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**THE SUBPRIME MELTDOWN: FOR CDO INVESTORS  
THERE IS A REMEDY.**

By: Alan Sparer, James J. Seltzer and James Nabwangu

As the damage from the subprime lending meltdown spreads, the question is not “Who will suffer losses?” but “Who will be legally responsible when the inevitable lawsuits follow?” There may be some surprises. The standard defenses offered by sellers of mortgaged backed securities—that sophisticated buyers understood the risks and that the investments were blessed by independent rating agencies—might finally land both sellers and so-called independent rating agencies in deep water.

***Who Will Suffer CDO Losses?***

CDOs are investment vehicles that pool and securitize fixed income instruments, such as bonds, mortgages, and loans.<sup>1</sup> The pool is then sliced into “tranches” consisting of new securities, each having a different claim on the flow of cash from the bonds and repayment of the mortgages or loans underlying them. The top tranche has the first call on cash flows from the loan pool, and accordingly gets a top investment grade from

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<sup>1</sup>These investment vehicles are also referred to as CLOs (collateralized loan obligations), CBOs (collateralized bond obligations) or CMOs (collateralized mortgage obligations). They vary in name only depending on what type of debt instruments are being pooled and securitized.

rating agencies comparable to the ratings they give U.S. Treasury securities. The return is predictably low but supposedly very safe. Other slices carry a lower rating, a subordinated place in the cash distribution and a correspondingly higher return. But the process cannot turn lead to gold. The risk of the whole pool does not disappear. It simply filters down to the bottom or “equity” tranche, which is never rated and often is referred to affectionately in the industry as “toxic waste.”

Over \$1 trillion in CDOs have been sold by Wall Street since 2002. It is estimated by some that CDO investors stand to lose as much as \$250 billion.<sup>2</sup> The big losers will be the universities, municipalities, insurance companies, and pension funds that bought CDOs thinking they were taking little risk by owning a rated tranche.<sup>3</sup> When CDO tranches are downgraded, such owners may be required by law to move their money back into genuinely high-rated fixed income investments, forcing sales of their CDO portfolio at a steep discount. Other big losers will be purchasers of the equity tranche who did not understand what they were buying or the risk it carried.<sup>4</sup>

***Is There a Villain in This Story, and More Importantly, a Remedy? The Answers Are “Yes” and “Yes.”***

While each CDO is unique, certain tendencies in the formation, rating and marketing of both the rated and unrated tranches quickly emerge. By 2006, data was available showing a dramatic increase in the risk of subprime mortgages constituting the main CDO collateral. The quality of loans, the rate of default, the loan-to-value ratios, and the level of documentation were known to be in decline.

Investment banks and financial managers creating CDOs could have taken defensive steps, including rejecting risky loans, adding more loans to cushion against loss, and fully and timely disclosing the declining creditworthiness of various CDOs. Rating agencies also could have demanded these changes. In fact, as the market for

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<sup>2</sup>Mark Pittman, *S&P May Cut \$12 billion of subprime Mortgage Bonds* (Update 6), Bloomberg.com, July 13, 2007.

<sup>3</sup>Not to mention Bear Stearns High Grade Structured Credit Strategies Fund, and its leveraged sibling, the High Grade Structured Credit Strategies Enhanced Leverage Fund, which made large bets on CDOs with exposure to subprime collateral in late 2006 and early 2007. Kate Kelly et al., *Two Big Funds At Bear Stearns Face Shutdown*, Wall Street Journal Online, June 20, 2007; Kate Kelly & Serena Ng, *Bear Stearns Bails Out Fund With Big Loan*, Wall Street Journal Online, June 23, 2007.

<sup>4</sup>Citigroup Inc. sold California Public Employees Retirement System, the nation’s largest public pension fund, \$140 million in such unrated CDOs. The New Mexico State Investment Council which funds education and government services for children has \$222.5 invested in equity tranches. The General Retirement System of Detroit holds three equity tranches purchased for \$38.8 million. The Teacher Retirement System of Texas owns \$62.8 million of these tranches, and the Missouri State Employees Retirement System owns \$25 million. D. Evans, *Banks Sell ‘Toxic Waste’ CDOs to Calpers, Texas Teachers Fund*, Bloomberg.com, June 1, 2007.

CDOs expanded and financial institutions discovered that they did not have to retain any of the risks of the mortgages they initiated, underwriting standards collapsed to irresponsible levels—with the full knowledge of the rating agencies. Both groups reaped enormous profits.

***Standard Industry Defenses Do Not Apply.***

Historically, Wall Street has responded to criticism of structured product sales with two powerful arguments, neither of which is persuasive with respect to mortgage-backed CDOs.

The first defense is that independent ratings agencies such as Standard and Poor, Moody's, and Fitch evaluated and blessed each CDO before it was sold, and continued to monitor tranches as conditions changed. Whereas it is true that rating agencies *are* gatekeepers for institutions that must place their funds in, for example, AAA or BBB rated fixed income instruments, in the past few years, these agencies were paid only on condition that the CDO went to market. The agencies also received large continuing fees for periodically re-evaluating the products.<sup>5</sup> It also is disturbing to learn that rating agencies collaborated with managers in structuring CDO investments, so they could go to market with the agency's blessing.

In short, the rating agencies were not independent, and now many 2006 CDOs are facing early defaults and downgrades, effectively an acknowledgment that the original ratings only months earlier were deficient. In some cases a CDO tranche ranked AAA was adjusted to junk bond status in one stroke less than a year after the initial rating. Commentators already are questioning the role of the rating agencies in the CDO frenzy.<sup>6</sup> The SEC has begun its own investigation of the matter. The ratings agencies were also slow to downgrade troubled CDOs. In early 2007, default rates on poorly underwritten mortgages were well in excess of levels earlier assumed by the investment banks and rating agencies. And still, the rating agencies failed in their duty to downgrade the affected securities until well after this was known.

The financial institutions that structured and issued CDO's and the ratings agencies that collaborated in the process may find themselves pointing the finger at each other. Both will face liability for structuring their investments without regard to the clear warning signs of mounting problems with the underlying collateral.

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<sup>5</sup>Over 90% of rating agency revenues (over \$8 billion in 2005) is from issuers who pay for ratings. Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers* 11-12, in *Financial Gatekeepers: Can They Protect Investors?* (Yasuyuki Fuchita, Robert E. Litan eds. 2006); John Mauldin, *The Panic of 2007*, "The Rating Agency Blame Game," Thoughts from the Frontline, August 17, 2007.

<sup>6</sup>Karen Richardson & Serena Ng, *Moody's Faces the Storm*, Wall Street Journal Online, July 10, 2007; Pittman, n.2, *supra*.

The second defense typically offered is that CDOs were purchased by institutions and sophisticated individuals with access to their own financial professionals, who were fully capable of evaluating the risks. This isn't rocket science. Caveat emptor.

But structured investment vehicles *are* rocket science, and not just any institutional investor or high net worth individual has the capacity to engage the army of math Ph.D.s and MBAs that Wall Street employs to create and value these products. In 2001, the National Association of Securities Dealers (now FINRA, the Financial Industry Regulatory Authority), issued a Notice to Members reminding them that products such as CDOs might be suitable for “only a very narrow band” of high net worth investors capable of evaluating the risks involved.<sup>7</sup> The responsibilities of the brokers and brokerages include: determining whether the product is suitable for sale generally; ensuring that written and oral presentations provide a “fair and balanced picture regarding both the risks and benefits”; and providing internal controls and adequate training for salespeople. Reports have emerged of sales of CDOs by brokers and advisors who did not understand or were careless in their descriptions of the risks associated with CDO investments.

In the end, the subprime meltdown likely will overshadow the days of ENRON and WorldCom because of its impact on financial markets worldwide. Each case will require its own fact-intensive inquiry. But Wall Street (including the rating agencies) likely will be required to return at least a part of the astonishing earnings it enjoyed and rectify losses to both institutional and individual investors.

*The authors practice law in San Francisco, CA and represent investors in litigation against financial institutions. In 2006, Sparer Law Group and Law Offices of James Jay Seltzer won an arbitration award of \$5.8 million against Deutsche Bank for its role in connection with the sale of CLOs and CDOs. Visit [www.sparerlaw.com](http://www.sparerlaw.com) or visit our CDO Blog at [www.sparerlaw.blogspot.com](http://www.sparerlaw.blogspot.com) or [www.jamesjayseltzer.com](http://www.jamesjayseltzer.com) for more information.*

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<sup>7</sup>NASD, Notice to Members 03-71, *NASD Reminds Members of Obligations When Selling Non-Conventional Investments* (Nov. 2003).