine now. You talked about a number of intriguing facts with respect to SEC settlements. 72% I think, the figure you used for settlements with no financial components associated with it. I wonder what that means. What should we take from that? Should we be concerned that there are a large amount of settlements that actually don't have finance piece to it or is that a good thing?

Elaine Buckberg: First of all, that's out of settlements with public companies relating to misstatements. And so these are companies that have investors. One of the primary considerations the SEC takes into consideration is whether the company itself received any financial gain. Did the company get money from some other party, including its investors, that it should be returning? Another primary consideration is, who were the investors at the time and who are the investors today? Because the consideration is, for example, if they are all the same investors, do you want to just transfer money to the company owned by the investors to those investors? It's not necessarily problematic. The nature of the admissions in the carefully-negotiated settlement documents is an alternative way of indicating the severity of an offense. Reforms may also be required under the settlement, as in the case in the Goldman settlement. So, it's not necessarily problematic. It could actual be fair to investors. The SEC has been transparent about how it thinks about these issues.

Lisa Fairfax: Another thing you said that was very intriguing, you talked about the Goldman settlement. And after the settlement it added to its market cap. I wondered, is that suggested on the opposite end that these kind of large settlements have some positive impact for their corporations and shareholders? What does that mean in terms of settlements?

Elaine Buckberg: The question is, what is the news compared to what the market was expecting. So there was a lot of discussion that the Goldman settlement could have been as high as a billion dollars. \$550 million looked like a relatively less expensive settlement. I think that there is also suggestion that the market is going to take away from that in terms of how problematic the conduct was behind it. If there was \$550 million settlement versus a billion dollar settlement, and there is no admission of fraud in it, both in terms of the magnitude of the dollar value of the settlement and the nature of the admissions that were and were not in the settlement, I think the settlement looked less problematic that the market feared it might have been.

Lisa Fairfax: Another question I wanted to ask is what you think the future is going forward. The one thing you talked about is the history of settlements and its starting off with this kind of very

narrow focus on insider trading. Now it seems like not only the amount but the nature of the suits that the SEC has coverage over.

Elaine Buckberg: I think that the shift to using that penalty authority to compensate investors is very reasonable and consistent with the goals of the SEC in protecting investors. I think an interesting question is that, with the Dodd-Frank Act, there will be no lack of overlapping authority and more possible overlaps between the SEC and the CFTC and the new Consumer Financial Protection Agency. And so I think we could possibly see the SEC bringing penalties in other areas - or not. So I think that is something that remains to be seen as the overlaps and how enforcement will work out develop.

Lisa Fairfax: I think we are definitely going to see a lot of changes to come with the new act. I want to go back to Chris for a second. I was thinking about changes and comparing history to now. One of things you talked about is the misconceptions about asset-backed securities. One of the misconceptions is that is kind of a new thing and in fact it had this kind of history behind it. Another thing that people said about the security is that it became riskier over time. And I wonder if you could talk a little bit about that. Is that a misconception as well? Or do you think that with asset-backed securities, the risk levels were the same?

Christopher Laursen: I think that if there 's a general conclusion, is that if you look in the mid to thousands underwriting standards whether you're talking about assets that were ending up in asset back securities or assets that were ending up on bank balance sheets as outright loans probably deteriorated. And this is across the different sectors. So, I think the famous quote by Chuck Prince about you having to dance as long as there's music was in relation to corporate leverage loans. That's where he thought that there was too much aggressiveness in the terms and the covenants and it ended up the mortgage space had problems first and more broadly than was expected.

Certainly there were some issues where underwriting standards deteriorated and for what ever reason the regulator didn't push back forceful enough strongly enough or didn't have power to do so. Some

of the entities were unregulated, some of them chased the unregulated entities to continue to getting business, and so there were some of those issues that are system wide. I think that a lot of what Dodd-Frank tried to get at was we can't have pockets that are hidden and are doing the same things as the pockets that are regulated because it begins to be a race to the bottom. So I wouldn't say that structured finance or asset-backed securities had unique issues with what was going on in terms of the quality. I think it was more broad. Part of what was going on had to do with information asymmetries as Chu spoke about, part of it had to do with not understanding the level of risk in the entire system. There were missteps and errors on both parts.

Lisa Fairfax: Chu's discussion about information asymmetries is an important one. My question before about whether or not if we should still be concerned, I think you are exactly right to say absolutely. I've asked everyone else what you thought the future of their various topics. What do you think the future of these kinds of products is going forward?

Chudozie Okongwu: I think that you are going to see a resuscitation of the market. I think that investors will demand increased transparency. I think there will be legal changes also that have already started to occur, which will limit the ability of people to completely offload their risk in deals. I think you'll see structures that are simpler much easier to understand, much more subordination, higher quality collateral. I think we all accept the idea that no-doc loans are gone. And I think you're likely in a few years to see relatively healthy market place, as healthy as the economy will allow.

Elaine Buckberg: We are all being a little cagey in some areas about Dodd-Frank. The reason why is in many of the areas it lays out broad principles and broad objectives. The details still remain to be worked out through rule makings by the various agencies. There are going to be public processes, proposed rules and common processes and so there are lots of details yet to be worked out.

Lisa Fairfax: I think that is exactly right. A lot of Dodd-Frank is about research reports and studies which in many ways is probably a good move because we probably do need to learn more.

There is a lot of room for that in terms of these products, in terms of asymmetrical information and misconceptions. I want to ask Chu one more question. Mores cases like Goldman?

Chudozie Okongwu: The SEC is examining a number of deals. There are allegations of mis-selling and inadequate disclosure, so yes I think there are going to be more cases of where again these issues of information asymmetry and a need to control deal outcomes will be at the center of what is being examine. And, as I said, in the absence of any directly observable facts. You're going to need to look at the data and draw inferences about the behavior of certain parties.

Lisa Fairfax: I will ask Elaine about Fair Funds. Do you think it's working in terms of getting things out to investors, in an organized and timely way?

Elaine Buckberg: Fair Funds are definitely distributed I don't know about the timelines and it's a little bit variable. One of the things when you create a Fair Fund, then there has be a rule create for how the fund would be allocated to the various investors at the relevant time. All those investors need to be identified and they need to be tracked down, if their addresses have been changed, before checks could be then sent to them. So it can take some time. But, Fair Funds have been created and they have been distributed in a number of cases.

Lisa Fairfax: You also talked about disgorgement too. Issues like that I think are important to keep in mind. Throughout this crisis, I think, like all of the rest of you, people are hopeful about the market and where it's going. More importantly, the type of products we've been talking about don't start from a negative background and being used in potentially negative ways.

Christopher Laursen: I think there is lot of importance in getting the market resuscitated because with banks and bank capital requirements, all the underlying assets financed with asset backed securities aren't going to be able to be absorbed with sort of remediation onto bank balance sheets. Because capital requirements are higher, there is not much leverage around, so the question is: if asset-backed securities aren't able to carry some of that, where is it going to come from?

Lisa Fairfax: Certainly I think you're exactly right. I think that really the important thing to keep in mind with the resuscitation is that we don't lose things like asset-backed securities and other products that can be a positive force in the resuscitation even though some have labeled them toxic.

This program has been incredibly interesting. I want to thank you Elaine, Chu and Chris, for making sure we have a very engaging discussion about these very important topics and for sharing your papers from NERA's recent Finance, Law and Securities Litigation seminar. I think we can all certainly appreciate why your presentations were deemed to be the best at this year's conference.

Today's broadcast can be accessed at any time through the virtual museum and archive; an edited transcript will soon be available. The museum will next broadcast Bingham Presents 2010 on Wednesday, September 29th, beginning at 5pm Eastern Time. The program will be broadcast live from the offices of Bingham McCutchen LLP in New York and online at www.sechistorical.org. The online broadcast will be free and accessible worldwide without prior registration.

The program will look at harmonization of the regulation of investment advisers and broker dealers. Professor Eric Sirri of Babson College, a member of the Society's Museum Committee and a former director of the SEC Division of Market Regulation will moderate the program. Presenters will include W. Hardy Calcott of Bingham McCutchen LLP, Mark Shelton of UBS AG, and David Tittsworth of the Investment Advisers Association. Please plan to join us on www.sechistorical.org on September 29th, and thank you again for being with us today.