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Appendix A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 15-1872-cv(L), 15-1874-cv(CON)

FEDERAL HOUSING FINANCE AGENCY, as Conservator for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation,

Plaintiff-Appellee,

v.

NOMURA HOLDING AMERICA, INC., NOMURA ASSET ACCEPTANCE CORPORATION, NOMURA HOME EQUITY LOAN, INC., NOMURA CREDIT & CAPITAL, INC., NOMURA SECURITIES INTERNATIONAL, INC., RBS SECURITIES., F/K/A GREENWICH CAPITAL MARKETS, INC., DAVID FINDLAY, JOHN MCCARTHY, JOHN P. GRAHAM, NATHAN GORIN, N. DANTE LAROCCA,

Defendants-Appellants.[*]

Decided: September 28, 2017

Before: WESLEY, LIVINGSTON, and DRONEY, *Circuit Judges*.

WESLEY, *Circuit Judge*:

In the wake of the Great Depression, Congress took measures to protect the U.S economy from

[*] The Clerk of the Court is respectfully directed to amend the caption.

suffering another catastrophic collapse. Congress's first step in that endeavor was the Securities Act of 1933 (the "Securities Act" or "Act"), ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a *et seq.*). The Act's chief innovation was to replace the traditional buyer-beware or *caveat emptor* rule of contract with an affirmative duty on sellers to disclose all material information fully and fairly prior to public offerings of securities. That change marked a paradigm shift in the securities markets. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-95 (1976).

This case demonstrates the persistent power of the Securities Act's full-disclosure requirement in the context of the Great Recession. The height of the housing bubble in the mid-2000s saw an explosion in the market for residential mortgage-backed securities ("RMBS"). *See* Adam J. Levitin & Susan M. Wachter*, Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1192-202 (2012). In the midst of that market frenzy, two government-sponsored enterprises, the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "Freddie)" and Federal National Mortgage Association ("Fannie Mae" or "Fannie") (collectively, the "GSEs"), purchased a subset of RMBS known as private-label securitizations ("PLS") from a host of private banks.

Defendants-appellants Nomura[1] and RBS[2] (collectively, "Defendants")[3] sold the GSEs seven of these certificates (the "Certificates") in senior tranches of PLS (the "Securitizations") using prospectus supplements (the "ProSupps"). Each ProSupp described the creditworthiness of the loans supporting the Securitization, including an affirmation that the loans "were originated generally in accordance with the underwriting criteria."

The housing market began to collapse in 2007 and the value of PLS declined rapidly. Shortly thereafter, plaintiff-appellee the Federal Housing Finance Agency (the "FHFA"), the statutory conservator of Freddie and Fannie,[4] brought sixteen actions in the

[1] "Nomura" refers to the following individuals and entities collectively: defendants-appellants David Findlay, John McCarthy, John P. Graham, Nathan Gorin, and N. Dante LaRocca (collectively, the "Individual Defendants"); and defendants-appellants Nomura Holding America, Inc., ("NHA") Nomura Asset Acceptance Corporation ("NAAC"), Nomura Home Equity Loan, Inc. ("NHELI"), Nomura Credit & Capital, Inc. ("NCCI"), and Nomura Securities International, Inc. ("Nomura Securities").

[2] "RBS" refers to RBS Securities, Inc. in its capacity as successor to Greenwich Capital Markets, Inc.

[3] We refer to Defendants collectively and attribute each argument to all Defendants, citing their individual briefs when necessary. *See* Nomura's Br. 2 (incorporating RBS's arguments by reference); RBS's Br. 4 (incorporating Nomura's arguments by reference).

[4] The FHFA was created by Congress out of concern for "the financial condition of Fannie Mae, Freddie Mac, and other [GSEs]" and is authorized to take any action necessary to restore the GSEs to solvency. *FHFA v. UBS Ams. Inc.* (*UBS II*), 712 F.3d

U.S. District Court for the Southern District of New York against financial institutions that sold PLS certificates to the GSEs, alleging that the offering documents used in those transactions overstated the reliability of the loans backing the securitizations, in violation of the Securities Act and analogous provisions of certain "Blue Sky laws,"[5] the Virginia Securities Act, as amended, VA. CODE ANN. § 13.1-522, and the District of Columbia Securities Act, D.C. CODE § 31-5606.05.[6] Sixteen of the FHFA's actions were coordinated before District Judge Denise Cote. Fifteen of those cases settled, resulting in more than $20 billion in recovery for the FHFA. The case on appeal was the only one to go to trial.

After issuing multiple pre-trial decisions and conducting a bench trial, the District Court filed a 361-page trial opinion rendering judgment in favor of the FHFA. The court found that Defendants violated Sections 12(a)(2) and 15 of the Securities Act, *see* 15 U.S.C. §§ 77*l*(a)(2), 77*o*, and analogous provisions of the Virginia and D.C. Blue Sky laws, *see* VA. CODE ANN. § 13.1-522(A)(ii); D.C. CODE § 31-5606.05(a)(1)(B), (c), by falsely stating in the ProSupps

136, 138 (2d Cir. 2013). The FHFA's statutory purposes and powers are discussed further below.

[5] For a discussion of the origin of the term "Blue Sky laws"—commonly used to describe state laws regulating the sale of securities—see Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359 n.59 (1991).

[6] The FHFA filed a similar action in the District of Connecticut, *FHFA v. Royal Bank of Scot. Grp., PLC*, No. 11 Civ. 1383; another, originally filed in New York, was transferred to the Central District of California, *FHFA v. Countrywide Fin. Corp.*, No. 12 Civ. 1059. Both have settled.

that, *inter alia*, the loans supporting the Securitizations were originated generally in accordance with the pertinent underwriting guidelines. As a result, the court awarded the FHFA more than $806 million in recession-like relief. Special App. 362-68.

Defendants appeal multiple aspects of the District Court's trial opinion, as well as many of the court's pretrial decisions. We find no merit in any of Defendants' arguments and AFFIRM the judgment. The ProSupps Defendants used to sell the Certificates to the GSEs contained untrue statements of material fact—that the mortgage loans supporting the PLS were originated generally in accordance with the underwriting criteria—that the GSEs did not know and that Defendants knew or should have known were false. Moreover, the FHFA's claims were timely, the District Court properly conducted a bench trial, Defendants are not entitled to a reduction in the FHFA's award for loss attributable to factors other than the untrue statements at issue, Defendants NAAC and NHELI were statutory sellers, and the FHFA exercised jurisdiction over Blue Sky claims.

BACKGROUND

I. Legal Framework

A. The Securities Act

"Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929." *Ernst & Ernst*, 425 U.S. at 194-95. The first set of regulations came in the Securities Act, which was "designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." *Id.* at 195 (citing H.R. REP. NO. 85, at 1-5 (1933)). Shortly thereafter, Congress passed a series of companion statutes, including the Securities Exchange Act of 1934 (the "Exchange Act"), ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a *et seq.*), which was intended "to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." *Ernst & Ernst*, 425 U.S. at 195 (citing S. REP. NO. 792, at 1-5 (1934)). Congress's purpose for this regulatory scheme "'was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . . in the securities industry.'" *Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

The Securities Act regulates the use of prospectuses in securities offerings. A prospectus is "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security," with certain exceptions not applicable here. 15 U.S.C. § 77b(a)(10). Section 5(b)(1) of the Securities Act provides that it is unlawful "to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security" unless the prospectus meets certain disclosure requirements. 15 U.S.C. § 77e(b)(1); *see* 17 C.F.R. § 230.164. Section

5(b)(2) provides that it is unlawful "to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus" that meets additional disclosure requirements. 15 U.S.C. § 77e(b)(2).

Section 12(a)(2) of the Act, as amended, 15 U.S.C. § 77*l*, accords relief to any person (1) who was offered or purchased a security "by means of a prospectus or oral communication"; (2) from a statutory seller; (3) when the prospectus or oral communication "includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading"; and (4) the plaintiff did not "know[] of such untruth or omission" at the time of sale (the "absence-of-knowledge element"). 15 U.S.C. § 77*l*(a)(2); *see In re Morgan Stanley Info. Fund Sec. Litig.* (*Morgan Stanley*), 592 F.3d 347, 359 (2d Cir. 2010). Scienter, reliance, and loss causation are not *prima facie* elements of a Section 12(a)(2) claim. *Morgan Stanley*, 592 F.3d at 359.

Section 12 authorizes two types of mutually-exclusive recovery. *See* 15 U.S.C. § 77*l*(a); *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1035 (2d Cir. 1979). If the plaintiff owned the security when the complaint was filed, Section 12 authorizes rescission—the plaintiff returns the security to the defendant and the defendant refunds the plaintiff the purchase price with adjustments for interest and income. *See* 15 U.S.C. § 77*l*(a); *Wigand*, 609 F.2d at 1035. If the plaintiff no longer owned the security when the complaint was filed, Section 12(a)(2) permits the plaintiff to recover "damages." 15 U.S.C. § 77*l*(a); *see Wigand*, 609 F.2d at 1035.

Section 12 contains two affirmative defenses. First, a plaintiff will not be entitled to relief if the defendant "did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission" at issue. 15 U.S.C. § 77*l*(a)(2). This is known as the "reasonable care" defense. *Morgan Stanley*, 592 F.3d at 359 n.7.

Second, a defendant may seek a reduction in the amount recoverable under Section 12 equal to

> any portion . . . [that] represents [an amount] other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be.

15 U.S.C. § 77*l*(b). This is known as the "loss causation" defense, *Iowa Pub. Emps.' Ret. Sys. v. MF Glob., Ltd.*, 620 F.3d 137, 145 (2d Cir. 2010), or "negative loss causation," *In re Smart Techs., Inc. S'holder Litig.*, 295 F.R.D. 50, 59 (S.D.N.Y. 2013). Unlike the Exchange Act, which generally requires plaintiffs to prove loss causation as a *prima facie* element, *see* 15 U.S.C. § 78u-4(b)(4), the Securities Act places the burden on defendants to prove negative loss causation as an affirmative defense, *see McMahan &*

Co. v. Wherehouse Entm't, Inc., 65 F.3d 1044, 1048 (2d Cir. 1995).

Section 12 is closely related to Section 11 of the Securities Act, as amended, 15 U.S.C. § 77k, which "imposes strict liability on issuers and signatories, and negligence liability on underwriters," for material misstatements or omissions in a registration statement. *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.* (*NECA*), 693 F.3d 145, 156 (2d Cir. 2012). Both provisions are limited in scope and create *in terrorem*[7] liability. *See id.*; William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933). The loss causation defense in Section 12 was adapted from the loss causation defense in Section 11(e) of the Securities Act. *See* S. REP. NO. 104-98, at 23 (1995).

Finally, Section 15 of the Act, as amended 15 U.S.C. § 77*o*, provides that "[e]very person who . . . controls any person liable under . . . [Section 12(a)(2)] shall also be liable jointly and severally with and to the same extent as such controlled person." 15 U.S.C. § 77*o*(a). "To establish [Section] 15 liability, a plaintiff must show a 'primary violation' of [Section 12] and control of the primary violator by defendants." *See In re Lehman Bros. Mortg.-Backed Sec. Litig.*, 650 F.3d 167, 185 (2d Cir. 2011) (quoting *ECA, Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 206-07 (2d Cir. 2009)).

In this case, the District Court awarded the FHFA rescission-like relief against all Defendants under

[7] "By way of threat; as a warning." BLACK'S LAW DICTIONARY (10th ed. 2014).

Section 12(a)(2) and found NHA, NCCI, and the Individual Defendants control persons under Section 15 for the seven PLS transactions at issue. *FHFA v. Nomura Holding Am., Inc.* (*Nomura VII*), 104 F. Supp. 3d 441, 598 (S.D.N.Y. 2015). Defendants appeal the District Court's decisions as to each *prima facie* element of the Section 12(a)(2) claims (except that the sales were made by means of a prospectus) and as to both affirmative defenses.[8]

B. The Blue Sky Laws

The Commonwealth of Virginia and District of Columbia have enacted Blue Sky laws modeled on the Securities Act as originally enacted in 1933. *Andrews v. Browne*, 662 S.E.2d 58, 62 (Va. 2008); *see Forrestal Vill., Inc. v. Graham*, 551 F.2d 411, 414 & n.4 (D.C. Cir. 1977) (observing that the D.C. Blue Sky law was based on the Uniform Securities Act); *see also Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 602-03 (1995) (Ginsburg, *J.*, dissenting) (observing that the Uniform Securities Act was based on the Securities Act of 1933). These Blue Sky laws contain provisions that are "substantially identical" to Sections 12(a)(2) and 15. *Dunn v. Borta*, 369 F.3d 421, 428 (4th Cir. 2004); *see Hite v. Leeds Weld Equity Partners, IV, LP*, 429 F. Supp. 2d 110, 114 (D.D.C. 2006).[9] As relevant

[8] Defendants appeal the court's Section 15 award only inasmuch as they contest the primary violations of Section 12(a)(2).

[9] It is not settled whether the Virginia or D.C. Blue Sky analogs to Section 12(a)(2) contain loss causation defenses. *See FHFA v. HSBC N. Am. Holdings Inc.* (*HSBC I*), 988 F. Supp. 2d 363, 367-70 (S.D.N.Y. 2013). Because we affirm the District Court's finding that Defendants failed to make out a loss causation defense, we need not address this issue on this appeal.

to this appeal, the Blue Sky laws are distinct only in that each requires as a jurisdictional element that some portion of the securities transaction at issue occurred in the State. D.C. CODE § 31-5608.01(a); *see Lintz v. Carey Manor Ltd.*, 613 F. Supp. 543, 550 (W.D. Va. 1985) (citing *Travelers Health Ass'n v. Commonwealth*, 51 S.E.2d 263 (Va. 1949)).

The District Court awarded the FHFA relief under the D.C. Blue Sky law for the sale of one Certificate and relief under the Virginia Blue Sky law for the sales of three other Certificates. *Nomura VII*, 104 F. Supp. 3d at 598.

II. Factual Background[10]

This case centers on the RMBS industry of the late 2000s. RMBS are asset-backed financial instruments supported by residential mortgage loans. A buyer of an RMBS certificate pays a lump sum in exchange for a certificate representing the right to a future stream of income from the mortgage loans' principal and income payments. PLS are RMBS sold by private financial institutions. *See Pension Benefit Guar. Corp. ex rel. St. Vincent Catholic Med. Ctrs. Ret. Plan v. Morgan Stanley Inv. Mgmt. Inc.* (*Pension Benefit Guar.*), 712 F.3d 705, 713-14 (2d Cir. 2013).

[10] Except where otherwise noted, these facts are drawn from the District Court's post-trial decision and from additional record evidence. *See id.* at 458-69; *see also Beck Chevrolet Co., Inc. v. Gen. Motors LLC*, 787 F.3d 663, 672 (2d Cir. 2015) (stating that factual findings after a bench trial are reviewed for clear error). To the extent portions of the record are quoted in this opinion, the Court orders the record unsealed solely with regard to those quoted portions of the record.

This case touches on nearly every aspect of the PLS securitization process—from the issuance of mortgage loans through the purchase of a securitization. Because of the size and complexity of this case, in addition to the fact that the final order rule requires us to review a number of the District Court's pre-trial rulings, *see* 28 U.S.C. § 1291, there is much to consider. We think it best to begin with a summary of the securitization process from 2005 to 2007, the time period relevant to this case, and then to introduce the parties and the transactions at issue. Issue-specific facts are addressed in more detail in the discussion sections below.

A. The PLS Securitization Process

1. Originating a Mortgage Loan Using Underwriting Guidelines

The first step in the PLS process was the issuance of residential mortgage loans. Mortgage loans were issued to borrowers by entities known as originators. Originators issued loans according to their loan underwriting guidelines, which listed the criteria used to approve a loan. *See United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.* (*O'Donnell*), 822 F.3d 650, 653 n.2 (2d Cir. 2016). These guidelines helped each originator assess the borrower's ability to repay the loan and the value of the collateral. Originators balanced those two criteria to determine a potential loan's credit risk.

Following the underwriting guidelines, originators required each prospective borrower to complete a loan application, usually on the Uniform Residential Loan Application (the "URLA"). The URLA required borrowers to disclose, under penalty of civil liability or criminal prosecution, their income, employment, housing history, assets, liabilities, intended occupancy status for the property, and the sources of the funds they intended to use in paying the costs of closing the loan. Originators used this information to determine objective factors relevant to the borrower's credit risk, such as a credit score according to the Fair Isaac Corporation's model (a "FICO score"), credit history, and debt-to-income ratio. Once each borrower submitted the URLA, the originator kept it and other related documentation in the borrower's loan file.

The underwriting guidelines required originators to assess the reasonableness of the borrower's assertions on the URLA. This was easiest when borrowers supported their URLA applications with corroborating documentation. Some applications required verification of both the borrower's assets and income, while some required verification only of the borrower's assets. Other borrowers submitted stated-income-stated-assets ("SISA") applications, which did not require verification of income or assets, or no-income-no-assets ("NINA") applications, which were complete without the borrower even stating his or her income or assets. SISA and NINA applications were more difficult to assess, but not categorically ineligible to receive loans.

The underwriting guidelines generally permitted originators to accept SISA and NINA applications and to make other exceptions to the underwriting criteria if there were compensating factors that indicated the borrower's ability and willingness to repay the loan. The guidelines set forth the specific conditions under which exceptions would be permitted. Originators were required to mark the borrower's loan file whenever an exception to the underwriting criteria had been granted and to explain the basis for that decision.

After forming an opinion about a borrower's creditworthiness based on the URLA and related documentation, originators assigned the transaction a credit risk designation, which affected the interest rate for the loan. When an applicant had good credit, the transaction was labeled "prime." When an applicant had materially impaired credit, the transaction was labeled "subprime." And when an applicant's credit fell between good and materially impaired, the transaction was labeled "Alt-A." *See Pension Benefit Guar.*, 712 F.3d at 715.

Once they had assessed the borrower's credit, originators balanced that assessment against the value of the collateral (*i.e.*, the present market value of the residence the borrower wanted to purchase or refinance), as determined by an appraiser, to measure the overall credit risk of the loan. Originators compared the amount of the loan against the value of the collateral to develop a loan-to-value ratio, a key indicator of credit risk. It was common in the RMBS industry to use a loan-to-value ratio of 80% as a benchmark. Relative to loans at that ratio, a loan worth between 80% and 90% of the collateral value was 1.5 times more likely to default and a loan worth between 95% and 100% of the collateral value was 4.5 times more likely to default. A loan-to-value ratio of more than 100% meant that the loan exceeded the value of the residence and the borrower was "underwater."

If the originator was comfortable with the overall credit risk after reviewing the buyer's creditworthiness, the value of the collateral, and the loan-to-value ratio, the loan would be approved.

The underwriting guidelines and loan files were crucial throughout and beyond the origination process. Supervisors employed by the originators could check loan files against the underwriting guidelines to ensure that loan issuance decisions met important criteria. For example, the District Court found that "[c]ompliance with underwriting guidelines ensure[d] . . . an accurate calculation of the borrower's [debt-to-income] ratio, which is a critical data point in the evaluation of a loan's risk profile." *Nomura VII*, 104 F. Supp. 3d at 536. After the loan issued, originators used the information in the loan file to describe the loan characteristics for financial institutions interested in purchasing it.

2. Creating a PLS

The next step in the PLS process was the aggregation and securitization of the residential mortgage loans into an RMBS. Originators compiled their issued loans into "trade pools" and then solicited bids from PLS "sponsors" or "aggregators" to purchase them. The originators provided prospective bidders with a "loan tape" for each pool—"a spreadsheet that provided data about the characteristics of each loan in the trade pool" including "loan type (fixed or adjustable rate), . . . original and unpaid principal balance, amortization term, borrower's FICO score, the mortgaged property's purchase price and/or appraised value, occupancy status, documentation type and any prepayment penalty-related information." J.A. 4385.

The sponsor that prevailed in the bidding process was given access to a limited number of loan files to conduct a due diligence review of the originators' underwriting and valuation processes before final settlement.[11] The sponsor was entitled prior to closing to remove from the trade pool any loans that did not meet its purchasing requirements, such as those below a minimum FICO score or exceeding a maximum debt-to-income ratio. Upon closing, the prevailing sponsor acquired title to the loans in the trade pools and gained access to the complete set of loan files. The prevailing sponsor was also given a copy of the underwriting guidelines the originators used to issue the loans.

The sponsor then sold the loans to a "depositor," a special purpose vehicle created solely to facilitate PLS transactions. The true sale from sponsor to depositor was intended to protect the future PLS certificate-holders' interests in the loans in the event that the sponsor declared bankruptcy. It was common in the RMBS industry for the depositor and sponsor entities to act at the direction of the same corporate parent.

The depositor then grouped the loans into supporting loan groups ("SLGs") and transferred each group of loans to a trust. In exchange, the trust issued the depositor certificates that represented the right to receive principal and interest payments from the

[11] Defendants' due diligence processes are discussed in further detail in the discussion sections below.

SLGs. The trustee managed the loans for the benefit of the certificate holders, often hiring a mortgage loan servicing vendor to manage the loans on a day-to-day basis. The depositor then sold most of the certificates to a lead underwriter, who would shepherd them to the public securities markets; a few certificates remained under the ownership of the depositor. It was also common in the industry for the lead underwriter to be controlled by the same corporate parent that controlled the sponsor and depositor.

3. Preparing a PLS for Public Sale

The final steps in the PLS process were the preparation and sale to the public of the certificates. The lead underwriter, sponsor, and depositor (collectively, "PLS sellers") worked together to structure the securitization, to solicit credit ratings for the certificates principally from three major credit-rating agencies, Moody's Investors Service, Inc. ("Moody's"), Standard & Poor's ("S&P"), and Fitch Ratings ("Fitch") (collectively, the "Credit-Rating Agencies" or "Rating Agencies"), and to draft and confirm the accuracy of the offering documents. Once those tasks were completed, the lead underwriter would market the certificates to potential buyers.

The PLS sellers structured securitizations with two credit enhancements that distributed the risk of the loans unequally among the certificate holders. The first was subordination. The PLS certificates were organized into tranches, ranked by seniority. Each SLG supported one or more tranches of certificates and distributed payments in a "waterfall" arrangement. This arrangement guaranteed senior certificate-holders first claim to all principal and interest payments. Once all the senior certificate-holders were satisfied, the SLGs' payments spilled over to junior certificate-holders, who would receive the remaining balance of the payments.

The second of these credit enhancements was overcollateralization. The total outstanding balance of all of the mortgage loans supporting an entire PLS often exceeded the outstanding balance of the loans supporting the publicly available PLS certificates. As a result, some loans in the PLS were tethered to certificates owned by the depositor or sponsor and were not available for public purchase. These non-public loans served as a loss-saving measure by making payments to the public certificate-holders (in order of seniority) in the event that the loans supporting their public certificates defaulted.

After structuring the PLS, the PLS sellers would solicit a credit rating for each tranche. Because, as the District Court explained, PLS "were only as good as their underlying mortgage loans," *Nomura VII*, 104 F. Supp. 3d at 465, the Credit-Rating Agencies based their determinations primarily on the quality of the certificates' supporting loans. They did this by modeling the credit risk of the SLGs using information from the loan tape, provided by the PLS sellers. The Rating Agencies also evaluated the certificates' credit enhancements.

The Rating Agencies' review included examining draft offering documents for representations that the supporting loans were originated in accordance with originators' underwriting criteria. This was standard in the industry, as the Rating Agencies agreed that compliance with the underwriting guidelines was an important indicator of a loan's credit risk. More credit enhancements were required to secure an investment-grade rating for any certificate backed by loans that either did not comply with the underwriting guidelines or were missing documentation from their loan files.

The PLS sellers explained these credit enhancements, credit ratings, and other important features of the PLS to the public primarily in three offering documents—a shelf registration, a free writing prospectus, and a prospectus supplement. The shelf registration was a pre-approved registration statement filed with the Securities and Exchange Commission (the "SEC") that contained generally applicable information about PLS. *See* 17 C.F.R. §§ 230.409, 230.415. The shelf registration enabled the lead PLS underwriter to make written offers to potential buyers using a free writing prospectus. *See id.* § 230.433(b)(1). The free writing prospectus broadly described the characteristics of the certificate and the supporting SLGs. If an offeree was interested after reading the description, it could commit to purchasing the certificate. Title in the certificate and payment were exchanged within approximately a month of that commitment. The PLS sellers sent the buyer a prospectus supplement and filed the same with the SEC near the date of that exchange.[12]

The prospectus supplement contained the most detailed disclosures of any of the offering documents. This document provided specific information

[12] This selling process is described in further detail in the discussion sections below.

regarding the certificate, the SLGs, and the credit quality of the underlying loans. It warranted the accuracy of its representations regarding loan characteristics. And, crucially, it affirmed that the loans in the SLGs were originated in accordance with the applicable underwriting guidelines. As the District Court noted, "whether loans were actually underwritten in compliance with guidelines was extremely significant to investors." *Nomura VII*, 104 F. Supp. 3d at 536. The prospectus supplement ordinarily disclosed that some number of loans in the SLG may deviate substantially from, or violate, the applicable underwriting guidelines.[13]

B. The PLS Transactions at Issue

1. The Parties

a. The Sellers

Defendants sold the Certificates to the GSEs. Subsidiaries of Defendant NHA were the Certificates' primary sellers. Defendant NCCI served as the sponsor for all seven of the transactions at issue. Defendant NAAC served as the depositor for one Securitization, and Defendant NHELI served as the depositor for the remaining six. And Defendant Nomura Securities, served as the lead or co-lead underwriter for three of the Securitizations.

Defendant RBS served as the lead or co-lead underwriter for four of the Securitizations.[14]

[13] For a chart from one of Defendants' ProSupps displaying the PLS transaction structure, as modified, see Appendix A.

[14] One Securitization was also underwritten by Lehman Brothers Inc., which is not a party to this action.

b. The Buyers[15]

Fannie and Freddie purchased the Certificates. Both GSEs are privately-owned corporations chartered by Congress to provide stability and liquidity in the mortgage loan market. Fannie was established in 1938. *See* National Housing Act Amendments of 1938, ch. 13, 52 Stat. 8. Freddie was established in 1970. *See* Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450. They were at the time of the transactions at issue, and remain today, "the dominant force[s]" in the mortgage loan market. *See Town of Babylon v. FHFA*, 699 F.3d 221, 225 (2d Cir. 2012).

The primary way the GSEs injected liquidity into the mortgage market was by purchasing mortgage loans from private loan originators. *See O'Donnell*, 822 F.3d at 653. This side of the GSEs' operations was known as the "Single Family Businesses." By purchasing loans from originators, the Single Family Businesses replenished originators' capital, allowing originators to issue new loans. The Single Family Businesses held the loans purchased from originators on their books and sometimes securitized them into agency RMBS, similar to a PLS, to be offered for public sale. *See Pension Benefit Guar.*, 712 F.3d at 714-15; Levitin & Wachter*, supra*, at 1187-89.

The Single Family Businesses contained due diligence departments. These departments conducted

[15] These undisputed facts are drawn from one of the District Court's summary judgment opinions and from additional record evidence. *See FHFA v. Nomura Holding Am., Inc.* (*Nomura I*), 60 F. Supp. 3d 479, 489-91 (S.D.N.Y. 2014).

due diligence of specific loans prior to purchase. They also periodically reviewed their originator counterparties' general underwriting practices, and PLS sellers' due diligence practices, including Defendants'.[16]

As a secondary element of their businesses, the GSEs operated securities trading desks that purchased PLS. PLS purchases created liquidity in the mortgage market by funneling cash back through PLS sponsors and underwriters to loan originators for use in future loans. The GSEs' PLS traders generally operated out of Fannie's headquarters in Washington, D.C. and Freddie's headquarters in McLean, Virginia.

The GSEs played a significant role in the PLS market despite the relatively minor role it occupied in their businesses. The GSEs' PLS portfolios reached their heights in 2005, when they owned approximately $350 billion worth of PLS, with $145 billion backed by subprime loans and $40 billion backed by Alt-A loans (loans that were rated lower than prime loans but higher than subprime loans). The GSEs bought approximated 8% of the $3 trillion dollars' worth of PLS sold from 2005 to 2007. PLS traders working for the GSEs purchased the Certificates at issue.

2. The Transactions

Between 2005 and 2007, the GSEs purchased Certificates from Defendants in seven PLS Securitizations—NAA 2005-AR6, NHELI 2006-FM1, NHELI 2006-HE3, NHELI 2006-FM2, NHELI 2007-1, NHELI 2007-2, and NHELI 2007-3. These

[16] The GSEs' Single Family Businesses' due diligence practices are discussed in further detail in the discussion sections below.

transactions were executed generally in accordance with the standard practices at the time, as described in the previous sections. The supporting loans are predominantly Alt-A or subprime. Each Certificate is in a senior tranche of its respective Securitization. Combined, the Certificates cost approximately $2.05 billion and, at times of sale, had expected value of $2.45 billion.[17]

Defendants sold the Certificates by means of shelf registrations, free writing prospectuses, and the ProSupps.[18] The ProSupps provided detailed information regarding the loans in the SLGs. They described the risks inherent in subprime and Alt-A loan transactions and provided the credit ratings for each tranche. They included charts displaying the objective characteristics for loans in each SLG, such as aggregate remaining principal balances, FICO scores, and loan-to-value ratios. Five ProSupps promised that "[i]f . . . any material pool characteristic differs by 5% or more from the description in this [ProSupp], revised disclosure will be provided either in a supplement or in a Current Report on Form 8-K." *E.g.*, J.A. 9120.

Most importantly for purposes of this appeal, every ProSupp stated that "the Mortgage Loans . . . were originated generally in accordance with the underwriting criteria described in this section," (the "underwriting guidelines statement"). J.A. 9117; *see*

[17] For a table listing the distributors and buyer for each Securitization, see Appendix B. For a table listing the purchase price and actual principal and interest payments made on each Securitization as of February 2015, see Appendix C.

[18] For a table listing the ProSupps' listed dates, settlement dates, and filing dates, see Appendix D.

J.A. 6884, 7174, 7527, 7895, 8296, 8718.[19] The ProSupps then described the underwriting criteria used by originators that contributed loans to the SLGs and stated that the originators may have made "certain exceptions to the underwriting standards . . . in the event that compensating factors are demonstrated by a prospective borrower." *E.g.*, J.A. 9117. Six of the ProSupps described the specific underwriting guidelines for each originator that alone contributed more than 20% of the loans in the SLGs. For these originators, the ProSupps typically also stated that the loans were issued "generally" in accordance with the underwriting guidelines. *E.g.*, J.A. 7520.

Six of the ProSupps stated that some loans were issued under "Modified [Underwriting] Standards." *E.g.*, J.A. 9118. The ProSupps stated that these modified standards permitted originators, for example, to issue loans to foreign nationals, who might lack reliable sources to verify their credit score or lack a score altogether, or use "less restrictive parameters" in issuing loans, such as "higher loan amounts, higher maximum loan-to-value ratios, . . . the ability to originate mortgage loans with loan-to- value ratios in excess of 80% without the requirement to obtain mortgage insurance if such loans are secured by investment properties." *E.g.*, J.A.

[19] Although the FHFA brings an individual claim as to each ProSupp, the parties agree that all of the ProSupps contained substantially similar language for purposes of this appeal.

9119. The ProSupps disclosed the number of loans issued under the modified standards.[20]

C. The Housing and Financial Crisis[21]

The GSEs purchased the Certificates from Defendants during a period when the markets for mortgage loans and associated securities were exploding. A combination of factors including low interest and unemployment rates, an increased use of adjustable-rate mortgages and other innovative loan products, and government policies encouraging home ownership heated the housing market. Home prices increased, and aggregate mortgage debt in the U.S. more than doubled between 2000 and 2008.

During this period, originators also relaxed underwriting standards. Subprime lending jumped from 9.5% of all new mortgage loans in 2000 to 20% of all new mortgage loans in 2005; Alt-A lending also grew substantially. Originators also began to approve loans that failed to meet the underwriting guidelines with an eye towards securitizing these loans quickly, thus transferring the credit risk of the loans from

[20] The ProSupp language relevant on this appeal is discussed in further detail in the discussion sections below.

[21] This account of the collapse of the housing market is derived from the District Court's post-trial findings and additional record evidence. *Nomura VII*, 104 F. Supp. 3d at 537--40; *see also* Ryan Bubb & Prasad Krishnamurthy, *Regulating Against Bubbles: How Mortgage Regulation Can Keep Main Street and Wall Street Safe—From Themselves*, 163 U. PA. L. REV. 1539, 1550--66 (2015) (describing the housing boom and bust); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have A Better Idea?*, 95 VA. L. REV. 707, 732--34 & nn.64--71 (2009) (same).

originators to PLS certificate-holders. *See* Levitin & Wachter, *supra*, at 1190.

Securitization fueled the credit bubble. As described above, securitization enabled originators to shift credit risk to the financial markets and turn the prospect of future loan repayment into instant cash for new loans. In 2000, the PLS market was worth less than $150 billion. By 2005-2006, the PLS market was worth more than $1.1 trillion. Once it began, the securitization frenzy built on itself—securitizations of subprime mortgages increased the quantity of new subprime mortgage originations. Those new mortgages were in turn securitized, and the cycle started over.

The housing market began its decline in 2006. Increased mortgage interest rates led to a spike in prices that made many homes too expensive for potential buyers, decreasing demand. An oversupply of housing also put downward pressure on home prices. U.S. housing prices started to fall in April 2006. From April 2007 through May 2009, they fell almost 33%.

Default and delinquency rates increased with the decline in housing prices. By 2009, 24% of homeowners, many of whom had purchased homes during the mid-2000s boom, were left with negative equity: mortgages with outstanding principal balances greater than the homes' current valuations. Shoddy underwriting practices, which approved loans for borrowers who could not afford to repay, and spikes in adjustable mortgage rates also contributed to an increase in defaults. With rising interest rates, refinancing was difficult. Defaulting on mortgage loans became an attractive option for homeowners. Each default and resulting foreclosure sale depressed the prices of surrounding homes further, sending the housing market into a vicious downward cycle.

Increased default rates had an adverse impact on investment products tied to mortgage loans, and on the entire financial system as a result. As principal and interest payments slowed over the course of 2007, the value of these securities declined. One bank in August 2007 reported that the decrease in mortgage securitization markets' liquidity made it "impossible" to value certain RMBS instruments. J.A. 5419. Banks that had invested heavily in RMBS sold off their positions (driving down the value of those assets further) and closed related hedge fund divisions. Credit tightened, interbank lending ceased, and concerns about financial institutions' liquidity and solvency led to runs on financial institutions. Several major financial institutions, including Lehman Brothers, Bear Sterns, and Merrill Lynch, experienced significant financial stress.

In December 2007, the U.S. entered a one-and-a-halfyear recession, the longest since the Great Depression. U.S. real gross domestic product contracted by about 4.3% during that time. Unemployment rose to 10% in 2009, more than double the 2007 rate.

III. Procedural History

In the aftermath of the financial crisis, Congress passed the Housing and Economic Recovery Act of 2008 (the "HERA"), Pub. L. No. 110-289, 122 Stat. 2654, out of concern for the GSEs' financial condition. *See UBS II*, 712 F.3d at 138. The HERA created the

FHFA, an "independent agency of the Federal Government," 12 U.S.C. § 4511(a), to serve as a conservator for Fannie, Freddie, and other GSEs in financial straits, *see id.* § 4617(a). The HERA empowered the FHFA to "collect all obligations and money due the [GSEs]," *id.* §4617(b)(2)(B)(ii), and take other actions necessary to return them to solvency. *Id.* § 4617(b)(2)(B)(i).

On September 2, 2011, the FHFA initiated sixteen actions that were eventually litigated together in the Southern District of New York, including the instant "Nomura action," against financial institutions that sold PLS certificates to Fannie Mae and Freddie Mac. These cases were consolidated before Judge Cote. They all settled before trial, with the exception of this case.

The FHFA began the Nomura action by bringing claims under Sections 11, 12(a)(2), and 15 of the Securities Act and Virginia and D.C. Blue Sky analogs based on alleged misstatements in the PLS offering documents. The FHFA alleged that Defendants' offering documents falsely stated (1) the underwriting guidelines statement, (2) the supporting loans' loan-to-value ratios, (3) whether mortgaged properties were occupied by the mortgagors, and (4) that the Credit-Rating Agencies were provided with accurate information regarding loan characteristics before issuing ratings decisions. The FHFA initially demanded a jury trial for "all issues triable by jury." J.A. 409.

The District Court issued numerous pre-trial decisions. Defendants appeal from the following:

- An opinion holding that the Virginia and D.C. Blue Sky laws do not provide a loss causation defense, *HSBC I*, 988 F. Supp. 2d 363;
- An opinion granting the FHFA's motion for summary judgment on the absence-of-knowledge element of a Section 12(a)(2) claim*, FHFA v. HSBC N. Am. Holdings Inc.* (*HSBC II*), 33 F. Supp. 3d 455 (S.D.N.Y. 2014);
- Two opinions denying Defendants' motion for summary judgment on the ground that the FHFA's claims are time-barred, *FHFA v. HSBC N. Am. Holdings Inc.* (*HSBC III*), Nos. 11cv6189, 11cv6201, 2014 WL 4276420 (S.D.N.Y. August 28, 2014) (statutes of repose); *FHFA v. Nomura Holding Am., Inc.* (*Nomura I*), 60 F. Supp. 3d 479 (S.D.N.Y. 2014) (statutes of limitations);
- An opinion granting the FHFA's motion for summary judgment on Defendants' reasonable care defense, *FHFA v. Nomura Holding Am. Inc.* (*Nomura II*), 68 F. Supp. 3d 439 (S.D.N.Y. 2014);
- An opinion granting the FHFA's motion *in limine* to exclude evidence related to the GSEs' housing goals, *FHFA v. Nomura Holding Am., Inc.* (*Nomura III*), No. 11cv6201, 2014 WL 7229361 (S.D.N.Y. Dec. 18, 2014);
- An opinion, *FHFA v. Nomura Holding Am., Inc.* (*Nomura IV*), 68 F. Supp. 3d 486 (S.D.N.Y. 2014), and a related bench decision, Special App. 544-49, denying Defendants' motion for a

jury trial on the FHFA's Section 12(a)(2) claims;

- An opinion granting the FHFA's motion *in limine* to exclude evidence related to the timing of the purchases of the Certificates, *FHFA v. Nomura Holding Am., Inc.* (*Nomura V*), 68 F. Supp. 3d 499 (S.D.N.Y. 2014);
- An opinion denying in relevant part Defendants' *Daubert* challenge to an FHFA expert's testimony, *FHFA v. Nomura Holding Am., Inc.* (*Nomura VI*), No. 11cv6201, 2015 WL 353929 (S.D.N.Y. Jan. 28, 2015);
- Several decisions excluding evidence related to the GSEs' Single Family Businesses, *e.g.*, J.A. 11619-21.

Trial was originally slated to be held before a jury to decide the Section 11 claims, while the District Court would decide the Section 12 claims, with the jury's determination controlling overlapping factual issues. Roughly a month before pretrial memoranda were due, the FHFA voluntarily withdrew its Section 11 claim. As a result, the District Court, over Defendants' objection, conducted a four-week bench trial on the Section 12, Section 15, and Blue Sky claims.[22]

One month after trial concluded, the District Court issued a detailed 361-page opinion systematically finding for the FHFA on each claim.

[22] Forty-eight witnesses testified at trial. The parties consented to the court receiving most of the direct testimony by affidavit and hearing oral cross-examinations and re-direct examinations in open court.

See generally Nomura VII, 104 F. Supp. 3d 441. The court held that Defendants violated Section 12(a)(2) because each ProSupp contained three categories of false statements of material information: (1) the underwriting guidelines statements, (2) the loan-to-value ratio statements, and (3) the credit ratings statements. *See id.* at 559-73. Our focus on appeal, on this point, is devoted solely to the statements regarding underwriting guidelines, which are sufficient to affirm the court's judgment. *See* 15 U.S.C. § 77*l*(a)(2) (authorizing relief if the offering documents contain just one untrue statement of material fact); *N.J. Carpenters Health Fund v. Royal Bank of Scot. Grp., PLC* (*N.J. Carpenters Health Fund II*), 709 F.3d 109, 116, 123 (2d Cir. 2013) (allowing a Section 11 lawsuit to proceed on the allegation that RMBS offering documents falsely stated that the loans adhered to the underwriting guidelines).

The court also rejected Defendants' loss causation defense, *see Nomura VII*, 104 F. Supp. 3d at 585-93, found that Defendants violated the analogous provisions of the Virginia and D.C. Blue Sky laws, *see id.* at 593-98, and held that NHA, NCCI, and the Individual Defendants were control persons under Section 15, *see id.* at 573-83. The court awarded the FHFA $806,023,457, comprised of roughly $555 million for violations of the Blue Sky laws and roughly $250 million for violations of the Securities Act. *See id.* at 598.[23]

This appeal followed.

[23] The District Court's opinions are discussed in more detail in the discussion sections below.

DISCUSSION

Our discussion proceeds in two parts. The first addresses issues the District Court resolved before trial: (A) whether the FHFA's claims were timely under the statutes of repose; (B) whether in light of the GSEs' generalized knowledge and experience in the mortgage loan market (1) the FHFA's claims were timely under the statutes of limitations and (2) the FHFA was entitled to summary judgment holding that the GSEs did not know the ProSupps' underwriting guidelines statements were false; (C) whether the FHFA was entitled to summary judgment holding that Defendants failed to exercise reasonable care; and (D) whether the Seventh Amendment entitled Defendants to a jury trial. The second addresses issues resolved after trial: (A) whether the FHFA is entitled to relief under Section 12(a)(2) because (1) each Defendant is a statutory seller, (2) the underwriting guidelines statements were false, (3) those statements were material, and (4) Defendants failed to make out an affirmative defense of loss causation; as well as (B) whether the FHFA is entitled to relief under the analogous Virginia and D.C. Blue Sky provisions.

I. Pretrial Decisions[24]

A. Statutes of Repose

Defendants appeal the District Court's denial of their motion for summary judgment on the ground that the FHFA's claims, which were filed on

[24] Because these pretrial rulings addressed matters of law, our review of these decisions is *de novo*. *See Noll v. Int'l Bus. Machs. Corp.*, 787 F.3d 89, 93-94 (2d Cir. 2015); *UBS II*, 712 F.3d at 140; *Eberhard v. Marcu*, 530 F.3d 122, 135 n.13 (2d Cir. 2008).

September 2, 2011 (more than three years after the Securitizations were sold), were time-barred by the Securities Act, Virginia Blue Sky, and D.C. Blue Sky statutes of repose. *See* 15 U.S.C. § 77m (three-year period of repose); VA. CODE ANN. § 13.1-522(D) (two-year period of repose); D.C. CODE § 31-5606.05(f)(1) (three-year period of repose).[25] The District Court held that the statutes of repose were displaced by an extender provision in the HERA, codified at 12 U.S.C. § 4617(b)(12), which permits the FHFA to bring any "tort claim" within three years and any "contract claim" within six years of its appointment as the GSEs' conservator on September 6, 2008.[26] *See FHFA v. UBS*

[25] Statutes of repose and statutes of limitations are "often confused" but "nonetheless distinct." *Police & Fire Ret. Sys. of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95, 106 (2d Cir. 2013) (internal quotation mark omitted; brackets omitted) (quoting *Ma v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 597 F.3d 84, 88 n.4 (2d Cir. 2010)). A statute of repose creates "a substantive right in those protected to be free from liability after a legislatively-determined period of time," regardless of the plaintiff's actions and equitable considerations. *Id.* (emphasis omitted; internal quotation mark omitted) (quoting *Amoco Prod. Co. v. Newton Sheep Co.*, 85 F.3d 1464, 1472 (10th Cir. 1996)). A statute of limitations "is intended to prevent plaintiffs from unfairly surprising defendants" by sleeping on and then later "resurrecting stale claims." *City of Pontiac Gen. Emps.' Ret. Sys. v. MBIA, Inc.* (*MBIA*), 637 F.3d 169, 175 (2d Cir. 2011).

[26] 12 U.S.C. § 4617(b)(12) provides:

> Statute of limitations for actions brought by conservator or receiver
>
> (A) In general
>
> Notwithstanding any provision of any contract, the applicable statute of limitations with regard to any

Ams., Inc. (*UBS I*), 858 F. Supp. 2d 306, 313-17 (S.D.N.Y. 2012) (holding all coordinate cases brought by the FHFA before September 6, 2011 timely under the HERA), *aff'd*, *UBS II*, 712 F.3d 136 (2d Cir. 2013); *see also HSBC III*, 2014 WL 4276420, at *1. On appeal, Defendants argue that while the HERA displaces otherwise applicable statutes of *limitations*, it does not affect statutes of *repose*.

In *UBS II*, a 2013 decision in an interlocutory appeal in one of the FHFA's parallel coordinated actions, a panel of this Court held that § 4617(b)(12) "supplants any other [federal or state] time limitations that otherwise might have applied" to the FHFA's actions, including the Securities Act and Blue Sky

> action brought by the [FHFA] as conservator or receiver shall be—
>
> (i) in the case of any contract claim, the longer of—
>
> (I) the 6-year period beginning on the date on which the claim accrues; or
>
> (II) the period applicable under State law; and
>
> (ii) in the case of any tort claim, the longer of—
>
> (I) the 3-year period beginning on the date on which the claim accrues; or
>
> (II) the period applicable under State law.
>
> (B) Determination of the date on which a claim accrues
>
> For purposes of subparagraph (A), the date on which the statute of limitations begins to run on any claim described in such subparagraph shall be the later of—
>
> (i) the date of the appointment of the [FHFA] as conservator or receiver; or
>
> (ii) the date on which the cause of action accrues.

statutes of repose. 712 F.3d at 143-44. This conclusion was compelled by the definitive language in § 4617(b)(12), which makes clear that "*the* applicable statute of limitations with regard to *any* action brought by the [FHFA] . . . *shall* be" time periods provided in the HERA, *see UBS II*, 712 F.3d at 141-42 (internal quotation marks omitted) (quoting 12 U.S.C. § 4617(b)(12)), and was corroborated by the purpose of the HERA to permit the FHFA to "'collect all obligations and money due' to the GSEs[] to restore them to a 'sound and solvent condition,'" *id.* at 142 (quoting 12 U.S.C. §§ 4617(b)(2)(B)(ii), (D)). We considered that reading § 4617(b)(12) to preclude and preempt all types of time-limitation statutes, including statutes of repose, was consistent with Congress's intent because it allowed the FHFA more "time to investigate and develop potential claims on behalf of the GSEs." *Id.*

Ordinarily, *UBS II* would end our inquiry. *See Lotes Co., Ltd. v. Hon Hai Precision Indus. Co.*, 753 F.3d 395, 405 (2d Cir. 2014) ("[A] panel of this Court is 'bound by the decisions of prior panels until such time as they are overruled either by an en banc panel of our Court or by the Supreme Court.'" (quoting *In re Zarnel*, 619 F.3d 156, 168 (2d Cir. 2010))). But one year after *UBS II* was decided, the Supreme Court handed down *CTS Corp. v. Waldburger*, 134 S. Ct. 2175 (2014), which held that 42 U.S.C. § 9658,[27] a

[27] 42 U.S.C. § 9658 provides in relevant part:

> (a) State statutes of limitations for hazardous substance cases
>
> (1) Exception to State statutes

In the case of any action brought under State law for personal injury, or property damages, which are caused or contributed to by exposure to any hazardous substance, or pollutant or contaminant, released into the environment from a facility, if the applicable limitations period for such action (as specified in the State statute of limitations or under common law) provides a commencement date which is earlier than the federally required commencement date, such period shall commence at the federally required commencement date in lieu of the date specified in such State statute.

(2) State law generally applicable

Except as provided in paragraph (1), the statute of limitations established under State law shall apply in all actions brought under State law for personal injury, or property damages, which are caused or contributed to by exposure to any hazardous substance, or pollutant or contaminant, released into the environment from a facility.

(b) Definitions

As used in this section—

. . .

(2) Applicable limitations period

The term "applicable limitations period" means the period specified in a statute of limitations during which a civil action referred to in subsection (a)(1) of this section may be brought.

(3) Commencement date

The term "commencement date" means the date specified in a statute of limitations as the beginning of the applicable limitations period.

(4) Federally required commencement date

(A) In general

Except as provided . . . , the term "federally required commencement date" means the provision in the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (the "CERCLA") that imposes a federal commencement date for state statutes of limitations, does not pre-empt state statutes of repose. *See* 134 S. Ct. at 2188. Defendants' sole argument in the present appeal is that *CTS* abrogated *UBS II*.

This is not the first case in this Circuit to consider the impact of *CTS* on *UBS II*. In *FDIC v. First Horizon Asset Sec., Inc.* (*First Horizon*), 821 F.3d 372 (2d Cir. 2016), *cert. denied*, 137 S. Ct. 628 (2017), we held that *CTS* did not disturb the portion of *UBS II*'s holding that held § 4617(b)(12) precludes the federal Securities Act's statute of repose. *Id.* at 380-81. That forecloses Defendants' argument insofar as it applies to the FHFA's claims under the Securities Act.[28] *See Lotes*, 753 F.3d at 405.

It remains an open question in this Circuit whether *CTS* undermined the portion of *UBS II*'s holding that held § 4617(b)(12) pre-empts the Virginia and D.C. Blue Sky laws' statutes of repose. *Cf. Church & Dwight Co., Inc. v. SPD Swiss Precision*

> date the plaintiff knew (or reasonably should have known) that the personal injury or property damages referred to in subsection (a)(1) of this section were caused or contributed to by the hazardous substance or pollutant or contaminant concerned.

[28] *First Horizon* is controlling with regard to the FHFA's federal claims even though it dealt with a different extender provision, 12 U.S.C. § 1821(d)(14)(A), which was designed for suits brought by the Federal Deposit Insurance Corporation (the "FDIC"). The FDIC extender provision is "materially identical" to the HERA extender provision. *First Horizon*, 821 F.3d at 375.

Diagnostics, GmBH, 843 F.3d 48, 64-65 (2d Cir. 2016) (observing that pre-emption analysis does not control preclusion analysis).[29] "[C]oncerns about the primacy of federal law and the state-federal balance" that are unique to the pre-emption context presented here distinguish it from preclusion context in *First Horizon*. *Church & Dwight Co.*, 843 F.3d at 64 (internal quotation mark omitted) (quoting *POM Wonderful LLC v. Coca-Cola Co.*, 134 S. Ct. 2228, 2236 (2014)). Still, some aspects of our earlier preclusion analysis aid in deciding the pre-emption issue on this appeal. *Cf. id.* ("[P]re[-]emption principles can be 'instructive' in the . . . preclusion context . . . ." (quoting *POM Wonderful*, 134 S. Ct. at 2236)).[30]

[29] This is not an open question in two other Circuits. *FDIC v. RBS Sec. Inc.*, 798 F.3d 244, 254 (5th Cir. 2015) (holding FDIC extender provision pre-empts state statutes of repose notwithstanding *CTS*); *Nat'l Credit Union Admin. Bd. v. Nomura Home Equity Loan, Inc.*, 764 F.3d 1199, 1217 (10th Cir. 2014) (holding an extender provision for claims brought by the National Credit Union Administration Board (the "NCUA") pre-empts state statutes of repose notwithstanding *CTS*); *see also Nat'l Credit Union Admin. Bd. v. RBS Sec., Inc.*, 833 F.3d 1125, 1135 (9th Cir. 2016) (holding NCUA extender provision pre-empts Securities Act statute of repose notwithstanding *CTS*).

[30] Defendants urge us to begin our pre-emption analysis with a presumption that Congress did not intend to displace the Blue Sky statutes of repose. It is well-established that courts presume Congress does not intend to supersede "the historic police powers of the States" absent clear intent, *CTS*, 134 S. Ct. at 2188 (Kennedy, *J.*, concurring) (quoting *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996)), and that Blue Sky laws are considered "'traditional' state regulation[s]" for pre-emption purposes, *Oneok, Inc. v. Learjet, Inc.*, 135 S. Ct. 1591, 1600 (2015) (quoting *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 308 n.11 (1988)). The presumption favoring traditional state regulations

Nothing about *CTS* seriously undermines *UBS II*. The Supreme Court's analysis in *CTS* focused primarily on four considerations. First, § 9658 provides that state law will be the default rule for time limitations and that a federal commencement date will operate as a limited "exception" to that rule. This suggested to the Court that Congress intended § 9658 to leave many of the state time-limitation rules in place. *See CTS*, 134 S. Ct. at 2185 (majority opinion). Second, § 9658 refers explicitly to a "statute of limitations" but does not mention a "statute of repose." Although this was not dispositive of the ultimate issue, the Court took this as an indication that Congress did not intend § 9658 to reach statutes of repose. *Id.* at 2185-86. Third, Congress, in debating the CERCLA, considered a report that recommended language providing for explicit pre-emption of state statutes of repose, but chose not to include the proposed language in the final statute. *Id.* at 2186. Fourth, § 9658 defines the state provisions it preempts as the "applicable limitations period[s]" during "which a civil action may be brought" and provides for equitable tolling in certain circumstances, two

is irrelevant, however, to the discrete question before us—whether *CTS* abrogated *UBS II*'s pre-emption holding. The presumption is no novel invention of *CTS*; it existed well before *CTS* and *UBS II* were decided. *See Medtronic*, 518 U.S. at 485. Further, the presumption is rebuttable upon a showing of clear congressional intent. *See id. UBS II* concluded that Congress clearly intended § 4617(b)(12) to eliminate all time limitations that might hinder the FHFA's charge "to 'collect all obligations and money due' to the GSEs[] to restore them to a 'sound and solvent condition.'" 712 F.3d at 142 (quoting 12 U.S.C. §§ 4617(b)(2)(B)(ii), (D)).

concepts inapplicable to repose analyses. *Id.* at 2187-88 (internal quotation marks omitted). For these reasons, the Supreme Court held § 9658 did not reflect clear congressional intent to pre-empt overlapping state statutes of repose. *Id.* at 2188.

One similarity between § 4617(b)(12) and § 9658 is that both refer to statutes of limitations but neither references statutes of repose. *See First Horizon*, 821 F.3d at 376, 379. While this might suggest on first glance that neither statute reaches repose statutes, we reasoned in *UBS II* that an explicit statutory reference to repose statutes is not a *sine qua non* of congressional intent to pre-empt such statutes. *See* 712 F.3d at 142-43. *CTS* confirmed—rather than undermined—that reasoning. *See* 134 S Ct. at 2185. *CTS* observed that usage of the terms "limitations" and "repose" "has not always been precise." *Id.* at 2186; *accord UBS II*, 712 F.3d at 142-43 ("Although statutes of limitations and statutes of repose are distinct in theory, the courts . . . have long used the term 'statute of limitations' to refer to statutes of repose . . . ."). Indeed, although Congress has indisputably created statutes of repose in the past, it "has never used the expression 'statute of repose' in a statute codified in the United States Code." *First Horizon*, 821 F.3d at 379 (observing that 15 U.S.C. § 77m, titled "Limitation of actions," creates a three-year repose period); *see also Cal. Pub. Emps.' Ret. Sys. v. ANZ Sec., Inc.* (*CalPERS*), 137 S. Ct. 2042, 2049 (2017) (analyzing federal statute to determine whether it included a statute of limitation or statute of repose). As a result, *CTS* cautioned, while the presence of the term "statute of limitations" in a federal statute may be "instructive" of Congress's intended pre-emptive scope, it is not "dispositive." *See* 134 S. Ct. at 2185. That reinforces *UBS II*'s refusal to resolve its pre-emption inquiry based solely on the bare text of § 4617(b)(12). *See First Horizon*, 821 F.3d at 376.[31]

Defendants also argue that, under *CTS*, § 4617(b)(12)'s repeated use of the words "claim accrues" indicates that it was meant only to pre-empt statutes of limitations. In *CTS*, the Supreme Court noted that § 9658 pre-empts the "commencement date" for any "applicable limitations period" under state law, 42 U.S.C. § 9658(a)(1), and defines the "applicable limitations period" as the period when "a civil action [alleging injury or damage caused by exposure to a hazardous substance] may be brought," *id.* § 9658(b)(2). *See* 134 S. Ct. at 2187. That indicated to the Court that Congress intended to displace only the commencement date for statutes of limitations because a "statute of repose . . . 'is not related to the accrual of any cause of action.'" *Id.* (quoting 54 C.J.S., LIMITATIONS OF ACTIONS § 7, p. 24 (2010)).

Section 4617 uses some similar language. It provides that the new filing period for claims brought by the FHFA is at least six years for any "contract" claim and three years for any "tort" claim, "beginning on the date on which the claim accrues." 12 U.S.C. §§ 4617(b)(12)(A)(i)(I), (ii)(I). It also describes how to determine "the date on which a claim accrues" for purposes of the HERA. *Id.* § 4617(b)(12)(B).

[31] That § 4617(b)(12) refers to "statute of limitations" in the singular while § 9658 refers to "statutes of limitations" in the plural is also unimportant in determining whether Congress intended to displace statutes of repose. *See id.* at 379.

Defendants argue that this language—specifically the words "claim accrues"—carries the same indication of congressional intent as § 9658's definition of the "applicable limitations period."

We disagree. *CTS* does not stand for the proposition that whenever "accrue" appears in a federal statute it is a talismanic indication of congressional intent to pre-empt only statutes of limitations. Context is crucial. Congress used the phrase "a civil action . . . may be brought" in § 9658 in defining the class of state statutes it intended to pre-empt. In contrast, Congress used the words "claim accrues" in § 4617(b)(12) in defining the time limitation the HERA newly created for claims brought by the FHFA. Put another way, the HERA's use of the word "accrues" "tells us . . . that [§ 4617(b)(12)] is *itself* a statute of limitations" but does not "provide[] . . . guidance on the question whether [§ 4617(b)(12)] *displaces* otherwise applicable statutes of repose . . . ." *First Horizon*, 821 F.3d at 379.

The only remaining argument against pre-emption of the state statutes of repose is that both § 9658 and § 4617(b)(12) pre-empt certain time limitations for state claims while leaving untouched "other important rules governing civil actions." *CTS*, 134 S. Ct. at 2188. ""The case for federal pre-emption is particularly weak where Congress has indicated its awareness of the operation of state law in a field of federal interest, and has nonetheless decided to stand by both concepts and to tolerate whatever tension there is between them."" *Id.* (brackets omitted) (quoting *Wyeth v. Levine*, 555 U.S. 555, 575 (2009)). But § 9658 leaves in place far more of state law than

§ 4617(b)(12). Section 9658 provides only a federally mandated accrual date for state limitations periods and leaves unchanged "States' judgments about causes of action, the scope of liability, the duration of the period provided by statutes of limitations, burdens of proof, [and] rules of evidence." *CTS*, 134 S. Ct. at 2188. Section 4617(b)(12), by contrast, provides a comprehensive, singular time limitation for all actions brought by the FHFA. *See UBS II*, 712 F.3d at 141-42. It governs entirely the rules regarding when the FHFA may bring its claims—from the moment the filing period commences, *see* 12 U.S.C. § 4617(b)(12)(B), through the length of the period for each type of the claim, *see id.* § 4617(b)(12)(A). Congress has not stood by any state time-limitation rules when it comes to claims brought by the FHFA as the GSEs' conservator.

In all other respects, *CTS* and *UBS II* arose in substantially different contexts. Section 9658's legislative history reveals that Congress specifically considered and decided against using language that would explicitly preempt statutes of repose. *See CTS*, 134 S. Ct. at 2186. There is no similar legislative history for Section 4617(b)(12). *See UBS II*, 712 F.3d at 143. Section 9658 "describ[es] the [pre-empted] period in the singular," which "would be an awkward way to mandate the pre-emption of two different time periods." *CTS*, 134 S. Ct. at 2186-87. Section 4617(b)(12) applies "to *any* action brought by the [FHFA]," 12 U.S.C. § 4617(b)(12)(A) (emphasis added), "'including claims to which a statute of repose generally attaches.'" *UBS II*, 712 F.3d at 143 (quoting *UBS I*, 858 F. Supp. 2d at 316-17). Section 9658 contains a provision for equitable tolling, an important characteristic of statutes of limitations that distinguishes them from statutes of repose. *See CTS*, 134 S. Ct. at 2187-88. There is no similar provision in § 4617(b)(12).

In sum, "*CTS*'s holding is firmly rooted in a close analysis of § 9658's text, structure, and legislative history." *First Horizon,* 821 F.3d at 377. None of those statute-specific considerations undermines *UBS II*'s close analysis of § 4617(b)(12), which differs significantly from § 9658. We reaffirm our prior holding that Congress designed § 4617(b)(12) to pre-empt state statutes of repose.[32]

B. Knowledge Issues—Statutes of Limitations and Knowledge of the ProSupps' Underwriting Guidelines Misrepresentations

Defendants next raise two pre-trial issues that turn on the extent to which the GSEs were or should have been aware that the ProSupps' underwriting guidelines statements were false. The first is the statute of limitations. In addition to the statute of repose discussed above, Section 13 of the Securities Act contains a statute of limitations that bars any action not brought within one year after the plaintiff learned or should have learned of the material misstatement or omission giving rise to the claim. 15 U.S.C. § 77m; *see CalPERS*, 137 S. Ct. at 2049 (2017)

[32] We reject Defendants' arguments that § 4617(b)(12) does not pre-empt statutes of repose because it refers only to "contract" and "tort" claims, rather than securities claims, and because the statute's initial language is not as sharp as other pre-emption clauses in the HERA. In addition to lacking in merit, these arguments are not grounded in any unique feature of *CTS* that might have undermined *UBS II. See Lotes*, 753 F.3d at 405.

(discussing three-year time bar).[33] The HERA extended the filing period only for contract claims that were valid on (or became valid after) September 6, 2008, the date when the FHFA assumed conservatorship. *See* 12 U.S.C. §§ 4617(b)(12)(A), (12)(B); J.A. 341-42. Thus, any FHFA claim that was time-barred by Section 13 on that date remained time-barred under the HERA. On the FHFA's motion for summary judgment, the District Court held that the FHFA's claims were timely as a matter of law. The court concluded that no reasonable jury could find the GSEs knew or should have known as of September 6, 2007, one year before the HERA extender became effective, that ProSupps' underwriting guidelines statements were false, despite widespread PLS credit downgrades in the summer of 2007 and the Single Family Businesses' generalized experience with mortgage loan originators and PLS aggregators. *Nomura I*, 60 F. Supp. 3d at 502-09; *see also UBS I*, 858 F. Supp. 2d at 321-22. Defendants contest that decision on appeal.

The second, related issue is whether the FHFA was entitled to summary judgment on the purchaser's absenceof- knowledge element of a Section 12(a)(2) claim. *See* 15 U.S.C. § 77*l*(a)(2).[34] The District Court granted the FHFA summary judgment on this element, holding again that the Single Family

[33] The D.C. Blue Sky statute of limitations is the same as the statute of limitations under the Securities Act. D.C. CODE § 31-5606.05(f)(2)(B).

[34] The standard for purchaser knowledge under the Blue Sky laws is the same as it is under the Securities Act. *See* VA. CODE ANN. § 13.1-522(A)(ii); D.C. CODE § 31-5606.05(a)(1)(B).

Businesses' expertise in the general mortgage loan market did not provide adequate knowledge of the specific untruths in the ProSupps. *See HSBC II*, 33 F. Supp. 3d at 480-93. Defendants also contest this decision on appeal. We address these issues in tandem, as the relevant facts and legal questions overlap in large part.

1. Factual Summary[35]

a. The Single Family Businesses' Due Diligence

The GSEs' Single Family Businesses, in their capacities as aggregators and sponsors of RMBS instruments, gathered a significant amount of information about the mortgage loan market and mortgage loan originators. Fannie's Single Family due diligence division was the Single Family Counterparty Risk Management Group (the "SFCPRM"); Freddie's Single Family due diligence division was the Alternative Market Operations Group (the "AMO"). Through the work of the SFCPRM and AMO, the GSEs amassed "more knowledge about the mortgage market than probably anybody else." J.A. 1317.

The SFCPRM and AMO conducted counterparty reviews of originators with whom the GSEs regularly did business. These reviews involved desk audits and on-site visits to originators' offices. Often the GSEs

[35] The following summary draws on the District Court's discussions of the relevant facts, which we view in the light most favorable to Defendants and which Defendants do not dispute. *See Nomura I*, 60 F. Supp. 3d at 489-92 (Single Family Businesses), 498-99 (credit downgrades); *HSBC II*, 33 F. Supp. 3d at 463-74 (Single Family Businesses).

hired Clayton Advisory Services, Ltd. ("Clayton"), a third-party mortgage diligence vendor, to re-underwrite a sample of the originators' issued loans and assess the originators' compliance with their underwriting guidelines. The GSEs also analyzed originators' adherence to appraisal protocols, capability to detect fraud, and ability to meet repurchase obligations. If an originator received a positive result from this review, the GSE placed, or maintained, it on a list of approved originators.

The SFCPRM and AMO conducted counterparty reviews for at least five originators that issued loans backing the Certificates in this case; we note some pertinent results of those reviews below:

- First NLC Mortgage Corporation, which issued ~14.5% of the loans backing NHELI 2006-HE3 and ~11.5% of the loan backing NHELI 2007-2: The AMO issued a "Poor" rating (the worst possible) in January 2005, reporting "poor command of its credit, appraisal and quality control units," and a "Marginal" rating in April 2005, J.A. 10409;
- Mandalay Mortgage, which issued ~5.7% of the loans backing NHELI 2006-HE3: The AMO issued a "Poor" rating in November 2004 based on its "aggressive" participation in risky loan product categories, *id.* at 10410;
- ResMAE, which issued ~77.6% of the loans backing NHELI 2007-3: The AMO issued a "Marginal" rating in April 2004 and recommended that Freddie Mac components dealing with ResMAE "Proceed with Caution" given ResMAE's lack of an internal quality

program and relaxed underwriting procedures, *id.* at 10411; the AMO placed ResMAE on a watch list in April 2007 due to a liquidity crisis; ResMAE later went bankrupt;

- Ownit, which issued ~42.4% of the loans backing NHELI 2007-2: The AMO, in August 2004, found controls "marginal" due to the originator's instability, and noted its practice of keeping "very inaccurate" loan data, *id.* at 10410; and
- Fremont, which backed entirely NHELI 2006-FM1 and NHELI 2006-FM2: After reviews in February 2004 and August 2005, the AMO found wide LTV variances, "data integrity issues," and a large number of exceptions to the underwriting guidelines, *id.* at 10314 (brackets omitted).

The GSEs' knowledge about the mortgage loan industry required a delicate information sharing arrangement between their Single Family Businesses and their PLS traders.

On the one hand, the GSEs did not want to purchase loans or securitizations supported by loans that they knew were originated or aggregated by companies they did not trust. The Single Family Businesses' research proved helpful to the PLS traders in that regard; and indeed each GSE required that any originator that individually contributed more than a certain percentage (10% for Fannie, 1% for Freddie) of the total unpaid principal balance of a PLS be on its list of approved originators.

On the other hand, the GSEs were concerned that its PLS traders would violate federal insider-trading laws if, before purchasing PLS, they reviewed the certain loan-specific information the Single Family Businesses considered in making purchases for their own aggregation practices. The GSEs accordingly limited their PLS traders' access to only the Single Family Businesses' reviews of originators' general practices. Fannie's PLS traders were given the final lists of approved originators; Freddie's were given the full counterparty review paperwork. PLS traders were not given access to any specific loan-level information for the transactions at issue.

The SFCPRM and AMO also evaluated PLS sellers and maintained a list of approved PLS counterparties. Both Nomura and RBS were placed on the GSEs' lists of approved PLS sellers. In August 2004, the AMO rated Nomura's due diligence program "Satisfactory" based on Nomura's "good due diligence methodologies, reasonable valuation processes and sound controls." *Id.* at 3170. In a November 2006 review, the SFCPRM noted it had access to somewhat limited information to review RBS's diligence, but apparently accepted RBS's characterization of its practices as robust. *Nomura I*, 60 F. Supp. 3d at 491.

Despite ensuring that they purchased loans from approved originators and PLS sellers, the GSEs knew that there was still a risk that some defective loans could creep into SLGs for PLS certificates they purchased. The heads of the GSEs' PLS portfolios acknowledged in deposition testimony that they believed that loans in an SLG "would reflect the general underwriting practices of the originators responsible for those loans." J.A. 10323. That meant that "if an originator was not following its own guidelines *and was contributing loans to the collateral for the pool*," the GSEs "would have expected that loans not underwritten to the originator's guidelines would then end up in the" SLGs. *Id.* at 10325 (emphasis added; internal quotation marks omitted). To limit that possibility, the GSEs required "rep[resentation]s and warrant[ie]s" from the approved PLS sellers for each certificate they purchased, believing that they could rely on those institutions to limit the number of the defective loans to an immaterial level. *Id.* at 1063; *see also HSBC II*, 33 F. Supp. 3d at 471 ("[A Fannie employee] testified that Fannie Mae's 'process basically relied on the dealers and originators providing it with reps and warranties as to the validity of how these loans were underwritten.'" (brackets omitted)).

b. The GSEs' Awareness of PLS Market Trends

GSEs were also familiar with public information about the overall RMBS market in 2006 and 2007. This information included a growing number of reports of borrower fraud and lower underwriting standards among mortgage loan originators. Beginning in July and August of 2007, it also included reports that the three primary credit-rating agencies, Moody's, S&P, and Fitch, began to accelerate their negative views of RMBS.

On July 10, 2007, Moody's downgraded the junior tranches of many RMBS—including Securitizations NHELI 2006-FM1 and NHELI 2006-FM2. The credit ratings for the senior tranches in these Securitizations did not change. Moody's attributed its downgrades to "a persistent negative trend in severe delinquencies for first lien subprime mortgage loans securitized in 2006." *Nomura I*, 60 F. Supp. 3d at 498 (internal quotation marks omitted). Moody's noted that the supporting loans "were originated in an environment of aggressive underwriting" and that increased default rates were caused in part by "certain misrepresentations . . . like occupancy or stated income and appraisal inflation." *Id.* (internal quotation marks omitted; brackets omitted).

That same day, S&P placed on negative rating watch a host of RMBS—but none of the Securitizations—citing "lower underwriting standards and misrepresentations in the mortgage market." *Id.* (internal quotation mark omitted). S&P questioned the quality of the data "concerning some of the borrower and loan characteristics provided during the rating process." *Id.* S&P made clear that, going forward, its ratings for RMBS certificates would hew more closely to their seniority within the securitization.

After expressing doubt on July 12, beginning in August of 2007 Fitch downgraded hundreds of RMBS. On August 3, 2007, Fitch downgraded junior tranches in Securitizations NHELI 2006-FM2 and NHELI 2006-HE3, but Fitch did not downgrade the senior tranches in those Securitizations at that time.

On August 17, 2007, S&P downgraded junior tranches in Securitization NAA 2005-AR6. As with Moody's and Fitch's downgrades, S&P did not change its rating for the senior tranches in the Securitization at that time.

The Rating Agencies took no further action on the Securitizations through September 6, 2007. As of that date, none of the GSEs' senior-tranche Certificates had been downgraded, but junior tranches in NHELI 2006-FM2 had been downgraded by two Rating Agencies, and junior tranches in NAA 2005-AR6, NHELI 2006-FM1, and NHELI 2006-HE3 had each been downgraded by one Rating Agency.

The GSEs monitored these junior tranche downgrades. The GSEs understood that the credit risks of the all of the tranches in a Securitization were connected. At least one Fannie employee during the summer of 2007 attempted to ascertain whether the GSE owned any Certificates in Securitizations that had been downgraded. On August 17, 2007, a Fannie employee circulated internally "a short eulogy for the subprime RMBS market." *Id.* at 499.

2. Analysis

a. Statutes of Limitations

Section 13's statute of limitations extinguishes any action not "brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." 15 U.S.C. § 77m. The filing period commences "when the plaintiff discovers (or should have discovered) the securities-law violation." *CalPERS*, 137 S. Ct. at 2049. A securities-law violation is discovered when the plaintiff learns "sufficient information about [the violation] to . . . plead it in a complaint" with enough "detail and particularity to survive a [Federal Rule of Civil Procedure] 12(b)(6) motion to dismiss." *MBIA*, 637 F.3d at 175. A plaintiff is charged with knowledge of any fact that "a reasonably diligent plaintiff would have discovered." *Id.* at 174 (internal quotation mark omitted) (quoting *Merck & Co., Inc. v. Reynolds*, 559 U.S. 633, 653 (2010)).

"[W]hen the circumstances would suggest . . . the probability that" a violation of the securities laws has occurred—a situation sometimes called "storm warnings"—we deem the plaintiff on inquiry notice and assume that a reasonable person in his or her shoes would conduct further investigation into the potential violation. *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 168 (2d Cir. 2005) (internal quotation marks omitted) (quoting *Levitt v. Bear Stearns & Co., Inc.*, 340 F.3d 94, 101 (2d Cir. 2003)). Under prior Circuit law, the Section 13 limitations period could begin to run as early as the moment a plaintiff knew or should have known of storm warnings that placed it on inquiry notice. *See Staehr v. Hartford Fin. Servs. Grp.*, 547 F.3d 406, 426 (2d Cir. 2008).[36] The Supreme Court's decision in *Merck* changed that rule. *See* 559 U.S. at 650-53. After *Merck*, we still assume a reasonable plaintiff on inquiry notice would conduct further investigation, but the limitations period begins to run only when, in the course of that investigation, the reasonable plaintiff would have discovered sufficient information to plead a securities-law violation adequately. *See id.* at 651; *MBIA*, 637 F.3d at 174.[37]

[36] If the plaintiff took some action on the information, however, the limitations period began to run only when an investor exercising reasonable diligence should have discovered the fraud. *Id.*

[37] Following the parties' lead, we assume *arguendo* that *Merck*, which involved the statute of limitations for claims under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), applies with equal

A storm warning "need not detail every aspect of the alleged" securities-law violation. *Staehr*, 547 F.3d at 427. Information triggers the duty to inquire if it "'relates directly to the misrepresentations and omissions the [p]laintiff[] . . .allege[s] in [its] action against the defendants,'" *id.* (alteration omitted) (quoting *Newman v. Warnaco Grp., Inc.*, 335 F.3d 187, 193 (2d Cir. 2003)), and is, in the totality of the circumstances, "specific enough to provide an ordinary investor with indications of the *probability* (not just the *possibility*) of" a violation. *Id.* at 430 (emphases added; citations omitted). For example, we have found that an insurance company taking three substantial "reserve charges" followed by a national periodical publishing an article about the company's issues with reserves triggered a duty to inquire about the company's concealment of a negligent practice to under-reserve for insurance claims. *See LC Capital Partners, LP v. Frontier Ins. Grp., Inc.*, 318 F.3d 148, 155 (2d Cir. 2003). We have also found a plaintiff on inquiry notice regarding a bank's concealment of conflicts of interest when a magazine article described one of an affiliated financial research analyst's conflicts. *See Shah v. Meeker*, 435 F.3d 244, 249-51 (2d Cir. 2006). But we have found "generic articles" regarding structural conflicts of interest in the financial services industry insufficient to trigger a duty to inquire about specific instances of knowing

force to the statute of limitations in Section 13 of the Securities Act. *See Pension Tr. Fund for Operating Eng'rs v. Mortg. Asset Securitization Transactions, Inc.* (*Pension Tr. Fund*), 730 F.3d 263, 273 (3d Cir. 2013) (holding *Merck* applies to both the Exchange Act and Securities Act); *UBS I*, 858 F. Supp. 2d at 318-20 (same).

and intentional fraud in that industry. *See Lentell*, 396 F.3d at 170.

In this case, Defendants argue the GSEs became aware of two categories of storm warnings before September 6, 2007, one year prior to the effective date of the HERA's extender provision. First, Defendants argue that the GSEs, through their Single Family Businesses, knew first-hand that originators that issued loans supporting the Securitizations had subpar underwriting practices. That knowledge, the argument goes, would have caused a reasonable investor in the GSEs' shoes to conduct an investigation into whether the loans in the SLGs supporting the Securitizations were poorly underwritten. Second, Defendants contend that the credit downgrades of junior tranches in the Securitizations in the summer of 2007 put the GSEs on notice that the supporting loans were not as trustworthy as the ProSupps portrayed.

We are not persuaded. The Single Family Businesses' generalized experience with originators in the mortgage loan market did not trigger inquiry notice to investigate the specific representations in the ProSupps. The Single Family Businesses clearly knew or should have known that some originators who issued loans backing the Certificates were, as a general matter, less-than-rigorous in adhering to underwriting guidelines. But they reasonably believed that not every loan issued by those originators was defective, that the SLGs backing the Certificates did not contain all of the originators' loans, and that the SLGs were not representative samples of the originators' entire loan pools. The SLGs contained specific loans that Defendants specifically selected from a larger population of loans issued by the originators.

Generalized knowledge that originators issued some defective loans alone would not cause a reasonable investor to believe necessarily that his or her particular PLS certificates were backed by such loans. A reasonable investor's suspicions would be raised only if Defendants' *loan-selection processes* were also defective such that the shoddily underwritten loans would slip past their screens and into the SLGs. In this case, there was little indication of that, as both Nomura and RBS were approved by the GSEs as PLS counterparties.

Neither do the acknowledgments by leaders in the GSEs' PLS trading departments that they expected the SLGs to contain some defective loans indicate that a reasonable investor in their shoes would have investigated whether the ProSupps contained false statements. *See HSBC II*, 33 F. Supp. 3d at 471. Those statements reflect an understanding that due diligence processes are never perfect and a reasonable expectation that those processes may fail to excise an *immaterial* number of defects from the SLGs. Knowledge of a risk of immaterial deviations is quite different from knowledge of a risk of material deviations. For a material portion of the SLGs, a reasonable investor would do exactly as the GSEs' did—"rel[y] on the dealers and originators providing . . . reps and warranties as to the validity of how these loans were underwritten." *Id.* (internal quotation mark omitted; brackets omitted).

Defendants argue that the GSEs were not entitled to rely on Defendants' diligence and should have assumed that the loans in the SLGs were representative of the originators' entire loan pools because the ProSupps did not represent that the loans in the SLGs would be "the cream of the crop." RBS's Br. 35. While it is true that the ProSupps made no representations about the loans in the SLGs relative to other loans the originators issued, the ProSupps did represent that the loans in the SLGs "were originated generally in accordance with the underwriting criteria." *E.g.*, J.A. 6884. A reasonable investor in the GSEs' shoes would take that statement for all that it was worth: an affirmation that, regardless of the quality of the median loan in the residential mortgage market, these specific loans in these specific SLGs met the underwriting criteria.

Neither would the credit downgrades of junior tranches cause a reasonable investor in the GSEs' shoes to investigate whether the ProSupps contained material misstatements or omissions. To be sure, the Credit-Rating Agencies' bearish turn on RMBS expectations revealed that they had begun to doubt the strength of the loans in the downgraded securitizations' SLGs, and those doubts would cause some concern for every reasonable certificate-holder regardless of seniority. As a product of the subordination for senior PLS certificates, a single SLG supported junior and senior-tranche certificates simultaneously. Thus, concerns about the SLGs' creditworthiness could reach the senior tranches of any Securitization that had downgraded junior tranches. *See Nomura I*, 60 F. Supp. 3d at 499 ("The GSEs recognized that, generally, downgrades to junior tranches increased the risk of a future downgrade to the GSEs' senior tranches.").

It does not follow, however, that the summer 2007 credit downgrades would cause a reasonable senior-certificate holder to believe the PLS offering documents contained false statements that were material. *See Staehr*, 547 F.3d at 430 (observing that a storm warning triggers inquiry notice only when it indicates a probability of a full securities violation). The senior and junior certificate-holders did not have the same risk exposure. Certificateholders were entitled to distributions of principal, interest, and collateral in the supporting loans in descending order of seniority. A reasonable senior certificate-holder might understand the Rating Agencies' decisions to downgrade junior tranches while maintaining the senior-tranche ratings to mean that any misrepresentation in the offering documents was mild enough that the subordination and over-collateralization still insulated them from loss. On that understanding, tranche-specific downgrades might seem material to a reasonable investor in a junior certificate but not to a reasonable investor in a senior certificate.

Finally, under *Merck*, it was Defendants' burden to prove that a reasonable investor in the GSEs' shoes would have conducted a fulsome investigation and uncovered information sufficient to make out a plausible claim for relief by September 6, 2007—just weeks after the credit downgrades. *See MBIA*, 637 F.3d at 174. Defendants adduced "no evidence of . . . how long it would take a reasonably diligent investor in the GSEs' position to investigate the [instant

Section 12(a)(2)] claims such that it could adequately plead them." *Nomura I*, 60 F. Supp. 3d at 509; *see also Pension Tr. Fund*, 730 F.3d at 279 (concluding that it would have taken a reasonable institutional investor in RMBS using a "proprietary process" that involved analyzing "court filings" two months to uncover loan-quality misrepresentations in offering documents). Their failure to establish this indispensable piece of the statute of limitations defense dooms their argument on appeal.

b. Absence-of-Knowledge Element

Section 12(a)(2) requires the plaintiff to prove that it did not "know[]" of the material misstatement in the prospectus. 15 U.S.C. § 77*l*(a)(2); *see Healey v. Chelsea Res., Ltd.*, 947 F.2d 611, 617 (2d Cir. 1991). This is an actual knowledge standard. *See Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989). In contrast to the reasonable care affirmative defense (discussed below), Section 12 does not require the plaintiff to undertake any investigation or prove that it could not have known the falsity of the misstatement at issue. *See* 15 U.S.C. § 77*l*(a)(2) (precluding recovery if the defendant "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission"). Section 12 requires plaintiffs to prove only that they in fact lacked knowledge of the falsity. *See N.J. Carpenters Health Fund v. Rali Series 2006-QO1 Tr.*, 477 F. App'x 809, 813 n.1 (2d Cir. 2012) (summary order); *cf. N.J. Carpenters Health Fund II*, 709 F.3d at 127 n.12 (observing that Section 11 creates an analogous "affirmative defense where a defendant can prove that 'at the time of . . . acquisition,' the purchaser 'knew' of the alleged 'untruth or omission'" (quoting 15 U.S.C. § 77k(a))).

Actual knowledge may be proven or disproven by direct evidence, circumstantial evidence, or a combination of the two. *See Desert Palace, Inc. v. Costa*, 539 U.S. 90, 100 (2003). Publicly available information may provide relevant circumstantial evidence of actual knowledge. *See id.* However, Section 12's amenability to circumstantial evidence of actual knowledge should not be viewed as creating a constructive knowledge standard. The mere "[*a*]*vailability* elsewhere of truthful information cannot excuse untruths or misleading omissions in the prospectus." *Dale v. Rosenfeld*, 229 F.2d 855, 858 (2d Cir. 1956) (emphasis added). A plaintiff is entitled to recover under Section 12 if it was genuinely unaware of the falsity no matter how easily accessible the truth may have been.

Furthermore, Section 12 requires the plaintiff to prove only that it did not know that the *specific* statement at issue in the prospectus or oral communication was false. *See* 15 U.S.C. § 77*l*(a)(2) ("[T]he purchaser not knowing of *such* untruth or omission . . . ." (emphasis added)). This is to be distinguished from knowing that there was a risk that the statement was false and from knowing that other similar statements in the same prospectus or other prospectuses were false. Section 12(a)(2)'s absence-of-knowledge element focuses on the buyer's actual knowledge of the truth-in-fact of the particular statement at issue.

For substantially the same reasons that undergird our statute of limitations ruling above, we conclude that the GSEs lacked actual knowledge of the falsity of the specific underwriting guidelines statements in the ProSupps. Defendants failed to link the GSEs' generalized knowledge about the mortgage loan origination industry to the ProSupps' specific statements regarding the quality of the loans in the SLGs. Section 12 permitted the GSEs to rely on the ProSupps' representations that the specific loans backing the Securitizations were originated generally in accordance with the underwriting criteria, regardless of the existence of other poorly issued loans in the market at the time. The Securities Act placed the sole burden on Defendants to ensure that representation was correct. *See Basic*, 485 U.S. at 234 (observing that the Securities Act replaces *caveat emptor* with "a philosophy of full disclosure" (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963))).

Two cases that bear directly on the absence-of-knowledge issue warrant further discussion.

Defendants' absence-of-knowledge argument relies on an analogy to *In re Initial Public Offerings Securities Litigation* (*IPO*), 471 F.3d 24 (2d Cir. 2006). *IPO* was an appeal under Federal Rule of Civil Procedure 23(f) to review the certification of a class of investors in an action against underwriters of initial public offerings ("IPOs"). *Id.* at 27, 31. The class alleged that the underwriters violated Section 10(b) of the Exchange Act and Section 11 of the Securities Act by "condition[ing] allocations of shares at the [IPO] price on agreements to purchase shares in the aftermarket." *Id.* at 27. This scheme allegedly inflated secondary share prices and, consequently, the underwriters' compensation. *See id.* Part of the class's burden was to establish that it could provide common proof that each plaintiff lacked actual knowledge of the underwriters' aftermarket-purchase scheme. *Id.* at 43.

We held that the class failed to meet its burden. *Id.* at 43-44. The class initially based its allegations of the aftermarket-purchase scheme on an "industry-wide understanding" that IPO underwriters secured agreements to make such purchases, gleaned from customer interactions with those underwriters and from publicly available information in an SEC bulletin and news reports. *Id.* at 43. Those allegations of widespread knowledge led us to require individual inquiries into which members of the class had been exposed to that information before participating in an IPO. *Id.* at 43-44. We also concluded in a footnote that knowing about the aftermarket-purchase agreements was the functional equivalent of knowing about the scheme to inflate secondary securities prices because one could reasonably infer knowledge of the latter from knowledge of the former. *Id.* at 44 n.14.

Drawing on *IPO*, Defendants argue that the GSEs could have reasonably inferred that the ProSupps contained false statements from their Single Family Businesses' experience with the mortgage loan originators. That argument reads *IPO* too broadly. *IPO*—in the course of decertifying the class—held that the widespread public information in that case made it too difficult to determine *as a common question* whether the plaintiffs had actual knowledge of the material misstatements at issue. We did not rule that public information alone can prove actual knowledge for all plaintiffs. *See id.* at 43-44. The district court on remand still had to examine whether each plaintiff had actual specific knowledge notwithstanding the public information.

We did not suggest in *IPO* that generalized public information plus a "reasonable inference" establishes specific knowledge. We stated that if a plaintiff actually knew about the aftermarket-purchase agreements, it was reasonable to infer that the plaintiff knew those agreements would result in inflated secondary market prices. *Id.* at 44 n.14. In other words, once a plaintiff had actual knowledge of a specific fact, a fact-finder could reasonably infer that the plaintiff knew of the natural specific consequences of that fact. For example, if the GSEs actually knew that the loans in the SLGs were not originated generally in accordance with the underwriting criteria, then under *IPO*, it would be reasonable to infer that the GSEs knew those loans were more likely to default and the value of the Certificates would likely fall. Defendants, however, attempt to establish actual knowledge of a specific fact (that the loans in the SLGs were defective) by drawing a "reasonable inference" from generalized knowledge about the mortgage loan industry. *IPO* cannot bear that weight.

Viacom International, Inc. v. YouTube, Inc. (*Viacom*), 676 F.3d 19 (2d Cir. 2012), is more on point. There, Viacom and other content-providers alleged that YouTube committed direct and secondary copyright infringement by hosting vast amounts of unlicensed copyrighted material on its website. *Id.* at 28-29. One issue was whether YouTube had actual and specific knowledge of the copyrighted material

Viacom accused it of hosting. *Id.* at 32-34. Record evidence revealed that YouTube knew, based on internal surveys of its website, that between 75% and 80% of its content contained copyrighted material. *Id.* at 32-33. We concluded that those surveys were "insufficient, standing alone, to create a triable issue of fact as to whether YouTube actually knew, or was aware of facts or circumstances that would indicate, the existence of particular instances of infringement." *Id.* at 33. More evidence was required to establish that YouTube had actual knowledge of the copyrighted material specified in Viacom's complaint. *See id.* at 33-34.

The best case scenario for Defendants is no better than the survey evidence in *Viacom*. At most, the GSEs were aware that many PLS were supported by loans that were not originated in accordance with the underwriting guidelines. There is no evidence that the GSEs knew whether the specific PLS at issue were within or without the class of infected PLS. Without that crucial piece of information, *Viacom* precludes a reasonable jury from holding that the GSEs actually knew of the specific misstatements in the ProSupps.[38]

C. Reasonable Care Defense

Defendants appeal the District Court's grant of the FHFA's motion for summary judgment seeking to preclude Defendants from asserting a reasonable care defense at trial. *Nomura II*, 68 F. Supp. 3d at 444-46.

[38] Affirming the award of summary judgment in the FHFA's favor, we do not reach Defendants' related requests to reopen and expand discovery.

Section 12(a)(2) provides a complete defense to any defendant who "did not know, and in the exercise of reasonable care could not have known," that the misstatement at issue was false. 15 U.S.C. § 77*l*(a)(2); *see Morgan Stanley*, 592 F.3d at 359 n.7.[39] This raises a classic, mixed-law-and-fact question of reasonableness, usually committed to a jury. For that reason, only in the rare case can a court, viewing the facts in light most favorable to defendants, resolve the reasonable care defense as a matter of law. We are aware of only two other federal decisions, one of which was recently decided in a similar RMBS case, holding on summary judgment that a Section 12 defendant cannot pursue this defense. *See Nat'l Credit Union Admin. Bd. v. UBS Sec., LLC*, Nos. 12-2591, 12-2648, 2017 WL 411338, at *4-6 (D. Kan. Jan. 31, 2017) (granting partial summary judgment where "defendants essentially offered *no* evidence of due diligence," *id.* at *5); *see also Plunkett v. Francisco*, 430 F. Supp. 235, 241 (N.D. Ga. 1977).[40]

Nevertheless, the District Court held this was an "exceptional" case "where no reasonable, properly instructed jury could find" that Defendants should not have known that the ProSupps' statements affirming

[39] Both Blue Sky laws provide a substantially similar reasonable care defense. *See* VA. CODE ANN. § 13.1-522(a)(ii); D.C. CODE § 31-5606.05(a)(1)(B).

[40] We are aware of another federal decision, *Massachusetts Mutual Life Insurance Company v. DB Structured Products, Inc.*, in which the court found that the due diligence defense failed as a matter of law and granted partial summary judgment with respect to one defendant, but also denied summary judgment regarding the due diligence defense with respect to other defendants. 110 F. Supp. 3d 288, 301 (D. Mass. 2015).

that the loans in the SLGs adhered to the underwriting guidelines were false. *Nomura II*, 68 F. Supp. 3d at 445.[41] Defendants argue on appeal that a reasonable jury could find that Defendants met the reasonable care standard because their due diligence complied with PLS industry practices at the time.

1. Factual Summary[42]

a. Nomura

Nomura's Transaction Management Group oversaw the process of purchasing and conducting due diligence of loans intended for securitization. Individual Defendants John P. Graham and N. Dante LaRocca both served, at different times, as the head of this group; Individual Defendant David Findlay, Nomura's Chief Legal Officer, also played a role in supervising this group. Nomura's Trading Desk purchased loans from originators, and Nomura's Due Diligence Group reviewed those loans. The Diligence Group consisted of between three and five employees, including its group leader, initially Joseph Kohout and later Neil Spagna.

The Trading Desk purchased a few loans individually, but a vast majority of the loans it

[41] The District Court also held as a matter of law that Defendants knew or should have known that the ProSupps' statements regarding loan-to-value ratios were false. *See id.* at 445-46. We need not review that decision because we affirm the court's alternative holding that Defendants' credit and compliance diligence processes were inadequate.

[42] The following summary draws on the District Court's discussion of the relevant facts and additional record evidence, which we view in the light most favorable to Defendants and which Defendants do not dispute. *See id.* at 448-65.

securitized were purchased in trade pools. A trade pool with an aggregate principal balance greater than $25 million was known as a "bulk pool." All other trade pools were "mini-bulk pools." The SLGs at issue here were comprised of 15,806 loans, 14,123 (~89%) of which came from 54 bulk pools and 1,561 (~10%) of which came from 140 mini-bulk pools. The remaining 122 (~1%) loans in the SLGs were purchased individually. When an originator solicited bids for a trade pool, it made only the loan tape available to Nomura and other PLS aggregators. Traders did not review individual loan files before bidding on a pool.

After Nomura won a bid to purchase loans but before final settlement, the originators made available some number of loan files for Nomura's Diligence Group to review. Consistent with industry practices at the time, this pre-acquisition review was the only round of diligence Nomura conducted prior to offering the Securitizations to the public. The Diligence Group directed, *inter alia*, a credit review and a compliance review of the loans. The credit review examined whether the loans were originated in accordance with the originators' underwriting guidelines. The compliance review examined whether the loans complied with the relevant federal, state, and municipal regulations.

The Diligence Group conducted credit and compliance reviews for approximately 40% of the loans in the SLGs at issue. Nomura reviewed each loan purchased individually, virtually every loan purchased in a mini-bulk pool, and virtually all of the loans in 24 of the bulk pools. For the remaining 30 bulk pools (which contributed 82.1% of the total loans in the SLGs), the Diligence Group reviewed only a sample. Nomura's Trading Desk—not the Diligence Group—sometimes entered into agreements with counterparty originators limiting the size of the samples, which ranged from about 20% to 50% of the pool. Some of those agreements placed a hard cap on the size of the sample, while others affixed the size of the sample but entitled Nomura to request additional loans, a process known as "upsizing" the sample. Nomura did not upsize any of the samples at issue in this case.

Nomura used a non-random process to compile their samples. The Diligence Group selected 90% of the sample using a proprietary computer program created by S&P known as LEVELS. LEVELS employed adverse sampling, a process which involves combing through the loan tape to select for review the loans with the highest credit risk in a trade pool based on debt-to-income ratio, FICO score, loan-to-value ratio, and outstanding principal balance. The remaining 10% of the sample was selected "in an ad hoc fashion" based on similar risk factors. *Id.* at 451.

Kohout warned Nomura employees in an internal email that Nomura's use of LEVELS "is a non industry standard approach," J.A. 2631, and "does not conform to what is generally deemed to be effective by industry standards," *id.* at 2632. He stated that "when presenting our process to both internal and external parties, it will have to be made clear that [the Diligence Group's] role in both the sample selection and management of risk on bulk transactions has been diminished to the point of that of a non effective entity pursuant to our limited role in the process." *Id.* at

2631-32. The Single Family Businesses' counterparty reviews of PLS sponsors revealed that several other sponsors also used LEVELS to compose portions of their due diligence samples.

After selecting the sample, the Diligence Group deputized a third-party vendor, often Clayton or American Mortgage Consultants Inc. ("AMC"), to perform the credit and compliance reviews, with occasional oversight and assistance from Nomura employees. This was consistent with industry practices. The vendor used the sample loan files to re-underwrite the loans according to the originators' underwriting guidelines, additional criteria provided by Nomura, and applicable laws. The vendor gave each loan an "Event Level" ("EV") grade on a scale from 1 to 3, 1 indicating that the loan met all of the review criteria and 3 indicating that the loan materially deviated from the criteria or lacked critical documentation. The vendor then transmitted those grades to Nomura's Diligence Group on a document titled "Individual Asset Summaries."

The Diligence Group reviewed all of the vendor's EV2 and EV3 grades and as many as half of its EV1 grades. This review was limited to examining the "Individual Asset Summaries"; Nomura did not examine any loan files. The Diligence Group possessed the authority to issue client overrides that vacated the vendor's grade and to direct the vendor to re-grade the loan. With respect to the loans drawn from the 54 bulk pools that contributed to the SLGs here, the Diligence Group directed the vendor to change roughly 40% of the EV3 grades to EV2 grades.

The record contains one audit of Nomura's pre-acquisition review vendors, which LaRocca, then-head of Nomura's Transaction Management Group, reviewed. The audit report is dated August 24, 2006 (before four of the Securitizations settled). It finds that in a sample of 109 loans previously graded EV1 or EV2, seven of these should have received an EV3 grade and another 29 should have received no grade at all given the lack of supporting documentation. There is no evidence that Nomura changed its credit and compliance review processes after this audit.

After it received the final results of the third-party review, Nomura purchased all of the EV1 and EV2 loans—and acquired their loan files. Nomura intended to "kick out" (*i.e.*, remove from the trade pool) all of the EV3 loans, although approximately 2.6% of the loans backing the Securitizations had been sampled and received an EV3 grade. In an internal email, Spagna stated that "typical" kick-out rate ranged from 7% to 8% of the sample and a rate of 12.12% was "much higher" than average. *Id.* at 2639. The average kick-out rates for the trade pools at issue was 15.2%.

Nomura held most of the purchased loans for between two and five months. During that time, the Trading Desk grouped the purchased loans into SLGs. Nomura's traders made loan-by-loan selections using a non-random process designed to create SLGs that would meet market demands. The traders based their evaluations of the loans on factors such as credit scores, geographic concentrations, and loan-to-value ratios. Nomura conducted no review of the SLGs' creditworthiness as a whole.

Nomura's Transaction Management Group wrote the ProSupps after the SLGs were formed. The ProSupps made representations about the characteristics of the SLGs. For three of the Securitizations, there is no specific evidence that Nomura verified the accuracy of these representations. For four of the Securitizations, Nomura's verification process consisted of the Transaction Management Group reviewing a "Due Diligence Summary"—a single page created by the Diligence Group listing the percentage of loans to be securitized that had been reviewed and the kick-out rates for the trade pools. Each summary included a disclaimer: "The material contained herein is preliminary and based on sources which we believe to be reliable, but it is not complete, and we do not represent that it is accurate." J.A. 2876.

b. RBS

RBS, the lead or co-lead underwriter for four of the Securitizations, also reviewed the loans in the SLGs. RBS's due diligence was led by Brian Farrell, the Vice President of RBS's credit risk department.

For two of the Securitizations it underwrote, RBS conducted no independent review. This practice was common among underwriters in the PLS industry. RBS's review of NHELI 2006-HE3 diligence consisted of reviewing three documents created by Nomura—an aforementioned Due Diligence Summary, an additional summary of collateral characteristics, and a list of the names of the originators that contributed more than 5% of the loans in the SLGs. RBS also relied on Nomura-provided data integrity studies that affirmed the ProSupps contained no input errors or mathematical miscalculations, as well as a "negative assurance letter" from Nomura's counsel that stated counsel was unaware of any facts that would render the ProSupps misleading.

RBS's review of NHELI 2006-FM2 consisted primarily of reviewing reports from AMC that described the loans. Before transmitting it to RBS, Nomura reviewed these reports and discovered that the SLGs contained 19 EV3 loans, despite Nomura's policy against purchasing such loans. Spagna, who took over Nomura's Diligence Group after Kohout, emailed AMC and requested that it "mark these loans as client overrides Credit Event 2s for all 19 loans in question" and then "forward to me the updated set of reports for these two deals." J.A. 2878. The vendor complied and Nomura sent RBS the reports as revised. After noting one issue based on experience with a particular originator, RBS approved the vendor's reports.

RBS also participated in a teleconference with RBS's counsel, Nomura (represented in part by Spagna), Nomura's counsel, and other underwriters to discuss diligence on NHELI 2006-FM2. Spagna recalled to a fellow Nomura employee that RBS asked two questions about Nomura's diligence processes, that he "took the liberty to bullshit them," and that he thought "it worked." *Id* at 2881.

After NHELI 2006-FM2 had closed, an RBS employee emailed Farrell to discuss RBS's diligence for this deal. Farrell wrote: "We did not perform actual diligence on this. Diligence was performed by another company for Nomura. We signed off on their results." *Nomura II*, 68 F. Supp. 3d at 460. The RBS employee responded: “How frequently is this done?” *Id.* Farrell replied: “Since being employed, this is the only review type I was involved in where due diligence results were reviewed and a new diligence was not ordered.” *Id.* (brackets omitted).

RBS did conduct independent reviews of sample loans from NHELI 2007-1 and NHELI 2007-2. RBS selected samples using adverse sampling in part and “semi-random” sampling in remaining part. J.A. 2606. The semi-random technique grouped the remaining loans by unpaid principal balance and selected randomly from within those groups. For NHELI 2007-1, RBS’s sample contained 5.8% of the adjustable-rate loans in a group, part of which eventually composed the relevant SLG. For NHELI 2007-2, Farrell requested RBS employees to form a larger sample, preferably 25% of the loan pool, because he thought the loans were “crap.” *Id.* at 2886. In the end, RBS sampled 6% of the loans from the NHELI 2007-2 SLG.

RBS’s diligence as an underwriter was similar to Nomura’s as a PLS sponsor.[43] RBS outsourced its credit and compliance reviews to Clayton, which used loan files to re-underwrite the loans in each sample subject to client overrides. The re-underwriting analyses for NHELI 2007-1 yielded 33 loans (~32% of the sample) graded “3,” the equivalent of EV3. Within an hour and six minutes after Clayton transmitted that information to RBS, RBS issued overrides for 30 of those grades and ordered that the loans be

[43] The District Court identified some evidence suggesting that RBS’s diligence standards were less strict when it acted as an underwriter than when it acted as a PLS sponsor. *See Nomura II*, 68 F. Supp. 3d at 462; *see also* J.A. 2832.

reclassified as acceptable for purchase. The re-underwriting analysis for NHELI 2007-2 yielded 50 grade-3 loans (~16.2% of the sample), all of which RBS overrode.

RBS provided no objective record evidence to support these overrides. An RBS employee testified that the decision-making process for issuing a client override consisted of "review[ing] a loan file to see if there were compensating factors for exceptions" by "flip[ping] through the pages" for between "20 minutes" and "three hours" depending on whether he "thought it was important." *Nomura II*, 68 F. Supp. 3d at 462. Farrell testified that he reviewed six of the overridden loans in NHELI 2007-1 and found them to have "sufficient compensating factors." *Id.* He justified the rest of the overrides in NHELI 2007-1 with similar reasoning.

2. Analysis

Section 12's reasonable care defense is available to any defendant who did not know and in the exercise of reasonable care could not have known of the material misstatement in the prospectus. *See* 15 U.S.C. § 77*l*(a)(2). Congress did not explicitly define the duty of reasonable care under Section 12. But one can discern the term's meaning by reference to related administrative guidance, non-statutory indicators of congressional intent, such as the section's legislative history and statutory context, and common-law principles. *See Mohamad v. Palestinian Auth.*, 132 S. Ct. 1702, 1709 (2012) ("Congress is understood to legislate against a background of common-law adjudicatory principles." (quoting *Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 108 (1991));

Demarco v. Edens, 390 F.2d 836, 842 (2d Cir. 1968) (looking to common-law principles to define reasonable care under Section 12).

Section 12 imposes negligence liability. *See NECA*, 693 F.3d at 156. "Negligence, broadly speaking, is conduct that falls below the standard of what a reasonably prudent person would do under similar circumstances . . . ." *Fane v. Zimmer, Inc.*, 927 F.2d 124, 130 n.3 (2d Cir. 1991). "[I]t is usually very difficult, and often simply not possible, to reduce negligence to any definite rules; it is 'relative to the need and the occasion,' and conduct which would be proper under some circumstances becomes negligence under others." W. Page Keeton et al., *Prosser and Keeton on Torts* § 31 at 173 (5th ed. 1984) (quoting *Babington v. Yellow Taxi Corp.*, 250 N.Y. 14, 18 (1928) (Cardozo, *C.J.*)).

Courts have explored negligence liability for securities offerors in the analogous context of Section 11. *See In re Software Toolworks Inc.* (*Software Toolworks*), 50 F.3d 615, 621 (9th Cir. 1994); *In re WorldCom, Inc. Sec. Litig.* (*WorldCom*), 346 F. Supp. 2d 628, 663 (S.D.N.Y. 2004) (Cote, *J.*). *But see Glassman v. Computervision Corp.*, 90 F.3d 617, 628 (1st Cir. 1996) ("The law on due diligence is sparse . . . ."). SEC guidance advises that "the standard of care under Section 12(a)(2) is less demanding than that prescribed by Section 11." Securities Offering Reform, SEC Release No. 75, 85 SEC Docket 2871, *available at* 2005 WL 1692642, at *79 (Aug. 3, 2005).[44] Still, Section 11 law is persuasive

[44] Some courts have agreed. *See Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 213 (7th

in defining reasonable care under Section 12.[45] *See* SEC Release No. 75, 2005 WL 1692642, at *79 ("[W]e believe that any practices or factors that would be considered favorably under Section 11, including pursuant to Rule 176, also would be considered as favorably under the reasonable care standard of Section 12(a)(2)."); H.R. REP. NO. 73-85, at 9 (1933) (discussing jointly the duties of care under Sections 11 and 12).

Section 11, like Section 12, imposes a negligence standard. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 383-84 (1983); *NECA*, 693 F.3d at 156. Section 11 achieves this by providing a defense to any underwriter defendant who "had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements [at issue] were true and that there was no omission to state a material fact required to be stated therein or necessary to make the

Cir. 1993) (describing the Section 12 duty to exercise "'reasonable care'" as "significantly lesser" than the duty to conduct a "'reasonable investigation'"); *Mass. Mut. Ins.*, 110 F. Supp. 3d at 298-99 (concluding that Section 12 is less demanding than Section 11); *see also John Nuveen & Co., Inc. v. Sanders*, 450 U.S. 1005, 1008-09 (1981) (Powell, *J.*, dissenting from denial of petition for certiorari) ("'Investigation' commands a greater undertaking than 'care.'" *Id.* at 1009.). Others have not. *See Software Toolworks*, 50 F.3d at 621 ("[T]he analysis of [the Section 11 and Section 12 defenses] on summary judgment is the same."); *Glassman*, 90 F.3d at 628.

[45] Because the FHFA withdrew its Section 11 claim and Defendants argue that they conducted reasonable due diligence, we need not consider today whether there are any differences in proof demands between Section 12 and Section 11 or whether the Section 12 defense is available absent an actual investigation. *See Nomura II*, 68 F. Supp. 3d at 475 & n.48.

statements therein not misleading." 15 U.S.C. § 77k(b)(3)(A). For a defendant's investigation to be reasonable, its actions must conform to those of "a prudent man in the management of his own property." 15 U.S.C. § 77k(c); *see WorldCom*, 346 F. Supp. 2d at 663.

The measures a reasonably prudent person would take in the management of his property are context dependent. Under Section 12, they are a function of, *inter alia*, (1) the nature of the securities transaction, (2) the defendant's role in that transaction, (3) the defendant's awareness of information that might suggest a securities violation and its response(s) upon learning of such information, and (4) industry practices. *See WorldCom*, 346 F. Supp. 2d at 674-77; 17 C.F.R. § 230.176 (listing relevant considerations in deciding whether an investigation was reasonable under Section 11).

The reasonable care standard adapts to the context of each transaction. The SEC has issued a rule regarding the due diligence review that issuers of asset-backed securities should conduct before making public offerings. *See* 17 C.F.R. § 230.193; Issuer Review of Assets in Offerings of Asset-Backed Securities, SEC Release No. 9176, 100 SEC Docket 706, *available at* 2011 WL 194494 (Jan. 20, 2011).[46]

[46] Although this rule issued after the transactions in this case and was "not intended to change" the standards of care under Sections 11 and 12, it is instructive for our analysis. SEC Release No. 9176, 2011 WL 194494, at *2 n.9; *see In re City of New York*, 522 F.3d 279, 286 (2d Cir. 2008) ("[F]ederal agencies are often better positioned to set standards of care than are common-law courts.").

The SEC requires issuers to adopt due diligence policies that provide reasonable assurance that the offering documents' descriptions of the assets are accurate in all material respects. *See* SEC Release No. 9176, 2011 WL 194494, at *6. Specific review standards depend on the type of product offered. *See id.* For RMBS, the SEC requires issuers to provide reasonable assurance of the truth of all information related to the supporting loans that is required to be in a prospectus or prospectus supplement, including representations of the loans' "credit quality and underwriting." *Id.* at *7. Sometimes that may require reviewing all of the supporting loans. But an RMBS issuer also may review a sample of the loans if the loan pool is so large that reviewing all of the loans is prohibitive and the sample is "representative of the pool." *Id.* at *6.

The nature of the defendant's position within a given transaction also affects the standard of care. *See* 2 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 7:45 (7th ed., 2016) ("Reasonable care imparts a sliding scale of standards of conduct . . . ."). As Congress explained when it initially passed the Securities Act, "[t]he duty of care to discover varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect." H.R. REP. NO. 73-85, at 9. Those closest to the offered securities—issuers, for example—are more likely to come into contact with material information, and thus may be required to exercise more care to assure that disclosures are accurate. *See Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 577-78 (E.D.N.Y. 1971). In an

RMBS distribution, the depositor as the formal issuer, and the affiliated entities that control it, such as the sponsor and affiliated underwriters, occupy this position of closeness to the offered products. *See* H.R. REP. NO. 73-85, at 12.

Unaffiliated underwriters are often the sole adversarial entities in a securities distribution. As a result, they assume a unique role. *See Feit*, 332 F. Supp. at 581-82. The Securities Act places upon underwriters "the primary responsibility for verifying the accuracy and completeness of information provided to potential investors." *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 369-70 (2d Cir. 1973). That special responsibility guides the standard of care for underwriters under Section 12 mandates. *See Sanders*, 619 F.2d at 1228 n.12 ("The fact that [Section 12] does not expressly single out underwriters . . . for a higher standard of liability does not mean that this status is irrelevant to determining what specific actions [an underwriter must] show to prove its exercise of reasonable care.").

Whether a defendant learns or should learn of alarming information that suggests a violation of the securities laws—so-called "red flags"—and how the defendant responds are perhaps the most important considerations in assessing reasonable care. *See WorldCom*, 346 F. Supp. 2d at 679. Reasonable care requires a context-appropriate effort to assure oneself that no such red flags exist. If a defendant encounters red flags, reasonable care mandates that it examine them to determine whether the offering documents contain a material falsehood and, if so, to correct it. *Cf. Lentell*, 396 F.3d at 168 ("Inquiry notice . . . gives rise to a duty of inquiry when the circumstances would suggest to an investor of ordinary intelligence the probability that [there has been a violation of the securities laws]." (internal quotation marks omitted) (quoting *Levitt*, 340 F.3d at 101)). An RMBS seller must conduct "further review" when "warranted in order to provide reasonable assurance that [the offering documents are] accurate in all material respects." SEC Release No. 9176, 2011 WL 194494, at *6.

Finally, industry standards and customs are highly persuasive in setting the standard of care, but they are not controlling. *See In re City of New York*, 522 F.3d at 285. As Judge Hand famously explained in *The T.J. Hooper*, in exceptional cases "a whole calling [or industry] may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required." 60 F.2d 737, 740 (2d Cir. 1932). The reasonable care standard will not countenance an industry-wide "'race to the bottom' to set the least demanding standard to assess [its] conduct." *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 857 (9th Cir. 2001). Thus, particularly where "the industry was comprised of only a few participants who controlled the practice," *id.*, and where industry practices have not previously survived judicial scrutiny, *see Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171 (2d Cir. 1970), custom is less persuasive evidence of reasonable prudence. *But see In re City of New York*, 522 F.3d at 285 ("Courts will not lightly presume an entire industry negligent.").

In this case, no reasonable jury could find that Defendants exercised reasonable care. Nomura, as the sponsor, depositor, and occasional underwriter, was given access to the loans—and the loan files—prior to purchase and later owned the loans themselves. That uniquely positioned Nomura to know more than anyone else about the creditworthiness and underwriting quality of the loans. As a result, investors relied on Nomura's review of the loans and representations about the loans' likelihood to default. In making those representations, Nomura fell below the standard of conduct Section 12 requires.

Nomura could not be reasonably sure of the truth of any statements in the ProSupps regarding the loans' adherence to the underwriting guidelines. The single round of diligence Nomura conducted involved credit reviews for only a sample of the loans. At the direction of its Trading Desk, Nomura limited that sample to about 40% of the trade pool. Nomura then used a combination of ad hoc selections and LEVELS, the adverse sampling program, to compile its samples. These selection procedures chose a sample of the "riskiest" loans rather than a sample that was representative of the entire loan pool.

The criteria LEVELS used to identify "risky" loans was not tied to the loans' adherence to the underwriting guidelines. LEVELS relied solely on loan-tape information, such as loan-to-value and debt-to-income ratios, to form its adverse samples. These characteristics may be indicators of general credit risk, but Nomura provided no evidence whatever to suggest that they are indicators of the likelihood that a loan met the underwriting criteria. "As Kohout [later] explained at trial," LEVELS's singular reliance on the loan tape "made it impossible to select a sample based on a prediction of which loans were more likely to have 'adverse' characteristics, such as a misstated LTV ratio or DTI ratio, an unreasonable 'stated' income, or to find loans that deviated from the originator's underwriting guidelines." *Nomura VII*, 104 F. Supp. 3d at 473.

The problems with Nomura's sample selection were compounded by its failure to conduct reliable credit and compliance reviews. The audit Nomura commissioned of its credit and compliance reviews, however, raised serious red flags about the efficacy of its due diligence procedures. Nomura learned that approximately 30% of a sample of 109 loans receiving a final grade of EV1 or EV2 after the loan-level reviews should have received an unacceptable grade of EV3 or no grade at all. There is no evidence that Nomura took any action to correct that deficiency in its procedures.

Similarly, the high kick-out rates for the trade pool samples observed by Nomura should have raised suspicions about whether its due diligence was reliable. Spagna considered a 7% to 8% kick-out rate to be standard and a 12% kick-out rate to be higher than normal, yet Nomura observed a 15.2% kick out rate for the trade pools at issue. In other words, Nomura's samples contained nearly double the normal amount of loans that failed credit or compliance review. A reasonable investor in that scenario would have upsized the sample to determine if this problem pervaded the entire trade pool. Nomura did not.

Nomura's SLG compilation procedures were also problematic. The Trading Desk grouped the loans into SLGs without any assistance from the Diligence Group. Nomura performed no review of the SLGs after they were compiled. The only due diligence the Trading Desk reviewed was a single-page summary describing diligence for the loan pool, attached to which was an express disclaimer that the information contained therein should not be taken as complete and accurate. Moreover, the Trading Desk's methodology for selecting loans broke the inferential chain between the results of its sample testing and the representations in the ProSupps. The ProSupps described the loans as SLGs, yet Nomura compiled SLGs using non-random and ad hoc selection procedures that turned on the trader's instincts about market demand. Despite its representations in PLS offering documents, in reality Nomura had no way to know the credit risk of any given SLG.[47]

RBS's conduct was no better. For NHELI 2006-HE3 and NHELI 2006-FM2, RBS relied entirely on Nomura's diligence. That did not adequately discharge RBS's responsibility as an underwriter to verify independently the representations in the offering documents. Spagna's conduct with regard to NHELI 2006-FM2 is a revealing example. Without RBS's knowledge, Spagna retroactively changed the *pre-acquisition* grades for 19 *purchased* loans from

[47] That the AMO found Nomura's diligence "Satisfactory" in August 2004 (and again in March 2006) after an on-site review and a re-underwriting of 50 sampled loans does not change our analysis of Nomura's diligence practice during the pertinent period. J.A. 3170, 3177.

EV3 to EV2 before sending the due diligence reports to RBS. And when RBS asked Spagna about Nomura's due diligence, he "bullshit[ted]" them. *Nomura II*, 68 F. Supp. 3d at 460. RBS was blind to these acts of malfeasance. *See Nat'l Credit Union Admin. Bd.*, 2017 WL 411338, at *4-6; *Mass. Mut. Life Ins.*, 110 F. Supp. 3d at 301.

For NHELI 2007-1 and NHELI 2007-2, RBS conducted some diligence but not enough to meet the standard of reasonable care. RBS sampled just 5.8% of a group of loans from which Defendants composed the SLG backing the NHELI 2007-1 Certificate and just 6% of the loans in NHELI 2007-2 even though it believed the loans in the latter Securitization were "crap." *Nomura II*, 68 F. Supp. 3d at 461 (internal quotation marks omitted). RBS compiled those samples in part using non-representative adverse selection. Its re-underwriting analyses revealed that ~32% of the loans in NHELI 2007-1 and ~16.2% of the loans in NHELI 2007-2 deserved a failing grade for credit or compliance review *even after* Nomura's pre-acquisition screening. But instead of requesting a larger sample to determine if this problem was consistent for the entire trade pool or further questioning Nomura about this issue, RBS overrode all, or nearly all, of those failing grades in short time periods—in the case of NHELI 2007-1 just over an hour. RBS provided no objective justification for any of those override decisions and only specific subjective justification for six. That conduct fell well below the standard of reasonable care.[48]

[48] As above, that the SFCPRM, after reviewing limited information, apparently accepted RBS's characterization of its

Defendants' primary contention on appeal is that their conduct could not be unreasonable as a matter of law because it conformed to industry practices at the time. They argue that LEVELS was an industry standard adverse selection software,[49] most PLS sellers conducted only one round of pre-acquisition diligence, it was standard for PLS sellers to outsource loan-level diligence to third parties such as Clayton, and many PLS underwriters relied on the aggregator's diligence representations.

We are not persuaded a properly instructed jury could find Defendants' conduct reasonable based on these standards. This argument is tellingly limited. Defendants do not contend that every choice they made was in keeping with best practices in the PLS industry, nor do they suggest that their actions, on the whole, were consistent with industry customs. They pick and choose instances of conduct that they claim met the standards of the industry. A seller's scattershot compliance with industry custom does not deprive a plaintiff of a Section 12 remedy. That Defendants' use of sampling or LEVELS or a third-party vendor complied with industry customs does not mean their conduct taken as a whole was reasonable under the circumstances.

Moreover, our analysis is only informed by industry standards, not governed by them. *See In re City of New York*, 522 F.3d at 285. The RMBS industry

diligence as "robust" does not change our analysis here. *Nomura I*, 60 F. Supp. 3d at 491 (internal quotation mark omitted).

[49] *But see* J.A. 2631-32 (Kohout warning Nomura employees that Nomura's use of LEVELS did not comport with industry standards).

in the lead up to the financial crisis was a textbook example of a small set of market participants racing to the bottom to set the lowest possible standards for themselves. *See Dain Rauscher*, 254 F.3d at 857. Accordingly, even if Defendants' actions on the whole complied with that industry's customs, they yielded an unreasonable result in this case.

Defendants also argue that use of adverse sampling cannot be unreasonable because the SEC has advised that asset due diligence may vary depending on the circumstances, in lieu of adopting a proposed rule that would require RMBS sellers to use representative samples in all cases. *See* SEC Release No. 9176, 2011 WL 194494, at *4, *6. This argument is not persuasive either. SEC's refusal to ban adverse sampling in all cases is not inconsistent with our holding that, in this particular case, Defendants' use of non-representative sampling contributed in part to a course of unreasonable conduct.

Finally, we have no doubt that, had they exercised reasonable care, Defendants could have learned that a material number of the loans were not originated in accordance with the underwriting guidelines. This is not a case where Defendants incorrectly forecasted a future occurrence or inaccurately assessed the future impact of a past event. The relevant information in this case was static and knowable when Defendants securitized the loans and wrote the ProSupps. At that time, the manner in which the loans were originated had already occurred—they had been issued either in accordance with the underwriting criteria or not. And it was possible for Defendants, who owned the loans and regularly conducted business with third-party vendors that perform re-underwriting analyses, to learn whether they were.

D. Jury Trial

After the FHFA withdrew its Section 11 claim, the District Court conducted a bench trial on the remaining Section 12(a)(2), Section 15, and analogous Blue Sky claims. *See Nomura IV*, 68 F. Supp. 3d at 496-98.[50] Defendants contend that the bench trial violated their right to a jury trial under the Seventh Amendment.

The Seventh Amendment to the United States Constitution preserves the right of any party to a civil action to compel a jury trial in "Suits at common law." "The phrase 'Suits at common law' refers to 'suits in which *legal* rights were to be ascertained and determined, in contradistinction to those where equitable rights alone were recognized, and equitable remedies were administered.'" *Eberhard v. Marcu*, 530 F.3d 122, 135 (2d Cir. 2008) (emphasis in original) (quoting *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 41 (1989)). Determining whether an action is a "Suit[] at common law" requires two steps. *Id.* The first assesses "whether the action would have been deemed legal or equitable in 18th century England." *Id.* (internal quotation marks omitted) (quoting *Germain v. Conn. Nat'l Bank*, 988 F.2d 1323, 1328 (2d Cir. 1993)). The second and "more important" step asks "whether 'the remedy sought . . . is legal or

[50] For the sake of clarity, we confine our discussion to whether the Seventh Amendment applies to Section 12(a)(2) claims. Our analysis applies equally to the FHFA's remaining Section 15 and Blue Sky claims.

equitable in nature.'" *Id.* (alteration in original) (quoting *Granfinanciera*, 492 U.S. at 42).

For years, there was little doubt that an action under Section 12(a)(2) was not a "Suit[] at common law," *id.*, within the meaning of the Seventh Amendment. A Section 12 action operates much like an 18th century action at equity for rescission, which extinguished a legally valid contract that had to "be set aside due to fraud, mistake, or for some other reason." 12A C.J.S. CANCELLATION OF INSTRUMENTS § 1 (2017); *see Randall v. Loftsgaarden*, 478 U.S. 647, 655 (1986) (describing Section 12's remedy of "rescission" upon "prospectus fraud").[51] The Supreme Court and this Court have recognized that a Section 12(a)(2) action is the Securities Act-equivalent of equitable rescission. *See Gustafson*, 513 U.S. at 576 ("[Section] 12(2) . . . grant[s] buyers a right to rescind . . . ."); *Pinter v. Dahl*, 486 U.S. 622, 641 n.18 (1988) ("Section 12 was adapted from common-law (or equitable) rescission . . . ."); *Deckert v. Indep. Shares Corp.*, 311 U.S. 282, 288 (1940) (concluding that a Section 12(a)(2) claim "states a cause for equitable

[51] Defendants argue that Section 12(a)(2) is unlike common-law equitable rescission because the latter required proof of scienter and justifiable reliance whereas the former does not. Scienter was not required to make out an equitable rescission claim at common law. *See* BLACK, RESCISSION OF CONTRACTS AND CANCELLATION OF INSTRUMENTS § 106 (1916). And Section 12(a)(2) does not omit justifiable reliance from a rescission claim as much as it presumes conclusively that the buyer relied on the prospectus, which "although [it] may never actually have been seen by the prospective purchaser, because of [its] wide dissemination, determine[s] the market price of the security." *Gustafson*, 513 U.S. at 576 (quoting H.R. REP. NO. 85, at 10).

relief"); *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1019 n.4 (2d Cir. 1989) ("An equitable claim such as rescission [under Section 12(a)(2)] is for the court, not the jury, to decide."). Commentators have also consistently analogized an action under Section 12(a)(2) to equitable rescission. *See, e.g.*, 69A AM. JUR. 2D Securities Regulation—Federal § 982 (2016); 2 HAZEN, THE LAW OF SECURITIES REGULATION § 7:56; Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 243-44 (1933).

In 1995, Congress added the loss causation affirmative defense to Section 12(a)(2). Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105(3), 109 Stat. 737, 757 (codified at 15 U.S.C. § 77*l*(b)). Defendants' primary argument is that the amendment altered the nature of the Section 12(a)(2) remedy to that of damages for the injury arising from the false statement—a decidedly legal remedy—and therefore a Section 12 action now triggers the Seventh Amendment jury trial right. There is some credence to Defendants' position. At 18th century common law, equitable rescission required the seller to refund the buyer the full original purchase price in exchange for the purchased item, regardless of its present value. *See Pinter*, 486 U.S. at 641 n.18; *Lyon v. Bertram*, 61 U.S. 149, 154-55 (1857) ("'Where a contract is to be rescinded at all, it must be rescinded *in toto*, and the parties put *in statu quo*.'" (quoting *Hunt v. Silk* (1804) 5 East 449, 452 (Lord Ellenborough, *C.J.*))). In other words, the seller bore the risk of depreciation unrelated to the misrepresentation. Section 12(a)(2) with a loss causation defense shifts the risk burden to the buyer by authorizing the seller to refund the original purchase price less any reduction in the item's present value not attributable to a material misstatement. *See Iowa Pub. Emps'. Ret. Sys.*, 620 F.3d at 145.

Furthermore, in the Section 10(b) context, this Court has "described loss causation in terms of the tort-law concept of proximate cause." *Lentell*, 396 F.3d at 172; *see also Nomura VII*, 104 F. Supp. 3d at 585 ("'Loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff . . . [and] is related to the tort law concept of proximate cause.'" (alterations in original) (quoting *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157 (2d Cir. 2007))). Proximate cause generally defines the scope of a defendant's legal liability. *CSX Transp., Inc. v. McBride*, 564 U.S. 685, 692-93 (2011); *Lattanzio*, 476 F.3d at 157. When a judgment imposes personal legal liability on a defendant, even occasionally in the context of a restitution claim, it can create a legal remedy. *See Great-West Life & Annuity Ins. Co. v. Knudson* (*Knudson*), 534 U.S. 204, 213-14 (2002).

Nevertheless, the addition of the loss causation defense did not transform Section 12(a)(2)'s equitable remedy into a legal one. The limited degree to which the modern Section 12(a)(2) remedy differs from common-law rescission does not change the fact that, fundamentally, it is equitable relief. Section 12(a)(2) has never provided exactly the same relief as 18th century equitable rescission. Section 12(a)(2) has traditionally been more buyer-friendly than its common-law counterpart because it authorizes recovery even after the buyer no longer owns the security at issue. *See Pinter*, 486 U.S. at 641 n.18; Shulman, *supra*, at 244. The availability of an alternative damages remedy never stood as a barrier to considering Section 12(a)(2)'s rescission-like remedy equitable for purposes of the Seventh Amendment. Nor does the loss causation defense, which merely tilts the balance of equities in the modern Section 12(a)(2) remedy slightly back toward sellers.

Likewise, our suggestion in the Section 10(b) context that loss causation is akin to proximate cause does not mean that Section 12(a)(2) with a loss causation defense necessarily provides a legal claim. Equitable rescission permits a court to order "the nullification of a transfer of property between the claimant and the defendant . . . and. . . a mutual accounting in which each party pays for benefits received from the other in consequence of the underlying exchange and its subsequent reversal." RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 54 cmt. a. Loss causation in Section 12(a)(2) serves the latter function—it is a mutual accounting that prevents the buyer from reaping an unjust benefit at the expense of the seller. This restores the parties to the *status quo ante* the securities transaction at issue while ensuring that the terms of the rescission are just (in Congress's view), a hallmark of equitable recessionary relief. *See Marr v. Tumulty*, 256 N.Y. 15, 22 (1931) (Cardozo, *C.J.*).

Defendants' further arguments come up short. As an initial matter, none of the Defendants' remaining arguments rely on changes in the law that would upset the long-established consensus that Section 12(a)(2) is an equitable claim that authorizes equitable relief. *See Pinter*, 486 U.S. at 641 n.18. Moreover, Defendants' arguments are unpersuasive on the merits.

Defendants contend that because Section 11 and Section 12 claims are similar and Section 11 claims are considered legal for purposes of the Seventh Amendment, Section 12 claims ought to be considered legal too. While Sections 11 and 12(a)(2) are "Securities Act siblings with roughly parallel elements," *Morgan Stanley*, 592 F.3d at 359, they are not identical twins when it comes to the nature of relief each authorizes; indeed, sometimes they are quite different. *See id.* ("Section 12(a)(2) [and Section 11] provide[]*similar* redress . . . ." (emphasis added)). Section 12 authorizes two forms of relief: A buyer who retains ownership over the security may sue under Section 12 for equitable rescission, which limits recovery to "the consideration paid for such security." 15 U.S.C. § 77*l*(a). A buyer who no longer owns the security may sue under Section 12 for "damages," *id.*, "the classic form of *legal* relief," *Knudson*, 534 U.S. at 210 (internal quotation mark omitted) (quoting *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 255 (1993)). *See also Wigand*, 609 F.2d at 1035 ("If [a Section 12(a)(2)] plaintiff owns the stock, he is entitled to rescission . . . ."). Section 11 authorizes only legal "damages." 15 U.S.C. § 77k(e).

Defendants argue further that since a plaintiff who no longer owns the security at issue is entitled to a legal remedy under Section 12(a)(2), the remedy for a plaintiff who still owns the security must be of the same nature. In Defendants' view, a plaintiff should not have the power to manipulate a seller's constitutional right to a jury trial by choosing, through the act of selling or retaining the security, whether the suit will sound in law or in equity. Assuming Defendants are correct that an action for money damages under Section 12(a)(2) is a "Suit[] at common law,"[52] *Eberhard*, 530 F.3d at 135, this case does not involve that situation. Here, the FHFA still owns and can physically return the Certificates as it would be required to do on an equitable rescission claim. Indeed, in issuing its final judgment, the District Court ordered the FHFA to "deliver" the Certificates to Defendants in exchange for the amounts recoverable. Special App. 365-67. Moreover, Defendants' contention that a buyer should not have the power to decide the form of relief sought overlooks the express language of Section 12(a)(2), which authorizes the buyer to sue "either at law or in equity." 15 U.S.C. § 77*l*(a).

Finally, Defendants urge that, at common law, a court of equity could issue an order only against persons who actually "possessed the funds in question and thus were . . . unjustly enriched." *Pereira v. Farace*, 413 F.3d 330, 339 (2d Cir. 2005). Defendants argue that the non-underwriter Defendants cannot be

[52] We express no view on the merits of this position. When a buyer who no longer owns the security successfully sues for damages under Section 12(a)(2), the monetary award "is the substantial equivalent of rescission." *Pinter*, 486 U.S. at 641 n.18. Although, as a "general rule," a money judgment is considered a legal remedy for Seventh Amendment purposes, a restitutionary damages award is sometimes considered equitable relief. *Chauffeurs, Teamsters & Helpers, Local No. 391 v. Terry*, 494 U.S. 558, 570 (1990). *But see Knudson*, 534 U.S. at 213 (explaining that some restitution remedies are legal in nature).

subject to equitable rescission because they did not in fact sell the Certificates nor did they receive funds from the GSEs in exchange for the Certificates. The Supreme Court has made clear that "there is no reason to think that Congress wanted to bind itself to the common-law notion of the circumstances in which rescission [under Section 12(a)(2)] is an appropriate remedy." *Pinter*, 486 U.S. at 647 n.23. "Congress, in order to effectuate its goals, chose to impose [rescission-like] relief on any defendant it classified as a statutory seller, regardless of the fact that such imposition was somewhat inconsistent with the use of rescission at common law." *Id.* As discussed further below, all of the Defendants were statutory sellers.

Accordingly, we reaffirm that, even after the addition of the loss causation defense, a Section 12(a)(2) action allows for equitable relief where the plaintiff still owns the securities and the remedy sought is literal rescission. Such an action is not a "Suit[] at common law," *Eberhard*, 530 F.3d at 135, for purposes of the Seventh Amendment.[53]

[53] The analysis here reflects the difficulty of trying to fit modern legal policy choices onto a grid of legal principles that originated in an agrarian economy reliant on custom to regulate transactional conduct. How many law schools teach remedies today? How many law students have a basic understanding of the genesis and nature of courts of equity?

II. Trial Decision[54]

A. Section 12(a)(2) Claims

1. Statutory Sellers

Defendants contest the District Court's finding that NAAC and NHELI, the PLS depositors for the transactions at issue, were statutory sellers for purposes of Section 12(a)(2). *See Nomura VII*, 104 F. Supp. 3d at 554-55; *UBS I*, 858 F. Supp. 2d at 333-34. Defendants argue that PLS depositors cannot be statutory sellers because they have no direct involvement in passing title in PLS to buyers.[55]

Section 12(a)(2) requires proof that the defendant is a "statutory seller" within the meaning of the Securities Act. *Pinter*, 486 U.S. at 641-42; *see* 15

[54] On appeal from a bench trial, we review findings of fact for clear error and conclusions of law *de novo*. *Beck Chevrolet Co., Inc. v. Gen. Motors LLC*, 787 F.3d 663, 672 (2d Cir. 2015). "Under [the clear error] standard, factual findings by the district court will not be upset unless we are left with the definite and firm conviction that a mistake has been committed." *Henry v. Champlain Enters., Inc.*, 445 F.3d 610, 617 (2d Cir. 2006) (internal quotation marks omitted) (quoting *FDIC v. Providence Coll.*, 115 F.3d 136, 140 (2d Cir. 1997)). Mixed questions of law and fact following a bench trial "are reviewed either *de novo* or under the clearly erroneous standard, depending on whether the question is predominantly legal or predominantly factual." *Krist v. Kolombos Rest. Inc.*, 688 F.3d 89, 95 (2d Cir. 2012) (internal quotation mark omitted; brackets omitted) (quoting *United States v. Skys*, 637 F.3d 146, 152 (2d Cir. 2011)). We review evidentiary rulings for abuse of discretion. *Boyce v. Soundview Tech. Grp., Inc.*, 464 F.3d 376, 385 (2d Cir. 2006).

[55] We review *de novo* this predominantly legal issue. *See Krist*, 688 F.3d at 95.

U.S.C. § 77*l*(a)(2).[56] The Securities Act does not define "statutory seller," however. *See Pinter*, 486 U.S. at 642. Judicial precedent has settled that an entity is a statutory seller if it "(1) 'passed title, or other interest in the security, to the buyer for value,' or (2) 'successfully solicited the purchase of a security, motivated at least in part by a desire to serve [its] own financial interests or those of the securities' owner.'" *Morgan Stanley*, 592 F.3d at 359 (brackets omitted) (quoting *Pinter*, 486 U.S. at 642, 647). SEC Rule 159A provides that, for purposes of Section 12(a)(2), an "issuer" in "a primary offering of securities" shall be considered a statutory seller. 17 C.F.R. § 230.159A(a). The Securities Act in turn defines "issuer" to include "the person or persons performing the acts and assuming the duties of depositor." 15 U.S.C. § 77b(a)(4). SEC Rule 191 further clarifies that "[t]he depositor for . . . asset-backed securities acting solely in its capacity as depositor to the issuing entity is the 'issuer' for purposes of the asset-backed securities of that issuing entity." 17 C.F.R. § 230.191(a).

The combination of this statutory provision and administrative direction makes clear that PLS depositors, such as NAAC and NHELI, are statutory sellers for purposes of Section 12(a)(2). Each is a "depositor for . . . asset-backed securities," specifically RMBS. *See* 17 C.F.R. § 230.191. PLS depositors are thus "issuers." *See* 15 U.S.C. § 77b(a)(4). And, as "issuers," PLS depositors fall within the definition of statutory seller. *See* 17 C.F.R. § 230.159A.

[56] The D.C. Blue Sky law's definition of statutory seller is the same as the Securities Act's definition. *See Hite*, 429 F. Supp. 2d at 115.

Defendants' only avenue of attack on appeal is to contest the validity of Rules 159A and 191. "[A]mbiguities in statutes within an agency's jurisdiction to administer are delegations of authority to the agency to fill the statutory gap in reasonable fashion." *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.* (*Brand X*), 545 U.S. 967, 980 (2005). "*Chevron* requires a federal court to accept [a federal] agency's construction of [a] statute" so long as the statute is ambiguous and the agency's interpretation is reasonable. *Id.* (citing *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council*, 467 U.S. 837, 843-844 & n.11 (1984)). "Only a judicial precedent holding that [a] statute unambiguously forecloses [an] agency's interpretation . . . displaces a conflicting agency construction." *Id.* at 982-83.

Defendants do not and cannot argue that SEC Rules 159A and 191 are unreasonable. Instead, they cite *Pinter v. Dahl* as "a judicial precedent holding that" the Securities Act "unambiguously forecloses" SEC Rules 159A and 191. *See Brand X*, 545 U.S. at 982-83. We disagree. *Pinter* actually stands for the proposition that the Securities Act is *ambiguous* as to the definition of statutory seller. *See* 486 U.S. at 642-47. *Pinter* acknowledged that, given the lack of clear guidance from Congress, statutory seller must include "[a]t the very least . . . the owner who passed title, or other interest in the security, to the buyer for value." *Id.* at 642. But it also observed that Section 12 "is not limited to persons who pass title" for value and that related statutory terms "are expansive enough" for Section 12 "to encompass the entire selling process." *Id.* at 643 (quoting *United States v. Naftalin*, 441 U.S. 768, 773 (1979)). The only element of the statutory seller provision *Pinter* found unambiguous is that "Congress did not intend to impose [Section 12] rescission . . . on a person who urges the purchase but whose motivation is solely to benefit the buyer." *Id.* at 647.

SEC Rules 159A and 191 locate depositors within the selling process for PLS. As the District Court explained, depositors play an essential role in PLS distribution schemes—at the direction of the PLS sponsor, they "purchase the loans . . . and deposit them in a trust," which "creates a true sale of the assets, thereby protecting certificate-holders against the risk of a subsequent bankruptcy by the sponsor." *Nomura VII*, 104 F. Supp. 3d at 463. Rules 159A and 191 therefore accord with *Pinter*'s understanding of the expansive definition of statutory seller. *See* 486 U.S. at 643.

2. Falsity

Defendants contest the District Court's finding that the underwriting guidelines statements were false.

Section 12(a)(2) requires proof that the prospectus at issue contains at least one "untrue statement of a . . . fact or omit[ted] to state a . . . fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77*l*(a)(2); *see Morgan Stanley*, 592 F.3d at 359.[57] "[W]hether a statement is

[57] The standards for falsity under the Virginia and D.C. Blue Sky laws are the same as the federal standards. *See Dunn*, 369 F.3d at 428-29 (applying Section 12(a)(2) case law to the analogous Virginia Blue Sky law provision); *Hite*, 429 F. Supp. 2d at 114

'misleading' depends on the perspective of a reasonable investor: The inquiry . . . is objective." *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015) (discussing misleading omissions in the context of Section 11). The falsity inquiry "requires an examination of 'defendants' representations, taken together and in context.'" *Morgan Stanley*, 592 F.3d at 366 (quoting *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d Cir. 2003)). "The literal truth of an isolated statement is insufficient." *Id.* "[W]hen an offering participant makes a disclosure about a particular topic, whether voluntary or required, the representation must be 'complete and accurate.'" *Id.* (quoting *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992)). Both false statements of fact and false statements of opinion are actionable under Section 12(a)(2). *See Omnicare*, 135 S. Ct. at 1325-27.

a. Factual Summary

This case turns on the following statement, which appeared in each of the ProSupps: "The Mortgage Loans [in the SLGs] have been purchased by the seller from various banks, savings and loan associations, mortgage bankers and other mortgage loan originators and purchasers of mortgage loans in the secondary market, and *were originated generally in accordance with the underwriting criteria* described in this section." J.A. 6884 (emphasis added).[58]

(noting that Section 12(a)(2) case law should be applied in interpreting the analogous D.C. Blue Sky law provision).

[58] Throughout this section we use language from the ProSupp for NAA 2005-AR6 as a representative example unless otherwise

Each ProSupp described that underwriting process:

> Generally, each borrower will have been required to complete an application designed to provide to the original lender pertinent credit information concerning the borrower. As part of the description of the borrower's financial condition, the borrower generally will have furnished certain information with respect to its assets, liabilities, income . . . , credit history, employment history and personal information, and furnished an authorization to apply for a credit report which summarizes the borrower's credit history with local merchants and lenders and any record of bankruptcy. The borrower may also have been required to authorize verifications of deposits at financial institutions where the borrower had demand or savings accounts. In the case of investment properties and two- to four-unit dwellings, income derived from the mortgaged property may have been considered for underwriting purposes, in addition to the income of the borrower from other sources. With respect to mortgaged properties consisting of vacation or second homes, no income derived from the property generally will have been considered for underwriting purposes. In the case of certain borrowers with acceptable compensating factors, income and/or assets

noted. All of the ProSupps contained substantially similar language. *See* J.A. 7174, 7527, 7895, 8296, 8718, 9117.

> may not be required to be stated (or verified) in connection with the loan application.
>
> Based on the data provided in the application and certain verifications (if required), a determination is made by the original lender that the borrower's monthly income (if required to be stated) will be sufficient to enable the borrower to meet their monthly obligations on the mortgage loan and other expenses related to the property such as property taxes, utility costs, standard hazard insurance and other fixed obligations other than housing expenses. Generally, scheduled payments on a mortgage loan during the first year of its term plus taxes and insurance and all scheduled payments on obligations that extend beyond ten months equal no more than a specified percentage not in excess of 60% of the prospective borrower's gross income. The percentage applied varies on a case-by-case basis depending on a number of underwriting criteria, including, without limitation, the loan-to-value ratio of the mortgage loan. The originator may also consider the amount of liquid assets available to the borrower after origination.

Id. at 6884-85.

Each ProSupp also included a warning regarding possible deviations from the underwriting guidelines:

> Certain of the Mortgage Loans have been originated under reduced documentation, no-documentation or no-ratio programs, which require less documentation and verification

> than do traditional full documentation programs. Generally, under a reduced documentation program, verification of either a borrower's income or assets, but not both, is undertaken by the originator. Under a no-ratio program, certain borrowers with acceptable compensating factors will not be required to provide any information regarding income and no other investigation regarding the borrower's income will be undertaken. Under a no-documentation program, no verification of a borrower's income or assets is undertaken by the originator. The underwriting for such Mortgage Loans may be based primarily or entirely on an appraisal of the Mortgaged Property, the loan-to-value ratio at origination and/or the borrower's credit score.

Id. at 6886.

NHELI 2007-3 contained an additional warning regarding originator ResMAE:

> The Depositor is aware that the originators of approximately 79.04% of the Mortgage Loans, by aggregate principal balance as of the Cut-off Date, have filed for bankruptcy protection under the United States Bankruptcy Code. These originators include ResMAE Mortgage Corporation, which originated approximately 77.61% of the Mortgage Loans, by aggregate principal balance as of the Cut-off Date. *Any originator whose financial condition was weak or deteriorating at the time of origination may have experienced personnel*

> *changes that adversely affected its ability to originate mortgage loans in accordance with its customary standards.* It may also have experienced reduced management oversight or controls with respect to its underwriting standards. Accordingly, the rate of delinquencies and defaults on these Mortgage Loans may be higher than would otherwise be the case.

Id. at 9069 (emphasis added).

b. Procedural Summary

The District Court examined the above language in detail.[59] The court interpreted the underwriting guidelines statements as asserting that the supporting loans, with a few immaterial exceptions, were originated in accordance with the underwriting guidelines the originators used to issue the loans.

The court then set out to determine whether in fact the loans in the SLGs were originated generally in accordance with the underwriting guidelines. (As the underwriting guidelines statement is unquestionably one of provable fact, the District Court did not need to consider Defendants' subjective belief in, inquiry into, or knowledge of the truthfulness of the statement. *See Omnicare*, 135 S. Ct. at 1325-26.) The court relied on the testimony of one of the FHFA's experts, Robert Hunter, a consultant with "expertise in residential loan credit issues." *Nomura VII*, 104 F.

[59] The District Court also reviewed statements in the ProSupps regarding loan-to-value ratios and credit ratings and found them to be false. As stated above, we need not address those findings here.

Supp. 3d at 456. Hunter conducted a forensic re-underwriting of 723 sample loans including "100 or close to 100 . . . loans for six of the seven SLGs, and 131 . . . loans for the relevant SLG in NAA 2005-AR6." *Id.* at 522.[60]

Hunter's review entailed comparing "the loan file for each loan to the originator's guidelines." *Id.* at 522. The parties stipulated for the most part to an applicable set of guidelines that were representative of the originators' guidelines at the time the loans were issued. When they did not, Hunter re-underwrote the sample loans using "originators' guidelines that were dated between 30 to 90 days prior to the closing of the loan." *Id.* When those were not available, Hunter analyzed the loans using what he styled "minimum industry standards." *Id.* Hunter's "industry standards" were "the most lenient standards employed for subprime and Alt-A loans between 2002 and 2007" drawn "from the many guidelines he examined and from his professional experience." *Id.* Hunter also used these industry standards to supplement gaps in the originators' guidelines.

Hunter concluded that approximately 66% of the sample loans contained material deviations from the originators' underwriting criteria that negatively affected the creditworthiness of the loans. *Id.* at 523. Hunter also found that "the level of underwriting

[60] This sample was composed by sorting "each SLG's loan population into four strata" by FICO score and then drawing "25 loans at random from each stratum." *Id.* at 495. The drawn loans were then "tested . . . against the corresponding SLGs on eleven separate metrics to ensure that they were adequately representative of the relevant loan populations." *Id.*

defects in the [s]ample was so severe that it was unlikely that any of the loans in the seven SLGs . . . was actually free of defects," *id.* at 541, although some of the defects in the sample were immaterial to credit risk.

Defendants called Michael Forester, founder of "a regulatory compliance, loan review, and internal audit services firm," *id.* at 457, as an expert to contest Hunter's findings. After reviewing Forester's analysis in detail, the District Court concluded that many of his complaints about Hunter's work were "essentially irrelevant." *Id.* at 525. The court also rejected Defendants' objections to Hunter's analysis.

The District Court ultimately credited the bulk of Hunter's analysis. *See id.* at 531. The court, acting as a factfinder and guided by the expert testimony, conducted its own loan-by-loan underwriting analysis. The court confirmed that, as a "conservative" measurement, at least 45% of the loans in each SLG "had underwriting defects that materially affected credit risk." *Id.* at 533. As a result, it found that the ProSupps' descriptions of the supporting loans "as having been 'originated generally in accordance' with originators' guidelines" were false. *Id.*

c. Analysis

On appeal, Defendants contend that the District Court misinterpreted the underwriting guidelines statements. They also argue that the District Court improperly credited Hunter's analysis. Neither argument is persuasive.

1. *The District Court's Interpretation of the Underwriting Guidelines Statements*[61]

Defendants attack the District Court's interpretation of the ProSupps on four grounds. First, they contend the District Court misinterpreted the phrase "the underwriting criteria described in this section" as referring to the underwriting criteria the originators used in issuing the loans. Defendants argue that the ProSupps meant to refer to the underwriting criteria described in the ProSupps themselves.[62] Because the District Court and Hunter re-underwrote the sample loans according to the originators' guidelines, Defendants conclude, their findings are fundamentally flawed.

This argument makes no sense. Defendants urge us to read the ProSupps as stating that the loans in the SLGs "were originated" in accordance with

[61] Although generally we review factual findings following a bench trial for clear error, *see Krist*, 688 F.3d at 95, at Defendants' urging we assume *arguendo* that the proper standard of review for this question of pure textual interpretation is *de novo*. *See Bellefonte Reins. Co. v. Aetna Cas. & Surety Co.*, 903 F.2d 910, 912 (2d Cir. 1990) ("The proper standard for appellate review of a pure textual construction by the district court, whatever the procedural posture of the case, is de novo."); *United States v. Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am.*, 899 F.2d 143, 148 n.5 (2d Cir. 1990) ("We review *de novo* the district court's interpretation of the language of a document such as a contract or a bylaw.").

[62] We assume for purposes of this argument that the originators' guidelines and the guidelines described in the ProSupps were materially different.

underwriting guidelines that the PLS sellers wrote after purchasing and securitizing the loans—that is, *after the loans were originated.* Of course, loans cannot be originated in accordance with guidelines that do not exist until after their creation. In a similar vein, the principal reason why the six later-issued ProSupps included descriptions of the underwriting guidelines was that SEC Regulation AB requires RMBS sponsors in their offering documents to describe "the . . . underwriting criteria *used* to originate . . . pool assets." 17 C.F.R. § 229.1111(a)(3) (emphasis added).[63] It would make little sense to read the ProSupps as stating that guidelines *written after loan origination* were "used to originate" the loans.

Defendants' own actions belie their argument. When Nomura hired Clayton and AMC to conduct pre-acquisition credit and compliance reviews, Nomura instructed it to compare the loan files against the originators' underwriting guidelines. *See Nomura II*, 68 F. Supp. 3d at 451. Furthermore, trial testimony from Nomura employees and others confirms that Defendants, other RMBS issuers and underwriters, as well as Moody's, S&P, and Fitch all understood the underwriter guidelines assertion in the ProSupps to refer to originators' guidelines. *E.g.*, J.A. 4392, 4491, 5355, 6295-96, 6299-300.

Second, Defendants argue that the ProSupps merely describe the *procedures* the originators' used to issue the underlying loans, rather than promise that the loans met the originators' *guidelines criteria.* It

[63] NAA 2005-AR6 was issued before Regulation AB went into effect on January 1, 2006.

would have been "meaningless" to promise compliance with that criteria, Defendants contend, because "investors did not know what those guidelines said." Nomura's Br. 39.

The central flaw in this argument is that it is atextual. The ProSupps affirm that the loans "were originated . . . in accordance with the underwriting *criteria*." Defendants' argument reads the word "criteria" out of that sentence.

Moreover, it would not be meaningless to read the ProSupps as promising that the loans complied with the underwriting guidelines, regardless of whether the reader is familiar with the details of those guidelines. *See ACE Sec. Corp., Home Equity Loan Tr., Series 2006-SL2 v. DB Structured Prods., Inc.*, 25 N.Y.3d 581, 596 (2015) (observing that PLS sponsors generally "warrant[] certain characteristics of the loans"). PLS consumers and the Credit-Rating Agencies—the primary audience for the ProSupps—considered it important that a sponsor warrant in offering documents that loans in the SLGs met the originators' underwriting criteria. This affirmed that the loans in the SLGs survived the gauntlet of the originators' underwriting reviews for creditworthiness, which bore directly on the loans' risk of default. The statement also assured investors that Defendants, through their diligence departments, independently checked that loans satisfied the originators' guidelines criteria. A mere description of the origination process would not accomplish that effect.

Third, Defendants argue that the word "generally"— as in, the loans "were originated *generally* in accordance with the underwriting criteria"—put readers of the ProSupps on notice that loans in the SLGs may deviate *materially* from the underwriting guidelines. The District Court, by contrast, interpreted "generally" to warn only that the SLGs may contain loans with "certain *immaterial* exceptions" to the underwriting guidelines. *Nomura VII*, 104 F. Supp. 3d at 563 (emphasis added; internal quotation marks omitted) (quoting *Nomura II*, 68 F. Supp. 3d at 485).

We agree with the District Court. Defendants' interpretation of "generally" would render the underwriting guidelines statement essentially meaningless. As noted above, readers of the ProSupps looked to this representation for an affirmation that the loans met the underwriting criteria. They would find cold comfort in a promise that contained the significant hedge Defendants urge. Furthermore, Defendants' interpretation of "generally" is undermined by the view of their own expert, Forester, who testified:

> Q. You understand the word "generally" to mean that there may be individual exceptions but that in most cases the statement that the loans were originated in accordance with [underwriting] standards will be accurate; is that right?
>
> A. I would agree with that, yes.

J.A. 6125.[64]

[64] This case is unlike *Glassman v. Computervision Corp.*, where the court held that an analysis of defendants' backlog, from a single one-week period, indicating that 39% of the backlog

Fourth, Defendants argue that the District Court failed to accord proper weight to the explicit warning in the ProSupp for NHELI 2007-3 that ResMAE's weak "financial condition . . . at the time of origination may have . . . adversely affected its ability to originate mortgage loans in accordance with its customary standards." J.A. 9069. They argue that this specific hedge superseded the more general statements about the quality of the supporting loans writ large. *See Omnicare*, 135 S. Ct. at 1330 ("[A]n investor reads each statement . . . in light of all its surrounding text, including hedges . . . .").

The problem with this argument is that the warning was too equivocal to hedge adequately against the ProSupps' later statements regarding compliance with underwriting guidelines. The vague warning that ResMAE's bankruptcy "may have . . . adversely affected its ability to originate mortgage loans in accordance with its customary standards" was insufficient to put the reader on notice that a critical mass—nearly 50%—of the loans in the pertinent SLG were not originated properly. J.A. 9069. Furthermore, despite the warning the ProSupp affirmed that ResMAE "fully reviews each loan to determine whether [its underwriting] guidelines . . . are met." *Id.* at 9113. That watered down any of the marginal

balance at that time would ship in over 30 days did not render false their representation that "shipments are generally made within thirty days of receiving an order." 90 F.3d at 634. Here, Defendants failed to comply with their affirmations at a rate of nearly 50% for multiple years, infecting multiple complex financial products with material defects in the process.

ameliorative effect the ProSupp's earlier warning might have had.

2. The District Court's Falsity Findings[65]

Defendants also challenge the District Court's crediting of Hunter's expert testimony and finding based thereon that at least 45% of the loans in the SLGs were originated with underwriting defects.

Their arguments, at best, marginally undercut the substance of Hunter's analysis.[66] We find in them no basis to second guess the District Court's adoption of Hunter's findings.

Defendants further argue that it was improper for the District Court, which lacks the expertise of Hunter and Forester, to conduct its own confirmatory re-underwriting analysis. We disagree. The court conducted this analysis in its capacity as fact-finder. A fact-finder is not required to make a binary choice between adopting an expert's conclusion in full or rejecting it entirely. *See United States v. Duncan*, 42

[65] We review this factual finding for clear error. *See Krist*, 688 F.3d at 95.

[66] Defendants lodge the following objections to Hunter's analysis: Hunter testified that he was "a little stricter" than he imagined the originators' underwriters were when making loan issuance decisions, J.A. 11736; Hunter made a "defect" finding when he "disagreed" with the originator's "judgment," *id.*; Hunter found a disproportionately low number of loans that were originated with "exceptions" based on "compensating factors," calling into question the reliability of all of his findings, i*d.* at 11737-40; and Hunter's "minimum industry standards" were marginally stricter than the lowest observed standard in the RMBS industry at the time, *see id.* at 11726-29, 11783.

F.3d 97, 101 (2d Cir. 1994) (explaining that expert testimony should not "tell the jury what result to reach" but "*aid* the jury in making a decision") (emphasis in original). Furthermore, any error the District Court committed in crediting only a portion of Hunter's testimony would be harmless. *See* 28 U.S.C. § 2111. The court made clear that "[i]f limited to the stark choice between Hunter's expert testimony and Forester's, [it] would unhesitatingly accept Hunter's." *Nomura VII*, 104 F. Supp. 3d at 531.[67]

For the foregoing reasons, Nomura offers no basis to reverse the District Court's finding that the ProSupps' underwriting guidelines assertion was false.

3. Materiality

Defendants contest the District Court's finding that the underwriting guidelines statements were material.

Section 12(a)(2) requires proof that each false statement or omission was material. *See* 15 U.S.C. § 77*l*(a)(2); *Morgan Stanley*, 592 F.3d at 359. Whether a statement or omission is material is an objective, totality-of-the-circumstances inquiry. *TSC Indus.,*

[67] Defendants also argue that the District Court failed to make detailed findings explaining why it accepted only a portion of Hunter's defect findings. Federal Rule of Civil Procedure 52(a) requires a court following a bench trial to "make sufficiently detailed findings to inform the appellate court of the basis of the decision and to permit intelligent appellate review." *T.G.I. Friday's Inc. v. Nat'l Rests. Mgmt., Inc.*, 59 F.3d 368, 373 (2d Cir. 1995) (quoting *Krieger v. Gold Bond Bldg. Prods.*, 863 F.2d 1091, 1097 (2d Cir. 1988)). The District Court's 361-page trial opinion satisfies that requirement.

Inc. v. Northway, Inc., 426 U.S. 438, 445, 449 (1976). A material fact is one that "assume[s] actual significance" for a reasonable investor deciding whether to purchase the security at issue, but it need not be outcome-determinative. *Id.* at 449; *see Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533 (2d Cir. 1991). "In the Second Circuit," a statement or omission is material "if a reasonable investor would view [it] as 'significantly altering the "total mix" of information made available.'" *Stadnick v. Vivint Solar, Inc.*, 861 F.3d 31, 36 (2d Cir. 2017) (brackets omitted) (quoting *TSC Indus., Inc.*, 426 U.S. at 449); *see Basic*, 485 U.S. at 231-32.

Here, the District Court easily found that the ProSupps' underwriting guidelines statements were material. *Nomura VII*, 104 F. Supp. 3d at 557-59, 570-73.[68] The court began by presuming materiality for any description in the ProSupps that deviated by 5% or more from the loans' true characteristics. *See id.* at 558. It drew the 5% figure from two sources: First, five of the ProSupps promised that Defendants would issue supplementary disclosures in the event that "any material pool characteristic differs by 5% or more from the description in this [ProSupp]." *Id.*; *see also* Asset-Backed Securities, SEC Release No. 8518, 84 SEC Docket 1624, *available at* 2004 WL 2964659, at *235 (Dec. 22, 2004) (requiring supplemental disclosure "if any material pool characteristic of the actual asset pool at the time of issuance of the asset-backed securities differs by 5% or more . . . from the

[68] The District Court also found that the ProSupps' loan-to-value ratio and credit ratings statements were material, but as explained above, we need not review those findings here.

description of the asset pool in the prospectus"). Second, SEC administrative guidance, which we have repeatedly cited with approval, counsels that 5% falsity for statements in offering documents may provide "a preliminary assumption" of materiality. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,151 (Aug. 19, 1999); *see Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 717 (2d Cir. 2011); *ECA, Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 197-98 (2d Cir. 2009); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 163-64 (2d Cir. 2000). The court found that the underwriting guidelines statements far exceeded that threshold, as at least 45% of the loans in the SLGs did not adhere to the originators' underwriting criteria. *Nomura VII*, 104 F. Supp. 3d at 571. The court then confirmed its presumption of materiality by demonstrating how loans that do not adhere to underwriting criteria have higher default rates, and as a result, affect a reasonable investor's view of the value of PLS supported by such loans. *Id.*

On appeal, Defendants raise five challenges to the District Court's materiality analysis—one procedural, two substantive, and two evidentiary.[69] We address each in turn.

a. Procedural Challenge: Use of a Numerical Threshold

[69] Materiality is a mixed question of law and fact. *See TSC Indus.*, 426 U.S. at 450. We review Defendants' primarily legal challenges *de novo* and primarily factual challenges for clear error. *See Krist*, 688 F.3d at 95. We review related evidentiary challenges for abuse of discretion. *See Boyce*, 464 F.3d at 385.

Defendants argue that the District Court employed a legally erroneous process for deciding materiality because it relied in part on a numerical threshold. *See Nomura VII*, 104 F. Supp. 3d at 558.

Although "we have consistently rejected a [purely] formulaic approach to assessing the materiality of an alleged misrepresentation," *Hutchison v. Deutsche Bank Sec. Inc.*, 647 F.3d 479, 485 (2d Cir. 2011) (alteration omitted) (quoting *Ganino*, 228 F.3d at 162), we have permitted courts to conduct materiality analyses that are partially quantitative, *see Litwin*, 634 F.3d at 717. A numerical threshold is no substitute for a fulsome materiality analysis that also considers qualitative factors, but it can provide "'a good starting place for assessing the materiality of [an] alleged misstatement.'" *Hutchison*, 647 F.3d at 487 (quoting *ECA, Local 134 IBEW Joint Pension Trust of Chi.*, 553 F.3d at 204); *see also id.* at 485. Indeed, an "integrative" materiality analysis will consider both quantitative factors and qualitative factors to determine whether a reasonable investor would have considered the misstatement or omission significant in making an investment decision. *Litwin*, 634 F.3d at 717.

The District Court in this case did exactly what we require. The court began with a reasonable quantitative analysis, using 5% falsity as a threshold for materiality. *See Nomura VII*, 104 F. Supp. 3d at 558. The court then turned to qualitative factors. It found "overwhelming, and essentially undisputed, evidence that" the ProSupps' false underwriting guidelines statements "would be viewed by the reasonable PLS investor as significantly altering the total mix of information available." *Id.* at 570. Indeed, Defendants' own witnesses agreed that, as a general matter, adherence to underwriting criteria is a reliable indicator of mortgage loan default rates, and the return for a PLS certificate is a function of the degree to which such loans are repaid. The court therefore concluded that a reasonable investor deciding whether to invest in PLS would consider the underwriting guidelines statements crucial to his or her investment decision. *See id.* at 570-71. The court buttressed its qualitative materiality conclusion by noting that defense counsel admitted in summation that the supporting loans' rate of adherence to the underwriting guidelines "could be material to an investor." *Id.* at 571 n.185.

The District Court's opinion is a textbook example of an integrative materiality analysis that considers "both quantitative and qualitative factors." *See Litwin*, 634 F.3d at 717 (internal quotation marks omitted) (quoting SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. at 45,151). We find no legal error in the court's use of a numerical threshold to inform its decision.

b. Substantive Challenge: The Trade Date

Defendants challenge the substance of the District Court's materiality decision first on the ground that none of the ProSupps' statements could have been material because the GSEs did not receive the ProSupps until after the so-called "trade dates."

1. Factual Summary

The Securities Act requires virtually every written offer of securities to qualify as a prospectus under Section 10. 15 U.S.C. § 77e(b)(1). Section 10 provides for two types of permissible prospectuses. The default type is a written offer that meets intensive disclosure requirements listed in Section 10(a), sometimes called a "Section 10(a) prospectus." *Id.* § 77j(a); *see* 17 C.F.R. § 229.1100 *et seq.* Alternatively, Section 10(b) permits the SEC to promulgate rules expanding the definition of a Section 10 prospectus to include offerings that "omit[] in part or summarize[]information" required by Section 10(a), sometimes called a "Section 10(b) prospectus." 15 U.S.C. § 77j(b).[70]

For years after the passage of the Securities Act, the SEC did not promulgate any rules pursuant to Section 10(b). During that time, every written offer of securities needed to comply with the detailed requirements of Section 10(a). *See FHFA v. Bank of Am. Corp.*, No. 11cv6195, 2012 WL 6592251, at *3-4 (S.D.N.Y. Dec. 18, 2012).

In 2005, the SEC invoked its Section 10(b) power for the first time when it promulgated Rule 164 and associated rules. These rules liberalize the offering process by permitting certain issuers to make initial written offers of securities using "free writing prospectuses." 17 C.F.R. §§ 230.164, 230.405; *see* Securities Offering Reform, SEC Release No. 75, 2005

[70] A Section 10(a) prospectus is not perfectly interchangeable with a Section 10(b) prospectus. For example, Section 5(b)(2) provides that it is unlawful to sell or deliver a registered security by means of interstate commerce unless accompanied or preceded by a Section 10(a) prospectus. *See id.* § 77e(b)(2).

WL 1692642, at *37-38. Free writing prospectuses may be used only if, *inter alia*, (1) the offered security is subject to a filed registration statement and to a base prospectus, 17 C.F.R. § 230.433, and (2) the issuer transmits a Section 10(a) prospectus to the SEC "no later than the second business day following . . . the date of the determination of the offering price" of the security, *id.* § 230.424(b)(5). The information in a free writing prospectus and the information in the final Section 10(a) prospectus "shall not conflict." *Id.* § 230.433(c)(1).

Defendants sold the Certificates at issue here in a fluid process that relied on the use of free writing prospectuses. They contacted GSE traders to offer a PLS certificate sale, and if a trader was interested, transmitted a free writing prospectus containing some (but not all) of the information regarding the loans in the SLG. After reviewing the free writing prospectus, the GSE trader and Defendants made mutual commitments to purchase and to sell the Certificate described in it. The date of this commitment is known as the "trade date."

Within roughly a month following the trade date, the GSE transferred payment to Defendants, who in turn transferred title in the Certificate to the GSE, on what is known as the "settlement date." Defendants filed a ProSupp with the SEC within one day of the settlement date and delivered the ProSupp to the GSE shortly thereafter. The ProSupp contained the balance of the detailed information regarding the supporting loans and served as Defendants' final Section 10(a) prospectus for purposes of 17 C.F.R. § 230.424(b)(5).

Each transaction was conditioned on Defendants' promise that the ProSupp would not reveal a material difference between the true character of the supporting loans and those described in the free writing prospectus. *Cf. id.* § 230.433(c)(1) (providing that a free writing prospectus and prospectus supplement "shall not conflict"). Conditional agreements of this sort were common in the market for asset-backed securities at the time. As comments to the SEC explained, "asset-backed securities offerings involved conditional contracts where investors agreed to purchase securities before they had all the prospectus information." Securities Offering Reform, SEC Release No. 75, 2005 WL 1692642, at *75 n.407. If a ProSupp revealed "new or changed information" that differed materially from the loan descriptions in the free writing prospectus, the GSE would be "given the opportunity to reassess [its] purchase decision[]." *See id.*

2. Analysis

With that context in mind, it is clear that the ProSupps, although transmitted after the GSEs initially committed to purchase the Certificates, could be material to the GSEs' purchase decisions. *See, e.g.*, *N.J. Carpenters Health Fund II*, 709 F.3d at 125-28 (holding statements in RMBS prospectus supplements could be material); *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 773 (1st Cir. 2011) (same). The ProSupps served dual functions of filling informational gaps left by the free writing prospectus offerings while also confirming that the loan quality representations in those initial offering documents were truthful in all material respects. In so doing, the ProSupps assumed the material role of convincing the GSEs to finalize the transactions. *Cf. Field v. Trump*, 850 F.2d 938, 948 (2d Cir. 1988) (concluding that misstatements or omissions that "lull" plaintiffs "into forgoing" a unilateral right are material).

A contrary result would undermine the Securities Act's "philosophy of full disclosure." *See Basic*, 485 U.S. at 234 (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)). It is fundamental to the Act that every sale of registered securities must be preceded or accompanied by a Section 10(a) prospectus without any material misstatements or omissions on pain of civil liability. *See* 15 U.S.C. §§ 77e(b)(2), 77*l*. The ProSupps were the sole Section 10(a) prospectuses delivered in these transactions. If they were categorically immaterial because of their dates of transmission, Defendants could be held to account only for statements made in free writing prospectuses, which may "omit[] in part or summarize[]information," 15 U.S.C. § 77j(b), and would no longer face the possibility of civil litigation for failing to satisfy the full disclosure requirements of Section 10(a). The Act does not permit such an outcome.

c. Substantive Challenge: The Reasonable Investor Standard

Defendants further attack the substance of the court's materiality holding by arguing that the ProSupps' underwriting guidelines statements would not have "assumed actual significance" to a reasonable investor in the GSEs' shoes. *See TSC Indus.*, 426 U.S. at 449. Defendants contend that, given the GSEs' unique power in the RMBS market, the analysis in this case should have focused on whether a reasonable investor *with the GSEs' knowledge and investment purposes*, rather than a reasonable generic buyer of PLS certificates, would have considered the underwriting guidelines statements material. This more-specific reasonable investor, Defendants claim, would have valued less the credit quality of the loans backing the Certificates because the GSEs' driving purpose for purchasing PLS certificates was to meet a statutorily-mandated goal of devoting a percentage of their loan portfolio to low- and moderate-income housing, not to secure a return on investment. Defendants further argue that, to the extent the GSEs valued such a return, the credit enhancements of the GSEs' senior tranche Certificates meant that the quality of the loans would have no more than a *de minimis* impact on their returns on these investments.

1. Factual Summary

In 1992, Congress imposed on the GSEs "an affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return." Federal Housing Enterprises Financial Safety and Soundness Act, Pub. L. No. 102-550, § 1302(7), 106 Stat. 3491 (codified at 12 U.S.C. § 4501(7)). Congress delegated authority to administer this mandate to the U.S.

Department of Housing and Urban Development ("HUD").[71]

HUD set annual requirements for the percentage of the GSEs' loan portfolios that were required to be devoted to low- and moderate-income housing. *See* Federal Housing Enterprises Financial Safety and Soundness Act, § 1331, 106 Stat. at 3956 (codified as amended at 12 U.S.C. § 4561). In 1993, HUD required the GSEs to devote 30% of their portfolios to low- and moderate-income housing. *See* 58 Fed. Reg. 53048, 53049 (Oct. 13, 1993). By 2006, HUD's requirement grew to 53%. The penalties for failing to meet HUD's low-income housing goals were severe. The GSEs' executives' compensation was tied to meeting HUD's goals. HUD could also send the GSEs cease-and-desist letters and assess civil monetary penalties against them.

The GSEs were entitled to count loans backing PLS toward HUD's low- and moderate-income housing goals. *See* 24 C.F.R. § 81.16(c)(2). The GSEs negotiated with Defendants and other PLS sellers for the right to select certain loans for the SLGs backing the Certificates to ensure that those loans met HUD's criteria. The GSEs knew that mortgage loans issued to borrowers with lower income came with an increased risk of default. Hence, they secured credit enhancements to protect their investments in the Certificates.

[71] In 2008, after the conduct at issue in this case, Congress repealed this version of the GSEs' low-income housing mandate and replaced it with a new scheme administered by the FHFA. *See* HERA, § 1128, 122 Stat. at 2696-703.

2. Analysis

"The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor." *TSC Indus.*, 426 U.S. at 445. For that reason, the GSEs' HUD-mandated investment goals have no role to play in the reasonable investor test in this case. A court is not required to import the subjective motives of a particular plaintiff into its materiality analysis.

The reasonable investor was designed to stand in for all securities offerees, whose purposes for investing and experiences with financial products may vary. Limiting the reasonable investor's intentions and knowledge to the plaintiff's subjective features would undermine that design. *See Basic*, 485 U.S. at 234.

Defendants' definition of the reasonable investor is not compelled by the rule that a court assessing the materiality of a statement must consider the offering documents "taken together and in context." *See Rombach v. Chang*, 355 F.3d 164, 172 n.7 (2d Cir. 2004) (quoting *I. Meyer Pincus & Assocs., P.C., v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 761 (2d Cir. 1991)). A court must, of course, consider the statement at issue in the context of the objective features surrounding *the sale* and *the seller*. That context includes, for example, all facts related to the statement or omission, its surrounding text, the offering documents, the securities, the structure of the transaction, and the market in which the transaction occurs. *See Omnicare*, 135 S. Ct. at 1330 ("[A reasonable] investor takes into account the customs and practices of the relevant industry."); *Freidus v.*

Barclays Bank PLC, 734 F.3d 132, 140 (2d Cir. 2013) (considering the materiality of misstatements and omissions in light of the "deteriorating credit market"). The context Defendants contend the District Court improperly ignored is different. They argue that the District Court should have considered subjective facts about *the buyers* and their motives for engaging in the transaction. We find no support for that position.

In any event, we would affirm even assuming *arguendo* that a reasonable investor would have shared the GSEs' subjective purpose of purchasing PLS certificates to meet HUD-mandated housing targets. Materiality casts a net sufficiently wide to encompass every fact that would significantly alter the total mix of information that a reasonable investor would consider in making an investment decision. *See Basic*, 485 U.S. at 231-32. An interest in whether the loans backing a particular PLS met HUD's definition of low- and moderate-income housing does not exist to the exclusion of a profit motive. Indeed, the fact that the GSEs sought credit protection for their investments indicates that they cared whether the PLS certificate would yield a reliable return. And, as explained above, a reasonable investor in PLS would consider the creditworthiness of the supporting assets material to his or her projection of the securities' total return.

Defendants similarly misplace their reliance on the GSEs' interest in credit protections. This argument erroneously implies a zero-sum game where, on the one hand, an investor either has no credit protection and therefore cares deeply about the credit quality of the loans or, on the other, has strong credit protection and therefore considers the credit quality of the loans irrelevant. Credit enhancement is one important factor that a reasonable investor would consider when deciding whether to invest in PLS. But credit enhancement is not so important that, alone, it would cause an investor to ignore entirely the quality of the loans in the SLG. As one of Defendants' witnesses explained, "[i]nvestors balanced the degree of credit enhancement against the expected losses on the underlying collateral, which generally depended on . . . collateral characteristics." J.A. 5226. In other words, the riskier the sponsor represents the loans to be, the more credit protection an investor will seek. It is crucial that a reasonable investor know the true nature of the collateral to ensure that her credit protection is appropriately tethered to the risk of default.

d. Evidentiary Challenges

Finally, Defendants argue that the District Court erred in excluding two categories of evidence related to materiality. First, Defendants argue the court improperly excluded evidence that showed the GSEs, through their Single Family Businesses, knew of the shoddy mortgage origination processes. Second, Defendants argue the court improperly excluded evidence of the GSEs' HUD-mandated housing targets, which they contend are relevant for the reasons described above.

The District Court granted the FHFA's motion *in limine* to exclude the above evidence under Federal Rule of Evidence 403 because the court found its probative value substantially outweighed by the prejudicial effect of injecting the issue of reliance into the trial. *Nomura III*, 2014 WL 7229361, at *3-4; *see also Morgan Stanley*, 592 F.3d at 359 ("[P]laintiffs bringing claims under sections 11 and 12(a)(2) need not allege . . . reliance . . . ."). At the time the court rendered its initial Rule 403 decision, the FHFA's Section 11 claims were still in the case, and thus the case was still set for a jury trial. After the trial was converted into a bench trial, the court maintained that the evidence violated Rule 403 and held in the alternative that such evidence was irrelevant. *Nomura VII*, 104 F. Supp. 3d at 593.

We conclude that the District Court did not abuse its discretion on the basis that the challenged evidence was irrelevant to whether the ProSupps' false statements regarding underwriting guidelines were material.

The GSEs' general knowledge of the mortgage market was irrelevant to materiality. As explained above, the GSEs were entitled to treat Defendants' loan quality representations as promises that the loans in these specific SLGs were not a representative cross-section of available mortgage loans but rather a select group of loans with the qualities described in the ProSupps. That the loans differed from those qualities would have affected a reasonable investor's view of the Certificate regardless of that investor's knowledge about mortgage market generally.

The GSEs' housing mandates were similarly irrelevant. However important HUD's housing mandates were to the GSEs' PLS investment decisions, they would not render immaterial to a reasonable investor in the GSEs' position whether or not the investment would produce a financial return.

4. Negative Loss Causation

Defendants appeal the District Court's denial of their negative loss causation defense.

Section 12(b) permits a defendant to seek a reduction in the plaintiff's Section 12 award equal to the depreciation in value of the security not resulting from the material misstatement or omission at issue. *See* 15 U.S.C. § 77*l*(b); *Morgan Stanley*, 592 F.3d at 359 n.7. The text of Section 12(b) plainly provides that loss causation is an affirmative defense to be proven by defendants, not a *prima facie* element to be proven by plaintiffs. *See* 15 U.S.C. § 77*l*(b) (placing the burden of proof on "the person who offered or sold [the] security"); *McMahan*, 65 F.3d at 1048. The burden to prove negative loss causation is "heavy," given "Congress' desire to allocate the risk of uncertainty to the defendants in [Securities Act] cases." *Akerman v. Oryx Commc'ns, Inc.*, 810 F.2d 336, 341 (2d Cir. 1987); *see also NECA*, 693 F.3d at 156 (observing that the Securities Act creates *in terrorem* liability designed to encourage full disclosure by offerors).

Defendants relied on the testimony of two experts, Kerry Vandell and Timothy Riddiough, to meet their burden. Both experts opined that *the entirety* of the Certificates' losses were attributable to macroeconomic factors related to the 2008 financial crisis and not attributable to the ProSupps' misrepresentations. Faced with the "all-or-nothing proposition" that the Certificates' losses either were or were not "caused entirely by factors other than any material misrepresentations," the court sided with the

FHFA. *Nomura VII*, 104 F. Supp. 3d at 541. The court agreed that the financial crisis played a role in the Certificates' reductions in value, but concluded that Defendants failed to disaggregate the crisis from the ProSupps' misstatements. As a result, the macroeconomic financial downturn provided no basis to reduce the FHFA's award. *See id.* at 585-93. On appeal, Defendants reiterate their arguments that the Certificates lost value as a product of macroeconomic factors related to the 2008 financial crisis, and that the ProSupps' misstatements or omissions are not causally linked to that crisis.[72]

Although Defendants have maintained that, "through trial, six of the seven Certificates at issue paid . . . every penny, and on the seventh, realized losses were $25 million," Nomura's Br. 72, it is clear that the Certificates have suffered loss. "[T]he value of a security may not be equivalent to its market price." *McMahan*, 65 F.3d at 1048. In the context of RMBS,

> basic securities valuation principles—discounting future cash flows to their present value using a rate of interest reflecting the cash flows' risk—belie the proposition that a fixed income investor must miss an interest payment before his securities can be said to have declined in "value." . . . [B]ecause the loans backing the Certificates were riskier than defendants represented, the future cash

[72] We review *de novo* whether the District Court applied the proper legal standards in assessing Defendants' loss causation defense, and we review for clear error the court's application of those standards to the facts of this case. *See Miller v. Thane Int'l, Inc.*, 615 F.3d 1095, 1104 (9th Cir. 2010); *Krist*, 688 F.3d at 95.

> flows to which [the Certificate-holder] was entitled. . . required a higher discount rate once the Offering Documents' falsity was revealed, resulting in a lower present value. Put differently, the revelation that borrowers on loans backing the Certificates were less creditworthy than the Offering Documents represented affected the Certificates' "value" immediately, because it increased the Certificates′ credit risk profile. In this analysis, whether Certificate-holders actually missed a scheduled coupon payment is not determinative.

NECA, 693 F.3d at 166.

The District Court's task was to determine the cause of that loss. Given that Defendants bore the burden of proof on this issue, the court correctly began with the presumption that "any decline in value" was "caused by the [ProSupps'] misrepresentation[s]." *See McMahan*, 65 F.3d at 1048. Defendants could break that causal link only by proving that "the risk that caused the loss[es] was [not] within the zone of risk concealed by the misrepresentations and omissions." *See Lentell*, 396 F.3d at 172 (emphasis omitted). In other words, they were required to prove that "the subject" of the ProSupps' misstatements[73] and omissions was not "the cause of the actual loss

[73] While the District Court stated that Defendants were required to show that the loss in value was caused "by events unrelated to the phenomena," *Nomura VII*, 104 F. Supp. 3d at 589, which is an arguably higher standard than the standard in *Lentell*, Defendants did not meet the lower bar either.

suffered." *See Suez Equity Inv'rs, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001).

We agree with the District Court that Defendants failed to break the link between the Certificates' reduction in value and the ProSupps' misstatements. We previously suggested that "there may be circumstances under which a marketwide economic collapse is itself caused by the conduct alleged to have caused a plaintiff's loss, although the link between any particular defendant's alleged misconduct and the downturn may be difficult to establish." *Fin. Guar. Ins. Co. v. Putnam Advisory Co., LLC* (*Putnam Advisory*), 783 F.3d 395, 404 n.2 (2d Cir. 2015).[74] The largely uncontested record evidence suggests that this was such a case. The District Court found that "shoddy [mortgage-loan] origination practices" of the sort concealed by the ProSupps' misstatements "contributed to the housing bubble" that created the 2008 financial crisis. *Nomura VII*, 104 F. Supp. 3d at 587; *id.* at 536-40; *see also* Bubb & Krishnamurthy, *supra*, at 1550-55 (arguing that overinflated expectations of expansions in the housing market created a bubble, which in turn led to the financial crash); Levitin & Wachter*, supra*, at 1202-10 (arguing that the housing bubble was the product of the PLS

[74] This suggestion came in the context of a claim under Section 10(b) of the Exchange Act, which requires the plaintiff to prove loss causation as a *prima facie* element. *See* 15 U.S.C. § 78u-4(b)(4). We express no opinion about whether the FHFA could have met that burden in this case. We conclude only that Defendants failed to *disprove* that the market-wide collapse in 2008 was connected to the ProSupps' misstatements.

market providing an oversupply of housing finance).[75] Defendants agreed "that there is a link between the securitization frenzy associated with those shoddy practices and the very macroeconomic factors that they say caused the losses to the Certificates." *Nomura VII*, 104 F. Supp. 3d at 587. They therefore failed to rupture the causal connection between "the subject" of the ProSupps' misstatements and the loss the GSEs suffered. *See Suez Equity Inv'rs*, 250 F.3d at 95.

The District Court concluded that the 2008 financial crisis was, if anything, an impediment to Defendants' attempt to carry their burden to prove negative loss causation. *See Nomura VII*, 104 F. Supp. 3d at 586-87. That was consistent with our prior statements regarding loss causation and macroeconomic crises. A financial crisis may stand as an impediment to proving loss causation because it can be difficult to identify whether a particular misstatement or macroeconomic forces caused a security to lose value in the fog of a coincidental market-wide downturn. *See Lentell*, 396 F.3d at 174. When a plaintiff alleges a violation of the Exchange Act, defendants benefit from the opacity of a financial crisis because the burden is on the plaintiff to prove

[75] The court "confirm[ed]" this finding by relying on similar observations in a 2011 report published by the U.S. Financial Crisis Inquiry Commission, which we have cited favorably in the past. *Nomura VII*, 104 F. Supp. 3d at 586 n.196; *see Putnam Advisory*, 783 F.3d at 404 n.2 (citing FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 190-95 (2011)). This was not reversible error. The court did not admit this report into evidence, nor did it rely on this report in reaching any of its factual findings. *See Nomura VII*, 104 F. Supp. 3d at 586 n.196.

loss causation as a *prima facie* element. *See id.* at 172. When a plaintiff alleges a violation of the Securities Act, loss causation is not a *prima facie* element but an affirmative defense. *McMahan*, 65 F.3d at 1048. The burden is then on defendants to prove loss causation, and any difficulty separating loss attributable to a specific misstatement from loss attributable to macroeconomic forces benefits the plaintiff. *See id.* (presuming absent proof to the contrary that any decline in value is caused by the misstatement or omission in the Securities Act context).

Defendants argue that the record clearly refutes the District Court's findings. They contend that testimony from Riddiough, Vandell, and FHFA loss-causation expert James Barth, as well as the GSEs' statements in legal briefs in other cases, SEC filings, and internal documents, all reveal that market-wide forces caused the Certificates to lose value. Even accepting Defendants' view of the trial evidence, we find no basis for reversal. It is uncontested that the housing market and related macroeconomic forces were partial causes of the Certificates' losses. The crucial point that doomed Defendants' loss causation defense is that those macroeconomic forces and the ProSupps' misstatements *were intimately intertwined.* The financial crisis may have been an important step in between the ProSupps' misstatements and the Certificates' losses, but all three events were linked together in the same causal chain. *See Nomura VII*, 104 F. Supp. 3d at 592 ("[The financial crisis] cannot be 'intervening' if [D]efendants' misrepresentations, and the underlying facts they concealed, were part and parcel of it.”).[76]

Finally, we reject Defendants’ argument that the ProSupps’ misstatements and the financial crisis were not connected because any contribution the ProSupps made to that crisis was “[t]iny.” Nomura’s Br. 85. Rarely, if ever, is it the case that one can point to a single bad actor or a single bad act that brought an entire financial system to its knees. Financial crises result when whole industries take unsustainable systemic risks. *See* John C. Coffee, Jr., *Systemic Risk after Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 797 (2011) (“In 2008, . . . a localized economic shock in [the U.S.] subprime mortgage market . . . nearly caused the meltdown of worldwide capital markets as that shock was transmitted through counterparties and global markets with the speed of a tsunami.”); Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 670-77 (2012) (explaining the systemic risk in the market for homeloan securitizations); *see also* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008) (defining systemic risk). The ProSupps’ misstatements contributed to the systemic risk in the PLS market in the mid-2000s. Defendants may not hide behind a market downturn that is in part

[76] The District Court did not abuse its discretion in excluding portions of Vandell’s testimony. *See FHFA v. Nomura Holding Am., Inc.*, No. 11cv6201, 2015 WL 539489, at *6-9 (S.D.N.Y. Feb. 10, 2015); *see Boyce*, 464 F.3d at 385.

their own making simply because their conduct was a relatively small part of the problem.

B. Blue Sky Claims

Even when a plaintiff prevails under Section 12(a)(2), the analogous Virginia and D.C. Blue Sky provisions require proof of an additional element to trigger relief—that the securities transaction(s) at issue occurred within the regulating jurisdiction. The District Court found that the FHFA met its burden of proof on this element. *Nomura VII*, 104 F. Supp. 3d at 595-97. Defendants contest that finding.[77]

1. Blue Sky Jurisdiction

"[B]lue-sky laws . . . only regulate[] transactions occurring within the regulating States." *Edgar v. MITE Corp.*, 457 U.S. 624, 641 (1982); *see* UNIF. SEC. ACT § 414(a) (1956); D.C. CODE § 31-5608.01(a) (providing that the D.C. Blue Sky law applies "when an offer to sell is made in [D.C.] or an offer to purchase is made and accepted in [D.C.]"); *Lintz*, 613 F. Supp. at 550 (observing that the Virginia Blue Sky law applies only to securities transactions that occurred in Virginia). A securities transaction occurs where each party "incur[s] irrevocable liability." *Absolute Activist Value Master Fund Ltd. v. Ficeto* (*Absolute Activist*), 677 F.3d 60, 68 (2d Cir. 2012). That may be more than one location. For example, if the buyer "incur[s] irrevocable liability . . . to take and pay for a security" in New York and the "seller incur[s] irrevocable liability . . . to deliver a security" in New Jersey, the

[77] We review this predominantly factual issue for clear error. *See Krist*, 688 F.3d at 95.

transaction occurs in both New York and New Jersey. *See id.*

It is undisputed that Defendants did not incur liability to deliver the Certificates in either D.C. or Virginia. The FHFA triggered Blue Sky liability by proving that Fannie incurred irrevocable liability to purchase NAA 2005- AR6 in D.C. and that Freddie incurred irrevocable liability to purchase NHELI 2006-FM2, NHELI 2007-1, and NHELI 2007-2 in Virginia.

2. The D.C. PLS Transaction

The District Court found that the NAA 2005-AR6 transaction occurred in D.C. based on the following facts: Fannie's principal place of business was D.C.; Fannie's PLS traders worked in D.C.; Nomura emailed offering materials to Fannie's PLS traders' work email addresses; and Nomura sent a physical confirmation of purchase to Fannie's D.C. headquarters. *Nomura VII*, 104 F. Supp. 3d at 597. On appeal, Defendants do not contest those findings, but argue they fail to provide a sufficient basis for D.C. Blue Sky liability.

First, Defendants argue that the mere fact that Fannie's principal place of business is in D.C. "does not affect where the transaction occur[red]." Nomura's Br. 93 (internal quotation mark omitted) (quoting *Absolute Activist*, 677 F.3d at 69).[78] That is accurate, but is insufficient to require reversal. The District

[78] Nomura slightly misquoted *Absolute Activist*. *See* 677 F.3d at 69 (noting that "[a] purchaser's citizenship or residency does not affect where *a* transaction occurs" (alteration in original) (emphasis added) (quoting *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reins. Co.*, 753 F. Supp. 2d 166, 178 (S.D.N.Y. 2010))).

Court's finding that Fannie purchased a Certificate in D.C. did not rely solely on Fannie's principal place of business. Rather, the court relied on the location of Fannie's principal place of business *in addition to* testimonial evidence that Fannie's PLS traders worked in the D.C. office. Those two facts taken together adequately support the court's inference for purposes of our review. *See Absolute Activist*, 677 F.3d at 68 ("[T]he location of the broker [is] relevant to the extent that the broker carries out tasks that irrevocably bind the parties to buy or sell securities . . . .").

Second, Defendants assert that the email addresses on which the District Court relied are "*non sequitur*[*s*]" because they "do not reveal anything about the geographic location of the addressee." Nomura's Br. 93 (internal quotation mark omitted) (quoting *Shrader v. Biddinger*, 633 F.3d 1235, 1247-48 (10th Cir. 2011)). There is a kernel of truth to this argument as well, but it misses the mark. An email address may not reveal much about geographic location of the addressee on its own, but the fact that an addressee received an email at his work email address can support the inference that the addressee opened the email at work. And that fact in turn, taken together with the District Court's finding that Fannie's PLS traders worked in D.C., supports the inference that Nomura's emails were opened in D.C. These findings are further buttressed by the fact that Nomura sent a physical copy of an after-sale confirmation to Fannie's D.C. headquarters. Where Nomura sent an after-sale confirmation is not irrefutable evidence of where the antecedent sale occurred. But the destination for that confirmation supports the inference that the entire Certificate transaction—including the initial offering, the sale, and the after-sale confirmation—occurred between Nomura's New York office and Fannie's D.C. office.

Finally, Defendants argue that the District Court improperly shifted the burden of proof when it observed that that "Defendants have offered no affirmative evidence that the offers to sell were not made in and/or accepted in . . . D.C." *Nomura VII*, 104 F. Supp. 3d at 597. Defendants misunderstand the District Court's statement. In deciding whether the evidence showed that the sale occurred in D.C., the District Court merely noted that Defendants offered no evidence to counterbalance the evidence in the FHFA's favor. Balancing evidence, a task well within the factfinder's competence, is not the same as shifting the burden of proof.

3. The Virginia PLS Transactions

The District Court found that the NHELI 2006-FM2, NHELI 2007-1, and NHELI 2007-2 transactions occurred in Virginia based on similar facts: Freddie's principal place of business was in Virginia; Freddie's PLS traders worked in Freddie's Virginia office; Defendants sent PLS offering materials to Freddie's PLS traders at their work email addresses; and Defendants sent a physical confirmation of sale to Freddie's Virginia headquarters. *Id.*

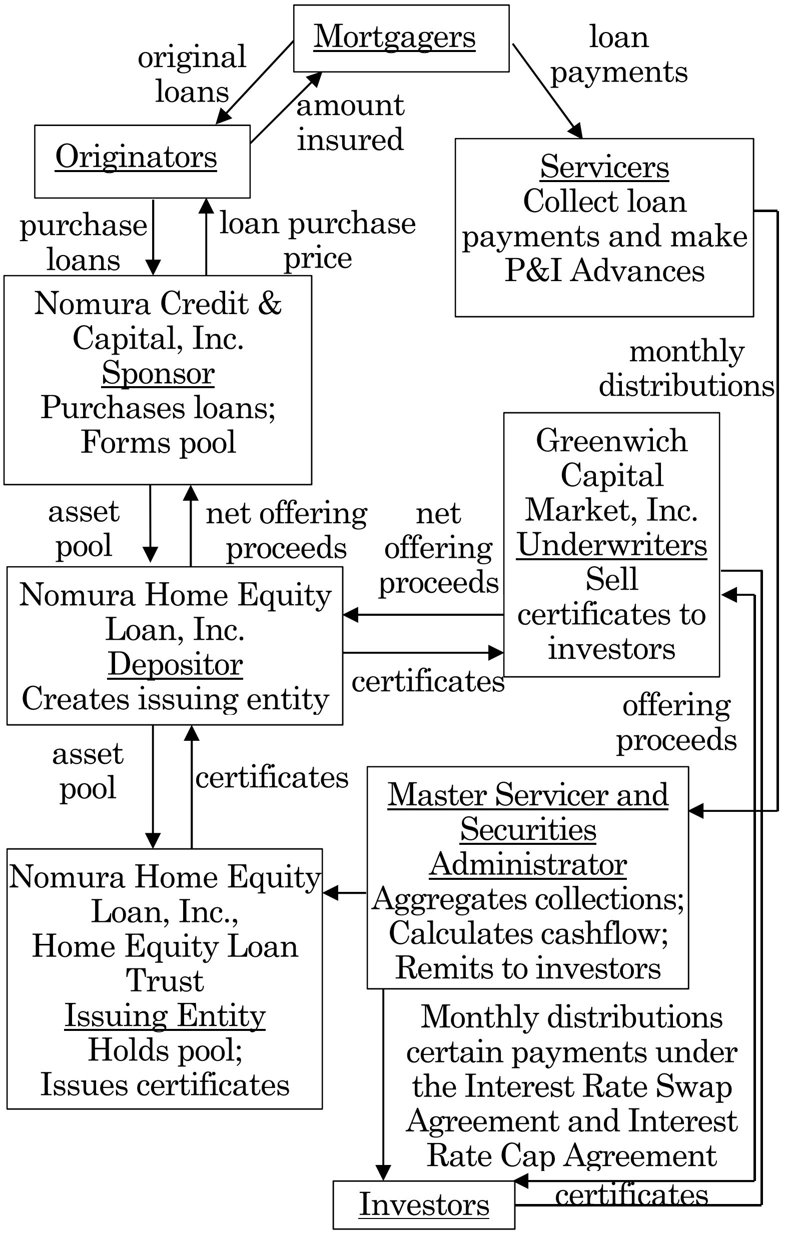
Defendants' arguments regarding Virginia Blue Sky jurisdiction largely track their D.C. Blue Sky arguments above and are rejected for the same reasons. Defendants offer two new arguments with regard to the Virginia PLS sales. First, Defendants fault the District Court for not requiring the FHFA to "present[] testimony from someone who . . . had direct knowledge about how and where [Freddie's PLS traders] executed the trades" at issue. RBS's Br. 59. While perhaps good advice for the FHFA going forward, that is no argument for clear error. There was more than one correct way for the FHFA to prove its case. Second, Defendants make much of the fact that two Freddie employees stated that Freddie's PLS traders purchased PLS certificates "generally"—instead of "always"—from an office in McLean, Virginia. That testimony may not be the best evidence that Freddie purchased the Certificates at issue in Virginia, but clear error requires more than pointing out that a plaintiff could have, in theory, offered stronger evidence. *See Krist*, 688 F.3d at 95.

CONCLUSION

"It requires but little appreciation of the extent of the [securities industry]'s economic power and of what happened in this country during the [Great Depression] to realize how essential it is that the highest ethical standards prevail" in financial markets. *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 366 (1963). In passing the Securities Act, Congress affixed those standards of honesty and fair dealing as a matter of federal law and authorized federal courts to impose civil remedies against any person who failed to honor them. *See Ernst & Ernst*, 425 U.S. at 195. And now, in the wake of the Great Recession, the mandate of Congress weighs heavy on the docket of the Southern District of New York. The district court's decisions here bespeak of exceptional effort in analyzing a huge and complex record and close attention to detailed legal theories ably assisted by counsel for all parties.

The judgment is AFFIRMED.

APPENDIX A
TRANSACTION STRUCTURE


Mortgagers
original loans
amount insured
loan payments
Originators
Servicers
Collect loan payments and make P&I Advances
purchase loans
loan purchase price
Nomura Credit & Capital, Inc.
Sponsor
Purchases loans; Forms pool
monthly distributions
Greenwich Capital Market, Inc.
Underwriters
Sell certificates to investors
asset pool
net offering proceeds
net offering proceeds
Nomura Home Equity Loan, Inc.
Depositor
Creates issuing entity
certificates
offering proceeds
asset pool
certificates
Master Servicer and Securities Administrator
Aggregates collections; Calculates cashflow; Remits to investors
Nomura Home Equity Loan, Inc., Home Equity Loan Trust
Issuing Entity
Holds pool; Issues certificates
Monthly distributions certain payments under the Interest Rate Swap Agreement and Interest Rate Cap Agreement
certificates
Investors

APPENDIX B

Securitization	**Buyer**	**Sponsor**	**Depositor**	**Lead Underwriter(s)**
NAA 2005-AR6	Fannie	NCCI	NAAC	Nomura Securities
NHELI 2006-FM1	Freddie	NCCI	NEHLI	Nomura Securities
NHELI 2006-HE3	Freddie	NCCI	NEHLI	RBS & Nomura Securities
NHELI 2006-FM2	Freddie	NCCI	NEHLI	RBS
NHELI 2007-1	Freddie	NCCI	NEHLI	RBS
NHELI 2007-2	Freddie	NCCI	NEHLI	RBS
NHELI 2007-3	Freddie	NCCI	NEHLI	[nonparty]

APPENDIX C

Securit ization	**Purchase Price**	**Principal Payments**[79]	**Interest Payments**
NAA 2005-AR6	$65,979,707	$42,801,327	$17,517,513
NHELI 2006-FM1	$301,591,187	$282,411,183	$23,756,542
NHELI 2006-HE3	$441,739,000	$331,937,382	$34,559,137
NHELI 2006-FM2	$525,197,000	$346,402,921	$42,099,996
NHELI 2007-1	$100,548,000	$53,271,881	$8,701,219
NHELI 2007-2	$358,847,000	$235,700,674	$29,010,757
NHELI 2007-3	$245,105,000	$127,924,783	$19,350,587

[79] All principal and interest payments made as of February 28, 2015.

APPENDIX D

Securitization	**ProSupp Date**[80]	**Settlement Date**[81]	**Filing Date**[82]
NAA 2005-AR6	11/29/2005	11/30/2005	11/30/2005
NHELI 2006-FM1	1/27/2006	1/31/2006	1/31/2006
NHELI 2006-HE3	8/29/2006	8/31/2006	8/30/2006
NHELI 2006-FM2	10/30/2006	10/31/2006	10/31/2006
NHELI 2007-1	1/29/2007	1/31/2007	1/31/2007
NHELI 2007-2	1/30/2007	1/31/2007	2/1/2007
NHELI 2007-3	4/27/2007	4/30/2007	5/1/2007

[80] This date listed on the cover of each ProSupp.

[81] The date when Defendants transferred title to the GSE and the GSE transferred payment in exchange.

[82] The date the ProSupp was filed with the SEC.

Appendix B

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 15-1872-cv(L), 15-1874-cv(CON)

FEDERAL HOUSING FINANCE AGENCY, as Conservator for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation,

Plaintiff-Appellee,

v.

NOMURA HOLDING AMERICA, INC., NOMURA ASSET ACCEPTANCE CORPORATION, NOMURA HOME EQUITY LOAN, INC., NOMURA CREDIT & CAPITAL, INC., NOMURA SECURITIES INTERNATIONAL, INC., RBS SECURITIES., INC., F/K/A GREENWICH CAPITAL MARKETS, INC., DAVID FINDLAY, JOHN MCCARTHY, JOHN P. GRAHAM, NATHAN GORIN, N. DANTE LAROCCA,

Defendants-Appellants.

December 11, 2017

ORDER

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:
Catherine O'Hagan Wolfe, Clerk
[seal]

Appendix C

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

Nos. 11-cv-6189(DLC), 11-cv-6201(DLC)

FEDERAL HOUSING FINANCE AGENCY,
Plaintiff,
v.
HSBC NORTH AMERICA HOLDINGS INC., et al.,
Defendants.

And other FHFA cases.

August 28, 2014

OPINION & ORDER

DENISE COTE, District Judge:

Plaintiff Federal Housing Finance Agency ("FHFA"), as conservator for the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") (together, the Government-Sponsored Enterprises or "GSEs"), brought these actions against financial institutions involved in the packaging, marketing, and sale of residential mortgage-backed securities ("RMBS") purchased by the GSEs between 2005 and 2007. FHFA has pled claims under Sections 11, 12(a)(2), and 15 of the Securities Act of 1933 ("Securities Act"), as well as the District of Columbia and Virginia Blue Sky laws (together, the "Blue Sky

Laws"). FHFA alleges, among other things, that defendants[1] made materially false statements in offering documents for the RMBS. Defendants now move for summary judgment on the ground that FHFA's securities claims are time-barred by the applicable statutes of repose.

BACKGROUND

The GSEs purchased the RMBS at issue in these actions between November 30, 2005 and July 3, 2007. More than three years later, FHFA brought the above-captioned actions. FHFA filed both of these actions on September 2, 2011, within three years of FHFA's appointment as conservator of Fannie Mae and Freddie Mac on September 6, 2008.

Section 13 of the Securities Act contains a three-year statute of repose that governs claims brought under Sections 11 and 12. 15 U.S.C. § 77m. The Blue Sky Laws contain two- and three-year statutes of repose. D.C. Code § 31-5606.05(f)(1) (three years); Va. Code Ann. § 13.1-522(D) (two years).

In 2008, in the aftermath of the financial crisis, Congress created the FHFA, authorized it to act as conservator for the GSEs, and passed a statute extending FHFA's time to bring any action on their behalf. The Housing and Economic Recovery Act of

[1] The remaining defendants are HSBC North America Holdings Inc. and related entities ("HSBC"), Nomura Holding America Inc. and related entities ("Nomura"), and RBS Securities Inc. ("RBS"). The GSEs purchased the securities at issue between the following dates: with respect to HSBC, from December 20, 2005 to July 3, 2007; with respect to Nomura, from November 30, 2005 to April 30, 2007; and with respect to RBS, from August 31, 2006 to January 31, 2007.

2008 ("HERA") creates a new "statute of limitations with regard to any action brought by the [FHFA] as conservator or receiver." 12 U.S.C. § 4617(b)(12)(A). In the case of any "tort claim," "the applicable statute of limitations" is the longer of (1) the three-year period beginning on the date FHFA is appointed as conservator or receiver; (2) the three-year period beginning on the date on which the cause of action accrues; and (3) the period applicable under state law. *Id.* at § 4617(b)(12). In addition, HERA provides for the revival of tort claims "for which the statute of limitations applicable under State law . . . has expired not more than 5 years before the appointment of the [FHFA]." Id. at § 4617(b)(13)(A). HERA defines "tort claim" to mean "a claim arising from fraud, intentional misconduct resulting in unjust enrichment, or intentional misconduct resulting in substantial loss to the regulated entity." *Id.* at § 4617(b)(13)(B).[2]

Defendants argue that HERA applies to statutes of limitations to the exclusion of statutes of repose and thus that Section 13's and the Blue Sky Laws' two- and three-year statutes of repose bar these actions. Former defendant UBS Americas, Inc. and its affiliates ("UBS"), which later settled the related action brought by FHFA against them, made the same argument to this Court in a motion to dismiss. On June 19, 2012, the Court denied that motion in

[2] This provision, subparagraph (13)(B), contains a typographical error, as it refers to "[a] tort claim referred to under clause (i)." The words "tort claim" appear in clause (ii), not clause (i). Immediately preceding subparagraph (13)(B) is subparagraph (13)(A), which refers to "any tort claim described under clause (ii)." Accordingly, it is clear that (13)(B) defines "tort claim" as used in clause (12)(A)(ii).

relevant part, holding that HERA extended statutes of repose as well as statutes of limitations, but certified the issue for interlocutory appeal pursuant to 28 U.S.C. § 1292(b). *FHFA v. UBS Americas, Inc.*, 858 F. Supp. 2d 306 (S.D.N.Y. 2012) ("*UBS I*"). The June 19 decision was affirmed by the Second Circuit on April 5, 2013. *FHFA v. UBS Americas Inc.*, 712 F.3d 136 (2d Cir. 2013) ("*UBS II*"). Defendants here raised the same argument in their own motions to dismiss, which were denied in relevant part on November 27, 2012 (Nomura and RBS) and November 28, 2012 (HSBC).

On June 9, 2014, the Supreme Court issued an opinion in *CTS Corp. v. Waldburger*, 134 S. Ct. 2175 (2014), holding that a provision in the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") extended certain statutes of limitations but not statutes of repose. Before *CTS* was decided, the Tenth Circuit held that an extender provision governing actions brought by the National Credit Union Administration ("NCUA")—a part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")—that is nearly identical to the HERA extender provision applied to statutes of repose.[3] *NCUA v. Nomura Home Equity Loan, Inc.*, 727 F.3d 1246 (10th Cir. 2013). The Supreme Court vacated and remanded that decision for reconsideration in light of *CTS*. *Nomura Home*

[3] HERA's subsection (b)(12) is identical to FIRREA's subsection (b)(14)—after changing "Board" to "Agency" and "liquidating agent" to "receiver"—with one trivial exception: the NCUA statute refers to "the date the claim accrues" where HERA refers to "the date on which the claim accrues." See 12 U.S.C. § 1787(b)(14); 12 U.S.C. § 4617(b)(12).

Equity Loan, Inc. v. NCUA, 134 S. Ct. 2818 (June 16, 2014). On August 19, 2014, the Tenth Circuit reinstated its decision, holding that *CTS* did not alter its analysis. *NCUA v. Nomura Home Equity Loan, Inc.*, --- F.3d ---, 2014 WL 4069137 (10th Cir. Aug. 19, 2014) ("*NCUA*").

Defendants brought these motions on June 20, 2014. They were fully submitted on July 18. Defendants contend that *CTS* so changes the applicable analysis that this Court is no longer bound by the Second Circuit's opinion. Defendants request summary judgment on this basis and, in the alternative, ask that this Court certify this issue for interlocutory appeal pursuant to 28 U.S.C. § 1292(b). For the reasons that follow, defendants' motions and their requests for certification are denied.

DISCUSSION

The Second Circuit has already decided this question, and the subsequent decision in *CTS* does not undermine the Second Circuit's ruling for many of the reasons set out in the Tenth Circuit's August 21 Opinion in *NCUA*, which is incorporated by reference, as well as certain additional reasons given below.

I. Legal Standard

"In construing a statute, we begin with the plain language, giving all undefined terms their ordinary meaning." *UBS II*, 712 F.3d at 141. Courts are "not to construe each phrase literally or in isolation," but rather to "attempt to ascertain how a reasonable reader would understand the statutory text, considered as a whole." *Id.* (citation omitted). When statutory text is ambiguous, courts turn to other methods of statutory interpretation, including legislative history. *Id.*

II. *CTS* Did Not Disturb the Second Circuit's Holding.

The Second Circuit squarely held that, "[i]n view of the text of the statute and its legislative history . . . it is clear that Congress intended one statute of limitations—§ 4617(b)(12) of HERA—to apply to *all* claims brought by FHFA as conservator" and to "supplant[] any other time limitations that otherwise might have applied." *UBS II*, 712 F.3d at 143-44. For each of the reasons set out in the Tenth Circuit's finely written opinion, *CTS* does not disturb this holding. As the text of FIRREA is identical, in all material respects, to that of HERA, the Tenth Circuit's textual analyses apply directly.

Among those holdings which this Court adopts, the following are of particular note:

> The text and structure of [HERA's] Extender Statute are fundamentally different from [CERCLA's]. . . . [B]y establishing all-purpose time limits for any actions [FHFA] may wish to pursue, the Extender Statute displaces *all* preexisting limits on the time to bring suit, whatever they are called. . . . CERCLA has a completely different structure. Rather than setting its own time limit to bring a [claim], [CERCLA] recognizes that the time limits in state statutes apply.

NCUA, 2014 WL 4069137, at *5 (citation omitted).

> [U]nlike [CERCLA], which employs the term "applicable limitations period" to identify the

> state law time frames modified by the federal commencement date (that is, the specific object of federal preemption), [HERA's] Extender Statute uses "period applicable under State law" to help construct a new exclusive time framework for [FHFA] actions that replaces all pre-existing time limits (including repose periods). Whether the state period used to construct this framework is one of limitations or repose has no bearing on whether the new Extender Statute framework itself displaces statutes of repose.

Id. at *9.

> In sum, [HERA]'s Extender Statute's surrounding language differs considerably from [CERCLA]'s in that it features the concept of repose, uses the word "period" differently, and lacks a tolling provision. The [Supreme] Court's analysis of the terms "period" and "civil action," as well as the tolling provision in [CERCLA], cannot be extended to [HERA's] Extender Statute because its text and structure are fundamentally different from [CERCLA's].

Id. at *10. The Tenth Circuit's other analyses apply as well for the reasons below.

A. Legislative History and Purpose

The Tenth Circuit emphasized that FIRREA's legislative history and purpose strongly support the court's holding, and contrast sharply with CERCLA's. *NCUA*, 2014 WL 4069137, at *11-13. The same is true for HERA.

In *CTS*, the Supreme Court relied, in part, on a report commissioned by Congress that recommended changes to state tort law including the discovery rule enacted in CERCLA's extender provision. This report "acknowledged that statutes of repose were not equivalent to statutes of limitations and that a recommendation to pre-empt the latter did not necessarily include the former." *CTS*, 134 S. Ct. at 2186. By contrast, the legislative history of HERA strongly confirms that its limitations provision displaces all previously applicable timeliness provisions.

The Second Circuit explained that

> Congress enacted HERA and created FHFA in response to the housing and economic crisis, precisely because it wanted to address the dire financial condition of Fannie Mae and Freddie Mac. As HERA makes clear, Congress intended FHFA to take action to "collect all obligations and money due" to the GSEs, to restore them to a "sound and solvent condition."

UBS II, 712 F.3d at 142 (quoting 12 U.S.C. § 4617(b)(2)(B)(ii), (D)). With HERA, Congress created the FHFA and vested it with investigatory powers, like the subpoena power, to enable it to suss out the GSEs' claims. HERA was designed "to give FHFA the time to investigate and develop potential claims on behalf of the GSEs." *Id.* As the Second Circuit noted, "Congress obviously realized that it would take time for this new agency to mobilize and consider whether it wished to bring any claims and, if so, where and how to do so." *Id.* Accordingly, HERA created a new statute of limitations running, at the earliest, from the appointment of FHFA as conservator, that "supplants any other time limitations that otherwise might have applied" to FHFA's claims. *Id.* at 143-44.

B. Statutory Context

The Tenth Circuit considered the use of the phrase "statute of limitations" or "statute of limitation" elsewhere in FIRREA. The court noted that the phrase is used in provisions setting deadlines for appealing NCUA's denial of a claim that do not allow for accrual or tolling, which is indicative of a broad use of the phrase "statute of limitations" encompassing statutes of repose. *NCUA*, 2014 WL 4069137 at *10.

HERA's Section 4617 includes two similar provisions setting deadlines for appeal of FHFA's denial of certain claims. *See* 12 U.S.C. § 4617(a)(6)(B), (8)(D). Both provisions are styled "[s]tatute of limitations," despite the fact that they do not allow for accrual or tolling. *Id.* "[I]t is a normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning." *Taniguchi v. Kan Pac. Saipan, Ltd.*, 132 S. Ct. 1997, 2004-05 (2012) (citation omitted). Accordingly, these provisions further support a broad construction of "statute of limitations" to encompass statutes of repose.

III. Additional Arguments

Defendants raise several additional arguments not treated in the Tenth Circuit's Opinion. They are addressed in turn.

A. HERA's Revival Provision Refers to a Singular Period.

Defendants argue that the phrase "statute of limitations" must be read narrowly in the HERA provision reviving expired tort claims, subparagraph (13)(A), and that this narrow reading should therefore apply throughout the statute. Defendants misconstrue this provision. It reads:

> In the case of any tort claim described [above] for which the statute of limitations applicable under State law with respect to such claim has expired not more than 5 years before the appointment of the [FHFA] as conservator or receiver, the [FHFA] may bring an action as conservator or receiver on such claim without regard to the expiration of the statute of limitations applicable under State law.

12 U.S.C. § 4617(b)(13)(A).

Defendants contend that reading "statute of limitations" broadly here to encompass statutes of repose "would not make sense where the five-year rule dictated a different result for the statute of limitations and the statute of repose." Yet this provision measures five years from the date the limitations period "expired"—i.e., when the claim became untimely—which is a single date, whether or not repose periods are included.

Consider, for example, the Securities Act, the model for many states' Blue Sky laws. Section 13 of the Securities Act bars any action brought more than (a) one year after discovery of the untrue statement or omission or (b) three years after the offering or sale of the relevant security. 15 U.S.C. § 77m. Section 13's limitations period "expires" when either the one-year period or the three-year period runs, whichever runs first. It would be odd, indeed, to contend that this period had not "expired" more than three years after the offering or sale, simply because the one-year period had not yet run. It is defendants' interpretation of the revival provision that is unreasonable, as defendants would have HERA resuscitate claims five years after the discovery-based period had run, but leave untouched claims barred by a two- or three-year repose period. That result would be wholly out of keeping with HERA's structure and purpose.

B. Date of Passage

Defendants next argue that "the distinction between statutes of limitations and repose was clear by the time of HERA's passage." The Supreme Court did note in *CTS* that the "more precise" usage of "statute of limitations," in distinction to a statute of repose, is "now predominant." *CTS*, 134 S. Ct. at 2186. But, in the immediately preceding paragraph, the Court "acknowledged that the term 'statute of limitations' is sometimes used in a less formal way" to "refer to any provision restricting the time in which a plaintiff must bring suit." *Id.* at 2185. In particular, the Court recognized that "Congress has used the term 'statute of limitations' when enacting statutes of repose," and cited in support a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010—which was passed two years after HERA. *Id.* (citing 15 U.S.C. § 78u-6(h)(1)(B)(iii)(I)(aa)). As in *CTS*, the fact that HERA employs the term "statute of limitations" is "instructive, but it is not dispositive." *Id.*

C. Securities Claim Is Not a "Tort Claim."

Defendants next contend that HERA applies only to state contract and tort claims, not to statutory claims or federal claims. As an initial matter, the Second Circuit squarely rejected this argument in *UBS*. "Giving the words of § 4617(b)(12) their plain meaning, and considering the provision as a whole, [the Second Circuit] conclude[d] that a reasonable reader could only understand it to apply to both the federal and state claims in this case." *UBS II*, 712 F.3d at 142. *CTS* did not address this issue, and defendants have offered no reason to believe the law in this circuit has changed subsequently.

Indeed, defendants' argument is rebutted by HERA's plain language, as HERA defines "tort claim" to mean "a claim arising from fraud, intentional misconduct resulting in unjust enrichment, or intentional misconduct resulting in substantial loss to the regulated entity." 12 U.S.C. § 4617(b)(13)(B). FHFA's securities fraud claims here are alleged to "aris[e] from fraud . . . or intentional misconduct resulting in substantial loss" to the GSEs, and thus are easily encompassed by this definition. Even if this definition did not apply,[4] HERA states expressly that it is creating "the applicable statute of limitations with regard to *any* action brought by the Agency as conservator or receiver." *Id.* at § 4617(b)(12)(A) (emphasis added).

[4] As noted above, due to a typographical error in the statute, HERA defines "tort claim" as used in "clause (i)" rather than "clause (ii)," despite the fact that "tort claim" only appears in clause (ii).

And defendants are wrong to contend that the reference to otherwise applicable state law periods somehow removes federal claims from HERA's scope. The fact that the limitations period created for FHFA's "tort claims" is "the period applicable under State law" in certain circumstances—where that period extends beyond three years after accrual or appointment of FHFA as conservator—does not indicate that the only claims covered are state law claims. Where there is no "period applicable under State law" for a "tort claim," the limitations period is simply three years from accrual or appointment. Again, HERA expressly applies to "*any* action" brought by FHFA as conservator. *Id.* at § 4617(b)(12)(A) (emphasis added).

D. Repeal by Implication

Defendants further argue that HERA should not be read to "impliedly repeal" Section 13's statute of repose, citing cases that predate the Second Circuit's considered opinion in *UBS II* holding that HERA "supplants any other time limitations that otherwise might have applied," including Section 13's. *UBS II*, 712 F.3d at 143-44. This Court expressly rejected defendants' argument in *UBS I*, 858 F. Supp. 2d at 317 n.8. Defendants offer no reason why the Court should revisit that decision or second-guess that of the Second Circuit. As explained in *UBS I*:

> Section 13 continues to apply with full force to the vast majority of litigants; HERA creates an exception for a single, privileged plaintiff—FHFA. Moreover, because, as explained above, HERA's reference to the "statute of limitations" encompasses not only the narrower use of the term advocated by

> defendants but also what defendants refer to as "statutes of repose," HERA no more impliedly repealed the latter than it did the former. And even defendants agree that, to the extent it applies to federal claims, HERA constitutes a valid extension of Section 13's one-year limitation period.

Id.

E. Presumption Against Pre-emption of State Law

Defendants also argue that a presumption against the pre-emption of state law should apply, citing to a part of Justice Kennedy's opinion in *CTS* joined by two other Justices. Yet, this presumption is only effective "when the text of a pre-emption clause is susceptible of more than one plausible reading." *CTS*, 134 S. Ct. at 2188 (citation omitted). For the reasons stated above, that is not the case here.

Moreover, HERA is quite different from CERCLA in this respect. Courts are to "assume[] that the historic police powers of the States [a]re not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." *Id.* (citation omitted). The presumption against pre-emption is strongest "when Congress legislates in an area traditionally governed by the States' police powers." *Id.* In CTS, there was "no question that States possess the traditional authority to provide tort remedies to their citizens as they see fit." *Id.* (citation omitted). Here, by contrast, "[p]olicing fraud against federal agencies is hardly a field which the States have traditionally occupied." *Buckman Co. v. Plaintiffs' Legal Comm.*, 531 U.S. 341, 347 (2001) (citation omitted). Thus, any such presumption applied here would be weak.

IV. Certification for Interlocutory Appeal

The standard for certification is well established. Section 1292(b) provides, in relevant part, that

> [w]hen a district judge, in making in a civil action an order not otherwise appealable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he shall so state in writing in such order. The Court of Appeals which would have jurisdiction of an appeal of such action may thereupon, in its discretion, permit an appeal to be taken from such order, if application is made to it within ten days after the entry of the order.

28 U.S.C. § 1292(b); *see Casey v. Long Island R.R. Co.*, 406 F.3d 142, 146 (2d Cir. 2005) (noting that Section 1292(b) "imposes both procedural and substantive requirements on a would-be appellant").

The Second Circuit has emphasized that Section 1292(b) certification should be "strictly limited because only exceptional circumstances will justify a departure from the basic policy of postponing appellate review until after the entry of a final judgment." *Flor v. BOT Fin. Corp.*, 79 F.3d 281, 284 (2d Cir. 1996) (*per curiam*) (citation omitted). Certification is thus appropriate only in the narrow class of cases in which "an intermediate appeal may avoid protracted litigation." *Koehler v. Bank of Bermuda Ltd.*, 101 F.3d 863, 866 (2d Cir. 1996).

Certification is inappropriate here. At the earliest stages of this massive litigation, this Court certified this very question to the Second Circuit, which issued an opinion that squarely addressed it. For the reasons stated by the Tenth Circuit in *NCUA* and those given above, it is clear that *CTS* does not disturb that decision. Accordingly, there is no "substantial ground for difference of opinion." 28 U.S.C. § 1292(b). Review of the decisions issued recently in the Western District of Texas does not alter that judgment. *See FDIC v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 2014 WL 4161561 (W.D. Tex. Aug. 18, 2014); *FDIC v. Goldman, Sachs & Co.*, 2014 WL 4161567 (W.D. Tex. Aug. 18, 2014).

Nor would interlocutory appeal "materially advance the ultimate termination of the litigation." 28 U.S.C. § 1292(b). Trial in the *HSBC* action begins on September 29; trial in *Nomura* is scheduled to begin in several months. The parties will soon be able to appeal this issue, together with all other issues, following a final judgment. The most efficient way to reach the ultimate termination of this litigation is to try these cases.

CONCLUSION

Defendants' June 20, 2014 motions for summary judgment concerning the applicable statutes of repose and requests for Section 1292(b) certification on this issue are denied.

SO ORDERED:

Dated: New York, New York
August 28, 2014

[handwritten: signature]
DENISE COTE
United States District Judge

Appendix D

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

No. 11-cv-6201(DLC)

FEDERAL HOUSING FINANCE AGENCY,
Plaintiff,
v.
NOMURA HOLDING AMERICA, INC., et al.,
Defendants.

December 18, 2014

OPINION & ORDER

DENISE COTE, District Judge:

This Opinion addresses a motion *in limine* brought by plaintiff Federal Housing Finance Agency ("FHFA") to prohibit defendants[1] from presenting, in connection with its Section 11 claims, evidence to the jury of principal and interest payments made on the certificates at issue in this action (the "Certificates") after September 2, 2011, which is the date on which

[1] Defendants are Nomura Holding America, Inc., Nomura Asset Acceptance Corp., Nomura Home Equity Loan, Inc., Nomura Credit & Capital, Inc., Nomura Securities International, Inc., David Findlay, John McCarthy, John P. Graham, Nathan Gorin, and N. Dante LaRocca ("Nomura"); and RBS Securities Inc. ("RBS") (collectively, "defendants").

this lawsuit was filed (the "Post-Filing Payments").[2] For the following reasons, the motion is granted.

BACKGROUND

FHFA, acting as conservator for Fannie Mae and Freddie Mac (together, the "Government Sponsored Enterprises" or "GSEs"), filed suit on September 2, 2011 against defendants alleging that the offering documents ("Offering Documents") used to market and sell seven Certificates to the GSEs associated with residential mortgage-backed securities ("RMBS") contained material misstatements or omissions. RMBS are securities entitling the holder to income payments from pools of residential mortgage loans ("Supporting Loan Groups" or "SLGs") held by a trust.

FHFA brought these claims pursuant to Sections 11 and 12(a)(2) of the Securities Act of 1933 (the "Securities Act"), as well as Virginia's and the District of Columbia's Blue Sky laws. This lawsuit is the sole remaining action in a series of similar, coordinated actions litigated in this district by FHFA against banks and related individuals and entities to recover losses experienced by the GSEs from their purchases of RMBS. A description of the litigation and the types of misrepresentations at issue in each of these coordinated actions, including the instant case, can be found in *FHFA v. Nomura Holding Am., Inc.*,

[2] FHFA requests that defendants be barred from presenting evidence of the Post-Filing Payments to the jury, and argues that the Section 12(a)(2) and the Blue Sky law claims may be tried to the Court. The Court construes this as a request to bar presentation of this evidence in connection with FHFA's Section 11 claims, and separately addresses whether a right to a jury trial attaches to the remaining claims.

--- F. Supp. 3d ---, 11cv6201 (DLC), 2014 WL 6462239, at *3-6, *16-17 (S.D.N.Y. Nov. 18, 2014) ("*Nomura*").

The GSEs purchased the seven Certificates between November 30, 2005 and April 30, 2007. The Certificates had an original unpaid principal balance of approximately $2.05 billion, and the GSEs paid slightly more than the amount of the unpaid principal balance when purchasing them. Six were purchased by Freddie Mac; one was purchased by Fannie Mae. The GSEs have retained the Certificates.

Nomura acted as sponsor and depositor for all seven of the Certificates, and as the sole lead underwriter and seller for two of them. RBS was the sole lead underwriter for three of the Certificates and a co-lead underwriter for a fourth. For an explanation of the RMBS securitization process, including the roles of mortgage loan originators, sponsors, and underwriters, see *Nomura*, 2014 WL 6462239, at *4-6.

Section 11 and Section 12(a)(2), as described below, use different measures of damages. The Blue Sky laws adopt the Section 12(a)(2) measurement of damages. As a result, FHFA's expert Dr. James K. Finkel ("Finkel") has used two different methodologies in calculating damages, and has also applied three different interest rates to his calculations. Finkel has calculated damages as high as roughly $1 billion for the claims against Nomura, and roughly $750 million against RBS.

Dr. Timothy Riddiough ("Riddiough"), one of defendants' experts, submitted a report on November 10, 2014 (the "Riddiough Report") in which he critiqued Finkel's valuation of the Certificates at the time of suit and offered his own valuation model. As explained below, where a plaintiff holds a security through judgment, Section 11 damages are equal to the difference between the purchase price (or the offering price, if lower) and the security's value at the time the suit is filed.

Each Certificate entitled its holder to the receipt of certain monthly payments, which were based on the principal balance for that Certificate.[3] The monthly payments to the Certificate holder were equal to a coupon payment—effectively interest, at a predetermined rate, on the remaining principal balance—plus some additional amount that paid down the principal balance.

Certificates were linked to tranches of varying seniority. Generally, holders of the most senior certificates for a given Supporting Loan Group were paid first, after which holders of the next-most-senior certificates received payment, and so on. Thus, should some borrowers in an SLG default on their loans, certificates in the junior-most tranche would absorb all or most of the shortfall before payments to more senior certificates were affected. Accordingly, the most senior certificates were subject to less risk than were more junior certificates. By apportioning risk in this way, defendants were able to create AAA-rated securities from Alt-A and subprime loans. The GSEs purchased senior certificates—often only the most senior—with the highest credit ratings.

For instance, in Nomura Securitization 2006-FM1, Freddie Mac purchased a Certificate linked to

[3] If a Certificate were purchased at par, its initial principal balance would be equal to the purchase price.

the senior-most tranche, class I-A-1, which was supported by Group I loans. That tranche had an initial principal balance of approximately $525 million; the nine subordinated (“mezzanine”) tranches below had a total principal balance of approximately $223 million. All realized losses on Group I loans were to be allocated to the nine mezzanine tranches, until their $223 million principal balance was reduced to zero.[4] This subordination, in addition to certain other credit enhancements,[5] protected Freddie Mac’s senior Certificate from loss, even in the face of substantial defaults (and limited recovery through foreclosure).

A certificate’s value in the market is determined, in large part, by the expected future flow of payments to the certificate holder. Because payments to the certificate holder depend upon borrowers’ payments pursuant to the underlying mortgage loans, the expected rate of borrower defaults is a key determinant of the certificate’s value. The average expected loss severity—which measures the shortfall between the unpaid principal balance of a loan and the amount recovered through foreclosure (less costs incurred in foreclosure)—is another key factor. In the years following September 2, 2011, all but one of the Certificates never missed a payment.

[4] The mezzanine tranches were also subordinate to the senior tranches backed by Group II loans, and would absorb realized losses from those loans as well.

[5] Other credit enhancements noted in the Offering Documents include overcollateralization, a basis risk cap agreement, an interest rate cap agreement, and an interest rate swap agreement, which served to hedge basis and interest-rate risk.

In his valuation analysis, Riddiough considered the performance of the Certificates after the date this suit was filed, September 2, 2011, for two purposes. First, Riddiough compared actual post-filing rates of default within the relevant Supporting Loan Groups against his and Finkel's predicted default rates, finding that his "forecasts . . . are much closer to what actually happened." Second, Riddiough looked at actual post-filing market prices for the Certificates as "an ex-post check" of his conclusion, based on trading volume, that the RMBS market was illiquid at the time of filing. Riddiough noted that, by one measure, the Certificates' prices in the market have increased by 28 to 81 percent.

Riddiough relies on the conclusions of Dr. Kerry D. Vandell ("Vandell"), a second expert for defendants, as to loss causation. Vandell's analysis considers the performance of loans, including the loans underlying the Certificates, through December 2013. According to FHFA, Vandell notes (in an exhibit to his report that no party has submitted to the Court in connection with this motion) the "expected dollar losses" to one of the Certificates as of December 2013.

FHFA filed the instant motion *in limine* on October 6, 2014 to prohibit defendants from presenting evidence to the jury of the Post-Filing Payments in connection with the Section 11 claims. This motion was fully submitted on October 24.

DISCUSSION

This motion *in limine* requires application of the damages provisions for Section 11 of the Securities Act, 15 U.S.C. § 77k, as well as the affirmative defense of negative causation available under that section.

Those provisions are set forth below, following the governing Federal Rule of Evidence. Application of this law is followed by a discussion of Section 12(a)(2) of the Securities Act.

I. Legal Standards

A. Rule 403

Pursuant to Rule 403, Fed. R. Evid., "[t]he court may exclude relevant evidence if its probative value is substantially outweighed by a danger of . . . unfair prejudice, confusing the issues, misleading the jury, undue delay, wasting time, or needlessly presenting cumulative evidence." *Accord United States v. Dupree*, 706 F.3d 131, 138 (2d Cir. 2013). A court must "conscientiously balance[] the proffered evidence's probative value with the risk for prejudice." *United States v. Massino*, 546 F.3d 123, 132 (2d Cir. 2008) (citation omitted). "'[U]nfair prejudice' speaks to the capacity of some concededly relevant evidence to lure the factfinder into [rendering its verdict] on a ground different from proof specific to the [claims brought]." *Id.* (citation omitted). For instance, the proffered evidence may have a "tendency . . . to prove some adverse fact not properly in issue or unfairly excite emotions against the [opposing party]." *Id.* at 133 (citation omitted). When conducting this balancing, a court "should consider the possible effectiveness of a jury instruction and the availability of other means of proof in making a Rule 403 determination." *Dupree*, 706 F.3d at 138.

B. Section 11 Damages

A Section 11 claimant is entitled to recover, pursuant to Section 11(e),

> such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and
>
> (1) the *value thereof as of the time such suit was brought*, or
>
> (2) the price at which such security shall have been disposed of in the market before suit, or
>
> (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought.

15 U.S.C. § 77k(e)(emphasis supplied).[6]

[6] Section 11 imposes, in certain conditions, a cap on an underwriter's liability at the price of the securities underwritten. It provides that: "In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public." 15 U.S.C. § 77k(e). How this limitation affects lead or co-lead underwriters is not raised by this motion *in limine*. *See In re WorldCom, Inc. Sec. Litig.*, 02cv3288 (DLC), 2005 WL 613107, at *3 n.8 (S.D.N.Y. Mar. 15, 2005).

Because the GSEs have retained their Certificates, their damages under Section 11(e) are measured as their "value . . . as of the time such suit was brought." *Id.* § 77k(e)(1). Post-filing changes to the security's value are irrelevant. Just as defendants are not liable for subsequent decreases, defendants cannot benefit from any subsequent increases in value. Instead, where a Section 11 plaintiff has held the security through the date of suit, the plaintiff bears all risk of loss, and will capture any gain, that occurs after the filing date.

The term "value" in Section 11(e) "was intended to mean the security's true value after the alleged misrepresentations are made public." *McMahan & Co. v. Wherehouse Entm't, Inc.*, 65 F.3d 1044, 1048 (2d Cir. 1995). Where a market value "is available and reliable," the "instances where the market price of a security will be different from its value are unusual and rare." *Id.* at 1049 (citation omitted). But, even in those instances where a market price "is not completely reliable, it serves as a good starting point in determining value." *Id.* Damages may not, however, "exceed the price at which the security was offered to the public." 15 U.S.C. § 77k(g).

As explained above, a certificate's value depends, in large part, upon the expected principal and interest payments to be made to the certificate holder, which are in turn based on mortgage payments by the relevant borrowers. Thus, a valuation is based on certain risk assessments. The parties agree that the value of a Certificate at the time of filing is to be based on the appropriate valuation as of that date, using only information then available. Accordingly, Finkel's and Riddiough's assessments of the relevant risks, including the risk of defaults, must look only to information available as of September 2, 2011. Like any forecast, the proper valuation's underlying risk assessments may prove more or less accurate; the fact that a risk is or is not realized does not establish how great or small that risk was, before the fact.

C. Section 11 Loss Causation Defense

Section 11 provides for an affirmative defense of negative causation:

> *if the defendant proves that* any portion or all of *such damages represents other than the depreciation in value of such security resulting from such part of the registration statement*, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, *such portion of or all such damages shall not be recoverable*.

Id. § 77k(e) (emphasis supplied). This defense "allocate[s] the risk of uncertainty to the defendants" and imposes upon them a "heavy burden." *Akerman v. Oryx Commc'ns, Inc.*, 810 F.2d 336, 341 (2d Cir. 1987). A decline in the price of securities before the disclosure of the truth regarding the representations at issue in a case "may not be charged to defendants." *Id*. at 342. In *Akerman*, the defendants succeeded in carrying their burden of showing negative causation where the misstatement was "barely material," and where "the public failed to react adversely to its disclosure." *Id*. at 343.

The concept of loss causation has been analogized to the concept of proximate cause. *In re Omnicom Grp., Inc. Sec. Litig.*, 597 F.3d 501, 510 (2d Cir. 2010). The concept recognizes that a security's loss of value may be attributed to disclosures of the truth behind misstatements or they may be attributed to other factors, such as "changed economic circumstances, changed investor expectations, [or] new industry-specific or firm-specific facts, [or] conditions." *Acticon AG v. China N.E. Petro. Holdings Ltd.*, 692 F.3d 34, 40 (2d Cir. 2012) (citation omitted).

II. Application to Section 11 Damages

Evidence concerning the Post-Filing Payments on the Certificates are inadmissible under Rule 403 with respect to defendants' Section 11 damages. As explained below, the Post-Filing Payments have very limited if any relevance to the calculation of those damages. Such post-hoc performance would have been unavailable to anyone assessing the value of the Certificates on the date the lawsuit was filed and is not, therefore, admissible to establish the appropriate valuation. Far outweighing any possible relevance is the great potential of such evidence to create unfair prejudice to FHFA. It is quite likely that even a properly instructed jury, told that all but one of the Certificates never missed a payment, would find it nigh impossible to calculate the Certificates' value as of September 2, 2011 without regard to their performance in the years that followed and that it would be improperly moved to disregard the statutory damages calculation and determine that the GSEs were not truly injured. Accordingly, any probative value of evidence of the Post-Filing Payments is substantially outweighed by the danger of unfair prejudice, confusing the issues, and misleading the jury.

Defendants argue that post-filing performance is relevant in four ways: (1) actual default rates provide a benchmark against which to compare the accuracy of the predicted default rates in Finkel's and Riddiough's models; (2) the illiquidity of the RMBS market at the date of filing is confirmed by the increase in the Certificates' market price since that time; (3) Post-Filing Payments should offset Section 11 damages; and (4) loss causation is undermined, as Post-Filing Payments show that any loss in value as of September 2, 2011 was unrelated to the alleged misrepresentations in the Offering Documents. These arguments are addressed in turn.

A. Model Accuracy

Post-filing default rates have limited relevance to the accuracy of Finkel's and Riddiough's models. Riddiough recognizes that valuation may be based only on information available as of September 2, 2011. The fact that Riddiough's model better fits actual default rates in the years following September 2, 2011 than Finkel's does little to indicate that Riddiough's model better captures the information available as of that date. The fact that, in a single instance, a given result occurred, gives little information about the likelihood of that result before the fact: it could be overwhelmingly likely, or it could be a freak occurrence. Here, Riddiough shows that the performance of the RMBS market as a whole improved during these years. Using these future performance gains as a "check" of valuation as of September 2, 2011 invites jury-rigging a model that backs into those rosier figures, whether or not they would have been reliably forecast at the time of filing; it does little to validate Riddiough's model or to undermine Finkel's. As noted above, the risk of unfair prejudice is great if Riddiough is permitted to tell the jury that post-filing default rates for the Certificates were lower than expected as of September 2, 2011.

B. Market Liquidity

While defendants contend that evidence of the Post-Filing Payments is also relevant to their expert's analysis of market liquidity as of September 2011, an examination of the expert's report does not bear that out. Riddiough makes a very limited use of the post-filing performance of the Certificates in connection with his examination of the liquidity of the market for RMBS sold by financial institutions like defendants ("Private Label Securities" or "PLS") in September 2011.[7]

Riddiough opines that the PLS market "remained quite illiquid and dislocated" at the time of filing, based on an analysis of PLS issuance and trading volume both before and after that date, as well as the opinions of investors and analysts. But, in his principal discussion of market liquidity, Riddiough makes no mention of the Certificates' post-filing performance, much less the record of Post-Filing Payments. Nor does he cite their post-filing performance in the principal passage of the Riddiough

[7] The term "PLS" distinguishes private label RMBS from those RMBS sold by federal agencies like the GSEs.

Report critiquing Finkel for finding the PLS market was liquid as of September 2, 2011.

Rather, the Certificates' post-filing performance, specifically their pricing, is cited only in a subsequent passage, to support the finding of a February 2011 industry publication that concluded that PLS were undervalued by 15%-20% as of that date, due to market illiquidity. "As an ex-post check" of this conclusion, Riddiough "compare[s] the average price of the seven At-Issue Certificates in September 2011 and March 2014 to see if there is a price increase over this period that would be consistent with a partial market liquidity recovery over time." In this context, Riddiough notes that, according to one pricing source, the Certificates' prices increased by 28 to 81 percent.

Accordingly, defendants have not shown that the Certificates' post-filing performance has much if any relevance to an analysis of market liquidity as of the filing date. FHFA's motion does not seek to generally exclude post-filing economic data, which may incorporate data concerning the Certificates within a larger data set. The Court reserves judgment on the admissibility of more general information used to measure market liquidity that incorporates data concerning the Certificates or their underlying loans.

C. Offsets

Third, defendants contend that the Certificates' Post-Filing Payments are relevant because they should offset any award of Section 11 damages by the jury. Defendants are incorrect.

The statutory formula for recovery provides no basis to reduce a damages award by offsetting payments on the Certificates. "The plain language of section 11(e) prescribes the method of calculating damages, and the court must apply that method in every case." *McMahan*, 65 F.3d at 1048. This alone bars defendants' offset argument.

Moreover, an offset would be entirely inappropriate given the fact that Section 11 damages, unlike Section 12 damages, do not seek to undo the purchase of the security, but rather to restore plaintiff to the approximate position plaintiff would have occupied had the representations in the Offering Documents been accurate and complete. A Section 11 plaintiff who holds a security is not entitled to a refund of the purchase price, but only to damages that approximate the drop in value between purchase and suit resulting from the misrepresented or omitted facts. As plaintiff here would have received the principal and interest payments if the Offering Documents were accurate, there is no reason to believe plaintiff should have to effectively give them up by offsetting them against damages for the drop in value.

It is true that the Certificates' valuation as of the filing date is based, in part, on the performance of the Certificates expected as of that date. It may well be that the Certificates performed better than expected, just as they might have done worse. This is irrelevant to a calculation of Section 11 damages, and it does not constitute a windfall. FHFA bore the risk of loss when it decided not to sell the Certificates after filing. Having taken that risk, it is entitled to recover the statutory damages and to keep any revenue received on the Certificates, just as it would be forced to absorb any post-filing losses.

D. Section 11 Loss Causation

Fourth, defendants argue, in their opposition of October 16, 2014, that Riddiough "would rely on actual cash flows from the Certificates after September 2011 to illustrate that the alleged misrepresentations did not, and could not have, caused the reduction in value that Mr. Finkel estimates." In fact, Riddiough does not cite to post-filing cash flows from the Certificates in his discussion of loss causation as it relates to Section 11 damages. Riddiough relies on the loss causation analysis conducted by Vandell, a second expert for defendants.

Vandell's report does not mention the Post-Filing Payments.[8] But his analysis includes a benchmarking model that considers the performance of loans in SLGs, including the SLGs underlying the Certificates, through December 2013. A single SLG may support dozens of certificates in any single securitization. As noted above, the Court reserves judgment as to defendants' use of aggregated post-filing performance data that incorporates data concerning the Certificates. Vandell's reliance on such data does not support the admissibility of evidence that specifically identifies the Certificates' post-filing performance, including the existence and extent of the Post-Filing Payments.

Defendants' only argument on this point is that "post-injury evidence can be relevant to show the

[8] The parties have only provided the Court with a short excerpt of Vandell's report in connection with this motion. The Court has received the full report and some of its supporting exhibits in connection with other applications from the parties.

proximate cause of an injury." Here, the last of the seven Certificates was purchased on April 30, 2007; defendants thus have more than four years of "post-injury evidence" prior to the date of filing on which to rely. Defendants do not explain why the three years after the filing date are necessary; indeed, many civil cases would have concluded years ago and such evidence would not exist.

Defendants cite two district court cases in support of their loss causation argument; neither is on point. In the first, *Zerega Ave. Realty Corp. v. Hanover Insurance Co.*, 04cv9651 (KNF), 2006 WL 1343643 (S.D.N.Y. May 17, 2006), a barge collided with a dock, which subsequently collapsed. *Id.* at *2. The magistrate judge permitted an engineer who had inspected the structural integrity of the dock before and after the collision to testify concerning causation. *Id.* at *4. The engineer's post-collision inspection was not at issue. Inspection of the scene of an accident bears little relevance to the use of performance data between four and seven years after alleged misrepresentations were made, where the first four years of performance data is readily available.

The second case, *Trzeciak v. Apple Computers, Inc.*, 94cv1251 (LAK) (MHD), 1995 WL 20329 (S.D.N.Y. Jan. 19, 1995), concerned a design defect claim by a plaintiff who alleged her use of an Apple keyboard and mouse caused her to suffer from repetitive stress injuries. *Id.* at *1. In a footnote, the magistrate judge noted that post-injury remedial measures taken by defendant "are potentially probative of the feasibility of corrective measure[s] prior to plaintiff's injury" and defendant's post-injury documents "are likely to contain other information that will be probative on such issues as causation and damages." *Id.* at *2 n.1. Defendants here have not explained how a defendant's post-injury documents concerning its response to a claimed design defect are relevant to post-filing performance of the Certificates.

Because the Section 11 loss causation analysis concerns loss in value as of the date of filing, and this value is determined solely by information available as of that date, post-filing performance is not directly relevant. Again, the Court reserves judgment as to the admissibility, for purposes of calculating Section 11 damages, of aggregated post-filing data that include—but does not break out—data concerning the Certificates or their underlying mortgage loans.

III. Section 12(a)(2) & Right to a Jury Trial

As explained below, there is no right to a trial by jury on FHFA's Section 12(a)(2) claims. Accordingly, although the Post-Filing Payments are relevant to Section 12(a)(2) damages, this does not require such evidence in the Section 11 case to be put before the jury.

A. Section 12(a)(2) Damages

Section 12(a)(2) has a different measure of damages than Section 11's. Section 12(a)(2) provides for "recover[y] [of] the consideration paid for [the] security [at issue] with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." 15 U.S.C. 77*l*(a). The Virginia and District of Columbia Blue Sky laws both adopt this measure of damages. See *FHFA v. Merrill Lynch & Co.*, 903 F. Supp. 2d 274, 280 (S.D.N.Y. 2012).

Where a plaintiff still owns the security, its remedy is rescission. *Commercial Union Assur. Co., PLC v. Milken*, 17 F.3d 608, 615 (2d Cir. 1994) (construing the identical language in predecessor Section 12(2)). "Under the rescissory measure of damages appellants would be entitled to a return of the consideration paid for the . . . interests plus prejudgment interest, less any income received on the interests." *Id.* The rate of prejudgment interest rests in the discretion of the trial court. *Id.*

B. No Right to a Jury Trial on Section 12(a)(2) Claim

The Seventh Amendment guarantees the right to a trial by jury "in Suits at common law." U.S. Const. amend. VII. "The phrase 'Suits at common law' refers to suits in which *legal* rights were to be ascertained and determined, in contradistinction to those where equitable rights alone were recognized, and equitable remedies were administered." *Eberhard v. Marcu*, 530 F.3d 122, 135 (2d Cir. 2008) (citation omitted). A two-step inquiry determines whether an action is a suit at law. *Id.* (citing *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 41 (1989)). First, courts look to whether the action or its analog "would have been deemed legal or equitable in 18th century England." *Id.* (citation omitted); *Pollara v. Seymour*, 344 F.3d 265, 268 (2d Cir. 2003). "[T]he second, more important step, requires a determination as to whether the remedy sought is legal or equitable in nature." *Eberhard*, 530 F.3d at 135 (citation omitted).

Where a case "present[s] both legal and equitable issues, it is for the jury to decide the legal issues and for the court to decide the equitable issues." Wright &

Miller, Fed. Practice & Pro. § 2305 (3d ed. 2014); *see also Heyman v. Kline*, 456 F.2d 123, 130 (2d Cir. 1972). Where there are "common factual issues necessary to the resolution of each claim," the legal claims should be tried to a jury first. *Robinson v. Metro-N. Commuter R.R. Co.*, 267 F.3d 147, 170 (2d Cir. 2001), *abrogated in unrelated part by Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

FHFA's Section 12(a)(2) claim is most analogous to an equitable action for rescission of contract, known in 18th-century England. *See* 2 Hazen, Law of Sec. Reg. § 7.9 (6th ed. 2009) ("[S]ection 12 closely resembles a traditional equity action for rescission."); Joseph Story, *Commentaries on Equity Jurisprudence, as Administered in England and America* § 200 (10th ed. 1870) ("[I]f a vendor, on a treaty for the sale of property, should make representations which he knows to be false, the falsehood of which, however, the purchaser has no means of knowing, but he relies on them, a court of equity will rescind the contract entered into upon such treaty . . . ."); *id.* § 692 ("Another head of equity jurisdiction . . . embraces that large class of cases, where the RESCISSION, CANCELLATION, or DELIVERY UP of agreements, securities, or deeds is sought . . . .") (citing *Bromley v. Holland*, [1802] 7 Ves. Jun. 3 (Ch.) at 18 (Eng.) (discussing equity jurisdiction in such cases)).[9]

[9] While rescission could be effected at law by tendering the property received to defendant and suing him at law to recover plaintiff's consideration, *see* Black's Law Dictionary (9th ed. 2009) ("rescission"), common law "had no action for rescission" and "common law courts had no jurisdiction to order the setting aside of contracts." Janet O'Sullivan, *Rescission as a Self-Help Remedy: A Critical Analysis*, 3 Cambridge L.J. 509, 517 (2000).

Likewise, the relief requested is, in effect, equitable rescission. *See Ballow Brasted O'Brien & Rusin P.C. v. Logan*, 435 F.3d 235, 240 (2d Cir. 2006) (rescission is an equitable remedy); *Standard Chlorine of Del., Inc. v. Leonard*, 384 F.2d 304, 308 (2d Cir. 1967) ("[I]t is clear that requests for . . . rescission have traditionally been considered equitable in nature."); *Mallory v. Citizens Util. Co.*, 342 F.2d 796, 797 (2d Cir. 1965) (action for rescission is "triable by the court," not the jury); *see also Deckert v. Independence Shares Corp.*, 311 U.S. 282, 284 (1940) (holding that the Securities Act "authorizes purchasers to maintain a suit in equity to rescind a fraudulent sale and secure restitution of the consideration paid").

Indeed, the Second Circuit has noted that a "district court did not err in deciding the section 12(2) issues on its own" because Section 12(a)(2) entitles a plaintiff "to rescission but not damages" and "[a]n equitable claim such as rescission is for the court, not the jury, to decide." *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1019 n.4 (2d Cir. 1989); *cf. Randall v. Loftsgaarden*, 478 U.S. 647, 651 (1986) (noting without comment, in Section 12(2) case, that trial court had accepted an advisory jury opinion with respect to the Section 12(2) claim). Accordingly, there is no right to a jury trial of FHFA's Section 12(a)(2) claim.

And equity had "exclusive jurisdiction" of rescission of "transactions induced by non-fraudulent misrepresentation, . . . certain non-fundamental mistakes, [or] those made in breach of fiduciary duty," like the alleged misrepresentations at issue here. *Id.*

Defendants do not offer an alternative 18th-century analog for a Section 12(a)(2) claim. Instead, they argue that relief under Section 12(a)(2) is not rescission, but rather is a legal remedy, pointing to Section 12(a)(2)'s loss causation defense.[10] Defendants are mistaken. In fact, the loss causation defense renders Section 12(a)(2) relief more, not less, like rescission.

Rescission of a contract "repudiate[s] the transaction and seek[s] [to] place[] [the parties] in [the] status quo." *Logan*, 435 F.3d at 238. "Inherent in the remedy of rescission is the return of the parties to their pre-contract positions. As a result, a party seeking rescission must restore the other party to that party's position at the time the contract was made." *In re APA Assessment Fee Litig.*, 766 F.3d 39, 56 (D.C. Cir. 2014). Section 12(a)(2)'s loss causation defense does precisely this: if the securities being tendered by FHFA are less valuable than the securities FHFA received at the time of the purchase agreements for reasons unrelated to defendants' alleged misconduct, then the return of the GSEs' consideration is similarly offset. When a defendant receives plaintiff's securities in exchange for the return of plaintiff's consideration paid, offset by any unrelated depreciation in value, the parties are placed in the *status quo ante*. This is fully in keeping with Section 12(a)(2)'s longstanding offset of the purchase price by "the amount of any income

[10] Because the loss causation defense was added in a 1995 amendment, *see* Pub. L. 104-67, 109 Stat. 737 (Dec. 22, 1996), defendants argue that the Second Circuit's 1989 guidance in *Royal American Managers* is inapposite. Defendants are wrong, for the reasons that follow.

received thereon." 15 U.S.C. § 77*l*(a)(2). Thus, Section 12(a)(2)'s loss causation defense renders its relief even more like equitable rescission, reaffirming the Second Circuit's conclusion in *Royal American Managers* that Section 12(a)(2) claims are not encompassed by the Seventh Amendment right to a trial by jury.

Defendants also argue that the Section 11 and Section 12 loss causation defenses are "interconnected, and thus they must both be determined by the jury." Defendants are incorrect. It is for the jury to determine, pursuant to Section 11, whether defendants have proven that all or any of the diminution in value of the securities between the dates of purchase and the time of suit was not the result of defendants' alleged misrepresentations. It is for the Court to determine, pursuant to Section 12(b), whether defendants have proven that all or any of the amount recoverable under Section 12(a)(2) was depreciation in the value of the securities that was not the result of defendants' alleged misrepresentations. In making the latter finding, the Court will, of course, accept as true any facts with respect to loss causation found by the jury. *See LeBlanc-Sternberg v. Fletcher*, 67 F.3d 412, 432 (2d Cir. 1995) (holding it an abuse of discretion for the district court to deny equitable relief by "relying on its own findings that were inconsistent with the jury's findings"); *Wade v. Orange Cnty. Sheriff's Office*, 844 F.2d 951, 954-55 (2d Cir. 1988).

The factual questions at issue in the Section 11 and Section 12 loss causation defenses may overlap, but they are certainly distinct. Indeed, it is precisely because the post-claim payments are relevant to the Section 12 defense but not to the Section 11 defense that defendants wish to try the two defenses together. Defendants' right to a jury trial of legal claims will be fully respected; the Seventh Amendment does not entitle defendants to have a jury try related equitable claims, and in that way sneak before the jury evidence irrelevant to the legal claims.

Pursuant to Rule 42(b), Fed. R. Civ. Pro., a court may, "[f]or convenience, to avoid prejudice, or to expedite and economize [litigation], . . . order a separate trial of one or more separate issues . . . [or] claims." As the parties have not yet addressed the issue of bifurcation, for present purposes it suffices to note that it is within the Court's discretion to bifurcate the determination of damages under Section 12(a)(2) and the Blue Sky laws. Accordingly, the relevance of the Post-Filing Payments to those damage calculations does not establish their admissibility in connection with Section 11.

CONCLUSION

FHFA's October 6, 2014 motion *in limine* to prohibit defendants from presenting evidence to the jury concerning the Post-Filing Payments in connection with FHFA's Section 11 claims is granted.

SO ORDERED:

Dated: New York, New York
December 18, 2014

[handwritten: signature]
DENISE COTE
United States District Judge

Appendix E

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

No. 11-cv-6201(DLC)

FEDERAL HOUSING FINANCE AGENCY,
Plaintiff,
v.
NOMURA HOLDING AMERICA, INC., et al.,
Defendants.

May 11, 2015

OPINION & ORDER

DENISE COTE, District Judge:

This case is complex from almost any angle, but at its core there is a single, simple question. Did defendants accurately describe the home mortgages in the Offering Documents for the securities they sold that were backed by those mortgages? Following trial, the answer to that question is clear. The Offering Documents did not correctly describe the mortgage loans. The magnitude of falsity, conservatively measured, is enormous.

Given the magnitude of the falsity, it is perhaps not surprising that in defending this lawsuit defendants did not opt to prove that the statements in the Offering Documents were truthful. Instead, defendants relied, as they are entitled to do, on a multifaceted attack on plaintiff's evidence. That attack failed, as did defendants' sole surviving affirmative defense of loss causation. Accordingly, judgment will be entered in favor of plaintiff.

PROCEDURAL HISTORY

In September 2011, the Federal Housing Finance Agency ("FHFA") brought sixteen lawsuits against banks and related entities and individuals to recover damages on behalf of two Government-Sponsored Enterprises, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") (collectively "GSEs") arising out of the GSEs' investments in residential mortgage-backed securities ("RMBS"), specifically their investment in so-called private-label RMBS ("PLS").[1] FHFA had been created in the midst of the financial crisis, on July 30, 2008, pursuant to the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (codified at 12 U.S.C. § 4617), to oversee the GSEs as well as the Federal Home Loan Banks. It became conservator of the GSEs on September 6, 2008.

The discovery, motion practice, and trials of the sixteen actions were coordinated before this Court, as described in *FHFA v. UBS Americas Inc.*, No. 11cv5201 (DLC), 2013 WL 3284118, at *1-9 (S.D.N.Y. June 28, 2013), *reconsideration denied sub nom. FHFA v. JPMorgan Chase & Co.*, No. 11cv6188 (DLC), 2013 WL 5354212 (S.D.N.Y. Sept. 25, 2013). Fact

[1] A seventeenth related action is proceeding in the District of Connecticut before the Hon. Alvin W. Thompson. *FHFA v. RBS et al.*, No. 11cv1383 (AWT) (D. Conn).

discovery in the actions largely concluded on December 6, 2013**.** The trials of the sixteen cases were separated into four tranches, with the earliest tranche scheduled for trial in January 2014, and the fourth tranche set for trial in early 2015. Expert discovery concluded in waves, with the final wave ending on November 26, 2014.

Ultimately, only this lawsuit, one of the sixteen actions, proceeded to trial. This case is referred to as the "Nomura Action."[2] The Nomura corporate defendants are Nomura Holding America, Inc. ("NHA"), Nomura Securities International, Inc. ("Nomura Securities"), Nomura Credit & Capital, Inc. ("NCCI"), Nomura Asset Acceptance Corporation ("NAAC"), and Nomura Home Equity Loan, Inc. ("NHELI").[3] The five individual Nomura defendants—David Findlay ("Findlay"), John Graham ("Graham"), Dante LaRocca ("LaRocca"), Nathan Gorin ("Gorin"), and John McCarthy ("McCarthy") (collectively "Individual Defendants")—signed Registration Statements for the PLS and were officers or directors of multiple Nomura defendants. Co-defendant RBS Securities Inc. ("RBS"), known at the time of the transactions as Greenwich Capital Markets, Inc., underwrote four of the seven securitizations ("Securitizations") at issue here.

FHFA alleges that defendants are liable under Sections 12(a)(2) and 15 of the Securities Act of 1933,

[2] This Opinion uses the term "Nomura" to refer collectively to the Nomura family of corporate entities and associated individuals.

[3] Nomura entities that are not named parties play a part in this story, too; these are Nomura Asset Capital Corporation ("NACC") and Nomura American Mortgage Finance ("NAMF").

15 U.S.C. §§ 77*l*(a)(2), 77o (the "Securities Act claims"), and parallel provisions of the District of Columbia's and Virginia's Blue Sky laws, D.C. Code § 31-5606.05(a)(1)(B), (c), Va. Code Ann. § 13.1-522(A)(ii) (collectively the "Blue Sky claims"). FHFA alleges that four sets of representations in each of the seven Prospectus Supplements were false. They are representations regarding the origination and underwriting of the loans within the SLGs backing the Certificates; loan-to-value ("LTV") and combined loan-to-value ("CLTV") ratios[4] and appraisals, including compliance with Uniform Standards of Professional Appraisal Practice ("USPAP"); occupancy status; and the credit ratings of the Certificates.

In advance of trial several rulings on summary judgment motions, *Daubert* motions, and motions *in limine* were issued. Of particular importance are decisions ruling that, as a matter of law, defendants were not entitled to two statutory affirmative defenses—the GSEs' knowledge of falsity, and defendants' due diligence and reasonable care, *FHFA v. HSBC N. Am. Holdings Inc.*, 33 F. Supp. 3d 455, 493 (S.D.N.Y. 2014), *FHFA v. Nomura Holding Am. Inc.* ("*Due Diligence Opinion*"), --- F. Supp. 3d ---, 2014 WL 7232443, at *40 (S.D.N.Y. Dec. 18, 2014); decisions excluding evidence of the GSEs' affordable housing goals ("Housing Goals"), *FHFA v. Nomura Holding Am., Inc.* ("*Housing Goals Opinion*"), No. 11cv6201

[4] LTV ratios represent the amount of a loan against the value of its collateral. CLTV ratios are used when the same collateral is used to support more than one loan. Following industry custom, this opinion variously uses the shorthand LTV (or LTVs) to refer to both LTV and CLTV.

(DLC), 2014 WL 7229361, at *4 (S.D.N.Y. Dec. 18, 2014), and the flawed statistical analysis regarding loss causation offered by defendants' expert Kerry Vandell ("Vandell"), *FHFA v. Nomura Holding Am., Inc.* ("*Vandell Opinion*"), No. 11cv6201 (DLC), 2015 WL 539489, at *11 (S.D.N.Y. Feb. 10, 2015); and a decision interpreting certain language in the Prospectus Supplements at issue here, *FHFA v. Nomura Holding Am., Inc.* ("*Hunter Opinion*"), --- F. Supp. 3d ---, 2015 WL 568788, at *11 (S.D.N.Y. Feb. 11, 2015). On January 15, 2015, FHFA was granted leave to voluntarily withdraw its Securities Act Section 11 claim, and the parties prepared for a bench trial in lieu of a jury trial. *See FHFA v. Nomura Holding Am. Inc.* ("*Post-Filing Payments Opinion*"), --- F. Supp. 3d ---, 2014 WL 7232590, at *9-11 (S.D.N.Y. Dec. 18, 2014) (holding no right to jury trial in Section 12(a)(2) action).

The parties' pretrial order in the Nomura Action, proposed findings of fact and conclusions of law, and defendants' pretrial memorandum were submitted on February 20, 2015. FHFA submitted an opposition to defendants' pretrial memorandum on February 27; over FHFA's objections, the Court received defendants' response on March 9.

With the parties' consent, the trial was conducted in accordance with the Court's customary practices for non-jury proceedings, which includes taking direct testimony from witnesses under a party's control through affidavits submitted with the pretrial order. The parties also served copies of all exhibits and deposition testimony that they intended to offer as evidence in chief at trial with the pretrial order.

Affiants were cross-examined and presented their redirect testimony in court beginning on March 16. Additional witnesses also testified at that time.

Accommodating the Court's request, the parties largely organized the presentation at trial around topics. This meant that plaintiff's and defendants' witnesses on a topic were typically called to the stand right after each other. The nine topics, in roughly the order they were presented at trial, were background to the PLS industry, valuation, data summary, re-underwriting, sampling and extrapolation, diligence, Individual Defendants, materiality, damages, and loss causation. No witnesses were ultimately called for cross-examination on two additional issues: the location of sale, and principal and interest payments.

At trial, FHFA called thirteen fact witnesses and nine experts. FHFA's fact witnesses fell into three categories. FHFA called witnesses to testify about defendants' due diligence practices, including Brian Farrell ("Farrell"), Vice President in the Credit Risk Department at RBS; Joseph Kohout ("Kohout"), former head (until mid-2006) of the Diligence Group at Nomura Securities and later NCCI; Randall Lee ("Lee"), former collateral analyst at Nomura Securities and NCCI; Neil Spagna ("Spagna"), former head (after mid-2006) of the Diligence Group at Nomura Securities and later NCCI; and Charles Cipione ("Cipione"), Managing Director at AlixPartners, LLP, a financial and operational consulting firm, who presented data and summary statistics about defendants' due diligence practices. FHFA also called the five Individual Defendants. In addition, FHFA offered the affidavits of several witnesses to testify to the location of the GSEs' headquarters during the period relevant here. They are Kenneth Johansen, Financial Controller Manager at Freddie Mac, Chaka Long, Senior Account Executive at Fannie Mae, and Kevin Palmer, Vice President of Strategic Credit Costing and Structuring at Freddie Mac. Defendants chose not to cross-examine these witnesses and they did not appear at the trial.

FHFA's ten expert witnesses and the principal subjects of their testimony were: Peter Rubenstein, an independent consultant with expertise in residential real estate, who provided background on the PLS and RMBS industry generally; John Kilpatrick ("Kilpatrick"), Managing Director of Greenfield Advisors, a real estate and economic consulting firm headquartered in Seattle, Washington, who testified about property appraisals underlying the sample of loans at issue here ("Sample loans"); Robert Hunter ("Hunter"), an independent consultant with expertise in residential loan credit issues, who testified about the results of his re-underwriting review of the Sample loans; Dr. Charles Cowan ("Cowan"), Managing Partner of Analytic Focus LLC, a statistical research and analysis consultancy firm, who testified about his statistical extrapolations of Kilpatrick's and Hunter's findings; Steven Campo, founder and principal of SeaView Advisors, LLC, a private equity firm, who testified to the role of independent accountants in reviewing representations in Offering Documents; Leonard Blum, a principal at Blum Capital Advisors LLP, an investment banking consulting firm, who testified as to what information those in the RMBS industry considered to be material, as did Dr. William Schwert ("Schwert"), Distinguished University Professor of Finance and Statistics at the William E. Simon Graduate School of Business Administration of the University of Rochester and Research Associate of the National Bureau of Economic Research;[5] James Finkel, Managing Director at Duff & Phelps, LLC, a corporate finance consulting firm, who opined as to the appropriate amount of damages due FHFA; and Dr. James Barth ("Barth"), the Lowder Eminent Scholar in Finance at Auburn University, a Senior Finance Fellow at the Milken Institute, and a Fellow at the Wharton Financial Institutions Center, who testified regarding defendants' loss causation defense.

FHFA also offered excerpts from the depositions of Michael Aneiro ("Aneiro"), former Freddie Mac PLS trader; Vicki Beal ("Beal"), corporate representative of Clayton Holdings LLC ("Clayton"), speaking as fact witness and Rule 30(b)(6) designee; Frank Camacho, former Vice President for Credit Risk at RBS; Debashish Chatterjee, Rule 30(b)(6) designee for Moody's Investors Service ("Moody's"); James DePalma, former Director at Nomura Securities; Jacqueline Doty ("Doty"), corporative representative for CoreLogic, Inc. ("CoreLogic"), a valuation diligence firm; David Hackney ("Hackney"), former PLS trader at Freddie Mac; Jeffrey Hartnagel ("Hartnagel"), former member of Nomura's Diligence Group; Tracy Jordan, former due diligence underwriter at Clayton; Steven Katz ("Katz"), former managing director of Nomura's trading desk ("Trading Desk"); Peter Kempf

[5] Schwert also offered testimony relevant to defendants' affirmative defense of loss causation.

("Kempf"), Rule 30(b)(6) designee for American Mortgage Consultants, Inc. ("AMC"); Pamela Kohlbek, a former employee of Clayton; Sharif Mahdavian, Rule 30(b)(6) designee for Standard & Poor's ("S&P"); Brett Marvin ("Marvin"), former managing director and head of the Trading Desk at Nomura; Nancy Prahofer, former Head of Litigation at NHA; Shayan Salahuddin, ("Salahuddin"), former PLS trader at Fannie Mae; Christopher Scampoli ("Scampoli"), Senior Credit Analyst consultant in Nomura's Diligence Group; Richard Syron ("Syron"), former Chairman and CEO of Freddie Mac; and James Whittemore, former Senior Vice President and Chief Underwriter at RBS.

Defendants called seventeen fact witnesses and nine experts. In addition to Kohout, Lee, Spagna, and the five Individual Defendants, defendants' fact witnesses included four residential real estate appraisers who had conducted or supervised some of the appraisals at issue here, Lee Clagett ("Clagett"), Michele Morris ("Morris"), Dan Platt ("Platt"), and William Schall ("Schall"). Defendants also called three former GSE officials, Patricia Cook ("Cook"), former Executive VP of Investments and Capital Markets at Freddie Mac; Daniel Mudd ("Mudd"), former President and CEO of Fannie Mae; and Peter Niculescu ("Niculsecu"), former Executive Vice President and Chief Business Officer at Fannie Mae. To testify about third-party due diligence practices, defendants called Derek Greene, Client Services Manager for Nomura at Clayton. And to counter Cipione's statistics on defendants' due diligence, they called David Mishol ("Mishol"), Vice President with Analysis Group, Inc., an economic consulting company.

Defendants' expert witnesses included several who addressed aspects of the analyses conducted by FHFA's expert Kilpatrick. They were Michael Hedden ("Hedden"), a Managing Director at FTI Consulting, Inc. ("FTI"), a business consulting firm; Lee Kennedy ("Kennedy"), Founder and Managing Director of AVMetrics, an automated valuation model ("AVM") testing firm; Dr. Hans Isakson ("Isakson"), Professor of Economics at the University of Northern Iowa; and Dr. Jerry Hausman ("Hausman"), MacDonald Professor of Economics at the Massachusetts Institute of Technology. Michael Forester ("Forester"), co-founder and managing director of CrossCheck Compliance LLC, a regulatory compliance, loan review, and internal audit services firm, testified regarding his review of Hunter's re-underwriting project. Dr. Andrew Barnett ("Barnett"), George Eastman Professor of Management and Professor of Statistics at the Sloan School of Management, Massachusetts Institute of Technology, testified about his analysis of Cowan's extrapolations. John Richard, a portfolio manager and financial consultant, testified about the types of information that reasonable investors in the PLS market considered significant during the period 2005 to 2007. Vandell, Dean's Professor of Finance and Director of the Center for Real Estate at the Paul Merage School of Business, University of California, Irvine testified about defendants' loss causation defense. Dr. Timothy Riddiough ("Riddiough"), E.J. Plesko Chair and Professor in the Department of Real Estate and Urban Land Economics at the Wisconsin School of Business, testified about defendants' loss causation defense as well as the appropriate measure of damages.

Defendants offered their own excerpts from the depositions of Aneiro, Beal, Doty, Hackney, Katz, Kempf, Marvin, Salahuddin, and Syron. In addition, they offered excerpts from the depositions of Clint Bonkowski, former Operations Director and Divisional Vice President at Quicken Loans, Inc., a residential loan originator ("Quicken"); Jeff Crusinberry, Rule 30(b)(6) designee for Fremont Investment & Loan ("Fremont"); Teresita Duran, Rule 30(b)(6) designee for the former Ocwen Financial Corp.; Ashley Dyson, former Senior Trader on Fannie Mae's PLS desk; Natasha Hanson, Rule 30(b)(6) designee for Fitch Ratings ("Fitch"); Tracy Hillsgrove, Rule 30(b)(6) designee for Ocwen Financial; Perri Henderson, former Associate Director in Portfolio Management at the adjustable-rate mortgage desk at Freddie Mac; Gary Kain, former Senior Vice President of Investments and Capital Markets at Fannie Mae; Gretchen Leff, Rule 30(b)(6) designee for Wells Fargo Bank, N.A. ("Wells Fargo"); Richard Rothleder, Rule 30(b)(6) designee for WMC Mortgage LLC ("WMC"); Guy Sindle, Rule 30(b)(6) designee for Deloitte & Touche ("Deloitte"); and Theresa Whitecotton, Rule 30(b)(6) designee of Bridgefield Mortgage Corp., testifying as to ResMAE Mortgage Corp.'s ("ResMAE") originating practices.

The bench trial was held from March 16 to April 9, 2015, and this Opinion presents the Court's findings of fact and conclusions of law. The findings of fact appear principally in the following Background section, but also appear in the remaining sections of the Opinion.

BACKGROUND

I. RMBS

The RMBS industry was a major economic force in 2005, 2006, and 2007, when defendants sold the securities at issue to the GSEs. RMBS are intricately structured financial instruments backed by hundreds or thousands of individual residential mortgages, each obtained by individual borrowers for individual houses. The process by which these discrete loans were to be issued, bundled, securitized, and sold is summarized first.

RMBS entitle the holder to a stream of income from pools of residential mortgage loans held by a trust.[6] Non-agency RMBS—RMBS offered by entities other than GSEs and the Government National Mortgage Association, or Ginnie Mae—are known as PLS.[7] The PLS purchased by the GSEs were backed by subprime and Alt-A mortgages. Subprime loans are made to borrowers with impaired credit. Alt-A loans are typically offered to borrowers with stronger credit, but they are a riskier loan than a prime loan. Because they are riskier than prime loans, subprime and Alt-A loans generally have higher interest rates.

A. Originating a Residential Mortgage Loan

Originators issuing subprime loans and Alt-A loans are the entities charged with evaluating and approving would-be borrowers' applications for mortgage loans. While this process inevitably involves

[6] In this context, "residential" refers to loans collateralized by one- to four-family residential properties.

[7] In this Opinion, the term RMBS will refer to PLS unless otherwise noted.

judgment, the originator's underwriting guidelines are central to the process of originating mortgages. Underwriting guidelines are intended to ensure that loans are originated in a consistent manner throughout an organization. They assist an originator in assessing the borrower's ability to pay the mortgage debt and the sufficiency of the collateral that will secure the loan; they also help the originator decide the terms on which to approve a loan. To the extent the originator intends to sell the loan, the guidelines also permit the originator to describe the qualifying characteristics for a group of loans and to negotiate a sale based on that description.

1. Credit and Capacity

Borrowers typically apply for a loan by completing a Uniform Residential Loan Application (known as "Form 1003").[8] In completing the Form 1003, a borrower discloses under penalty of civil liability or criminal prosecution her income, employment, housing history, assets, liabilities, intended occupancy status for the property, and the sources of the funds she will use in paying the costs of closing the loan. Every loan at issue here required a final Form 1003 signed by all borrowers.

Among other things, originators rely on objective factors, such as a borrower's credit score (often called a FICO score[9]) and history, and a borrower's debt-to-

[8] The Uniform Residential Loan Application is produced by the GSEs; "Form 1003" is its designation by Fannie Mae. The identical document is Freddie Mac Form 65.

[9] FICO refers to a consumer credit score issued by the Fair Isaac Corporation.

income ("DTI") ratio, to assess a borrower's ability and willingness to make required mortgage payments. FICO scores may determine the maximum amount of the loan that the originator will issue and the originator's ceiling for the LTV ratio for the property. Originators often require that the borrower's credit history, as reflected in a credit report, contain at least three trade lines—that is, credit accounts reported to credit rating agencies. Unexplained credit inquiries on a credit report may suggest undisclosed debt obligations that may negatively affect the borrower's DTI ratio calculation or even reflect deceit by the borrower. Credit inquiries made right around the time of the borrower's application for the loan, however, may reflect nothing more than the borrower shopping around for a good mortgage loan rate. The calculation of a borrower's DTI ratio will also typically include consideration of "payment shock," which refers to the degree to which a borrower's monthly housing payments will increase with the new loan.

The amount of information an originator gathers from a borrower depends on the type of loan being issued. A full documentation or "full doc" loan requires the borrower to substantiate current income and assets by providing documents, such as pay stubs, a W-2 form, and bank account statements. Other types of loans require less. Stated income, verified assets ("SIVA") programs do not require a borrower to provide documentation to support her represented income, but do require verification of assets. Stated income, stated assets ("SISA") programs do not require the borrower to provide documentation confirming her claim of either income or assets. And "No income, no assets" ("NINA") programs do not require borrowers even to state an income or their assets, let alone confirm them with documentation.[10]

No matter what the loan program, however, underwriting guidelines require an originator to evaluate the borrower's ability and willingness to repay a mortgage loan. Accordingly, originators assess, *inter alia*, the reasonableness of disclosed income asserted by the borrower and use a variety of information to verify income and assets. For instance, a written or verbal verification of employment may be obtained and online sources may provide the underwriter with information about salary ranges based on occupation and location.

When a borrower fails to meet the requirements of an originator's underwriting guidelines, many originators permit their underwriters to exercise discretion and allow exceptions to the guidelines. The originators' guidelines typically explain the circumstances under which exceptions may be granted, including how to document any exception that has been made. Exceptions to guidelines are documented in the loan file (described below) so that the exceptions may be understood and evaluated by others within the organization and, in those cases in which the loan will be sold, by those who acquire the loan. Exceptions to underwriting guidelines typically require the presence of compensating factors. For example, a low LTV ratio, which reflects strong

[10] For NINA loans, underwriters must rely on the borrower's credit history, credit score, and strength of the collateral, but may be required to obtain verification of employment.

collateral securing the loan, might compensate for a higher-than-guidelines-permitted DTI ratio.

During the origination process, originators assemble the documents associated with the mortgage loan into a "loan file." The loan file includes, at a minimum, a borrower's completed Form 1003, a property appraisal, a credit report, and legally required documents like HUD-1 forms and TIL disclosures.[11] During the relevant period, documents were frequently received in paper form and then scanned to convert them to digital images, but this conversion might not occur until after the origination process. Some originators created and relied on electronic loan files.

2. Collateral

During the underwriting process, originators must also determine whether the value of the mortgaged property is sufficient to support repayment of the loan in the event of default. The primary tool for assessing the value of the collateral for the loan is an appraisal of the property. The most common metric for measuring the collateral risk associated with a loan is

[11] If a loan is approved, certain documents are required by law to be completed in connection with the issuance of the loan. The closing costs for the mortgage loan appear on a "HUD-1" form called a Settlement Statement or Closing Statement, which itemizes all of the money changing hands at closing. In addition, the originator must notify the borrower of the true cost of the loan, including finance charges and the schedule of payments. This appears on a truth-in-lending ("TIL") disclosure. Borrowers also have a right to rescind ("ROR") the transaction within three days of closing, which must likewise be disclosed. If the TIL and ROR disclosure are not available, it is more difficult to foreclose on the property in the event of a default.

the LTV ratio. When the mortgage supports the purchase of a property, the value of the collateral is usually measured as the lesser of the sales price or the appraisal value. Appraisals are also prepared in connection with the refinancing of existing debt. Accurate appraisals are particularly important in the case of second mortgages, because an overstated appraisal value increases the likelihood that the liquidated collateral value will be insufficient to cover both the first and second mortgages.

Appraisals are, essentially, an estimate of a property's market value as of a given date. A central component of all residential appraisals is the selection of comparable properties with which to assess the value of the subject property ("comparables"). Appraisers are supposed to select the best comparables—which typically means the geographically closest properties with the most similar characteristics, such as lot size, house size, style, and number of bathrooms—that have been the subject of sales transactions within the past year. Appraisers also consider market conditions, including housing supply and demand in the property's neighborhood.

Appraisers document their work in a formal report, usually using a Fannie Mae Form 1004 or Freddie Mac Form 70 Uniform Residential Appraisal Report ("URAR"). When the appraisal is in connection with a sale of the property, the appraiser is required to analyze the sales contract.

While accuracy and good faith should be the watchwords of appraisers, it is easy for appraisers to inflate their appraisals through their selection and analysis of comparables. For instance, an appraiser can choose a comparable from a nicer neighborhood, ignore key features of a comparable's sales price, such as thousands of dollars of assistance with closing costs or escrowed repair funds that are not associated with the value of the property, or ignore more recent comparables that reflect a local market's turn for the worse. An appraiser might also mislabel the number of stories in a comparable, or fail to follow up on evidence that a property had been flipped, raising doubt about the sales price's reflection of market value. For these reasons, the URAR is supposed to include sufficient information about each selected comparable and its relevant characteristics to permit meaningful review.

Appraisers may inflate their appraisals because of pressure from loan officers. An officer may mention the desired appraisal value he is seeking, ask for the appraiser to call back if she cannot hit a specific value, or send out appraisal assignments to multiple appraisers with the explanation that the assignment will be given to the first one who can find the target value. Appraisers can be made to understand that their ability to receive future assignments depends upon delivery of the desired results.

During the overheated housing market at issue here, residential appraisers felt intense pressure to inflate appraisals. Defendants' appraisal expert, Hedden, observed that such pressure was simply part of what appraisers were faced with "on a regular basis." Defendants' appraiser witnesses acknowledged that they and other appraisers with whom they worked experienced pressure to provide "predetermined appraisal values."

In a national survey of appraisers conducted in late 2006, 90% of the participating appraisers indicated that they felt some level of "uncomfortable pressure" to adjust property valuations.[12] This was an increase of 35% from a survey conducted three years earlier.

Indeed, the widespread feelings of discomfort prompted 11,000 appraisers in 2007 to submit a petition to Congress and the Appraisal Subcommittee of the Federal Financial Institutions Examination Council,[13] copying "[o]ther state or federal agencies

[12] The 2007 National Appraisal Survey was composed of 33 questions presented to "a representative group of the nation's leading real estate appraisers." It was intended to give a comprehensive understanding of the real estate appraisal business in the second half of 2006 through 2007. Its predecessor, conducted in 2003, "shocked the industry when 55% of appraisers surveyed indicated that they felt uncomfortable pressure to overstate property values in greater than half of their appraisals." The component of the survey conducted in the last half of 2006 represented responses from 1,200 appraisers, and showed "an alarming increase" in the extent of pressure felt by real estate appraisers.

[13] The Federal Financial Institutions Examinations Council (FFEIC) is a formal interagency body empowered to prescribe uniform principles, standards, and forms for the federal examination of financial institutions, and to make recommendations to promote uniformity in the supervision of financial institutions. *FFIEC*, https://www.ffiec.gov (last visited May 11, 2015). The FFEIC Appraisal Subcommittee was created to provide federal oversight of state appraiser regulatory programs and a monitoring framework for the Federal Financial Institutions Regulatory Agencies in their roles to protect federal financial and public policy interests in real estate appraisals

with authority in the . . . matter." The petition explained that the signatories were licensed and certified real estate appraisers who

> seek your assistance in solving a problem facing us on a daily basis. Lenders . . . have individuals within their ranks, who, as a normal course of business, apply pressure on appraisers to hit or exceed a predetermined value.
>
> This pressure comes in many forms and includes the following:
>
> - the withholding of business if we refuse to inflate values,
> - the withholding of business if we refuse to guarantee a predetermined value,
> - the withholding of business if we refuse to ignore deficiencies in the property,
> - refusing to pay for an appraisal that does not give them what they want,
> - black listing honest appraisers in order to use "rubber stamp" appraisers, etc.

The petition requested action. It added, "We believe that this practice has adverse effects on our local and national economies and that the potential for great financial loss exists. We also believe that many

utilized in federally related transactions. *Appraisal Subcommittee*, https://www.asc.gov/Home.aspx (last visited May 11, 2015).

individuals have been adversely affected by the purchase of homes which have been over-valued."[14]

It was against this backdrop that in 2008 FHFA announced the Home Valuation Code of Conduct ("HVCC"). *See* T. Dietrich Hill, Note, *The Arithmetic of Justice: Calculating Restitution for Mortgage Fraud*, 113 Colum. L. Rev. 1939, 1946 & n.49 (2013). Under the HVCC, the lender, whether it be a bank or a mortgage company, was not permitted to have direct, substantive contact with the appraiser. Even though the HVCC was only briefly in effect, *see* 15 U.S.C. § 1639e(j) ("[T]he Home Valuation Code of Conduct announced by the Federal Housing Finance Agency on December 23, 2008, shall have no force or effect."), one of the residential home appraisers testifying for defendants indicated that the HVCC had a salutary effect on the practices of lending officers.

B. Overview of the Securitization Process

The loans at issue here were sold almost immediately after origination. During the period 2005 to 2007, originators sold subprime and Alt-A loans either individually or in the aggregate in what are known as trade pools to sponsors, like Nomura. With these sales, the originators received payments allowing them to originate more loans.

A sponsor could accumulate tens of thousands of loans from scores of originators. Sponsors would then

[14] While the survey and petition were received only for the state of mind of the appraisers, and not for the truth that lending officers actually exerted the pressure of which the survey participants and petitioners complained, virtually every trial witness with knowledge of the appraisal industry, including defendants' witnesses, confirmed that such pressure existed.

select loans from among those on its books, place the selected loans into groups for securitization, and sell them to depositors, typically a sponsor's affiliate. Depositors would transfer the groups of loans to trusts created specifically for each securitization. These loans formed the supporting loan groups ("SLGs") whose principal and interest payments were channeled to investors. Depositors issued certificates entitling holders to payments; these would then be marketed and sold by underwriters.

When selling a pool of loans, the originator provided a "loan tape" for the loans. Loan tapes are spreadsheets containing 50 to 80 fields of collateral and borrower data for each loan, including the borrower's name, street address, FICO score, DTI ratio, LTV ratio, property type, loan amount, loan purpose, interest rate, owner-occupancy status, documentation program, and presence of mortgage insurance. The information on these loan tapes was the principal source of data for the disclosures to investors and the SEC that were made in the Offering Documents for the PLS. A more detailed description of this process and the roles played by critical participants in this process follows.

1. The Sponsor

Each RMBS needed a sponsor. Sponsors purchase loans from originators or loan aggregators, a transaction that is generally governed by a Mortgage Loan Purchase Agreement, which contains representations and warranties. The sponsor holds title to the loans before they are transferred to the RMBS depositor. During the securitization process, sponsors have access to information about individual loans, including the loan files created at the time the loan was originated and the loan originator's guidelines. As the loans it holds on its books mature, sponsors also have access to information about loan performance from the loan's servicers, such as any delinquency or default history.

2. The Depositor

Depositors are special purpose vehicles ("SPVs")—essentially shell corporations—that exist for one purpose: to purchase the loans from the sponsor and deposit them in a trust. This step creates a true sale of the assets, thereby protecting certificate-holders against the risk of a subsequent bankruptcy by the sponsor. The depositor establishes a trust and deposits the loans into the trust in exchange for certificates. The depositor also issues Registration Statements, Prospectus Supplements, and other Offering Documents for the securitization. Apart from their directors and officers, SPVs typically have no employees or other business operations.

The RMBS trusts created by depositors are typically established pursuant to a Pooling and Servicing Agreement ("PSA"). The trustee for each trust is generally responsible for maintaining custody of operative documents related to the mortgage loans, receiving the cash flows each month from the entities servicing the loans, and allocating the cash flows to the certificate-holders and others pursuant to the rules laid out in the PSA.

3. The Underwriter

To pay for the loans it has purchased, the depositor sells the certificates produced during the trust transaction to the underwriters who will take the securities to market. The lead underwriter for an RMBS often designs the structure of the securitization and coordinates with the rating agencies to obtain credit ratings for the deal. Typically, the lead underwriter is also responsible for performing due diligence to ensure that the Offering Documents are accurate and complete. If an underwriter's due diligence uncovers discrepancies between the loans intended for the RMBS and the description of the loans in the Offering Documents for the securitization, it may choose to eliminate non-conforming loans from the loan pool or to revise the Offering Documents for the securitization so that they accurately describe the loans.

4. The Servicer

Another entity essential to securitization is the loan servicer. The servicer for the mortgage loans interacts with the individual borrowers on behalf of the trust. It collects monthly mortgage payments and forwards the receipts to a master servicer or trustee. When a loan becomes delinquent, the servicer takes steps to cure the delinquency. These steps may include foreclosure proceedings that may in turn result in the trust obtaining ownership of the property, which is referred to as Real Estate Owned ("REO"). The servicer is then responsible for selling the REO property and forwarding the liquidation proceeds to the master servicer or trustee.

C. Structure of an RMBS Instrument and Credit Enhancement

RMBS certificates are backed by one or more groups of loans that collateralize a certificate. The stream of payments that are made to investors in

RMBS over time consist of the principal and interest payments on the certificates. These flow from the underlying principal and interest payments made by the individual borrowers on the mortgage loans within the SLG (or SLGs); the rate at which interest payments are made to investors in an RMBS is referred to as the coupon rate.

The credit profile of RMBS can be improved through "credit enhancement" features. These features are critically important to credit rating agencies, particularly for RMBS supported by subprime and Alt-A loans. Enhancements are designed to protect investors in the more senior certificates—the more expensive, less risky, and higher-rated certificates—from loss. Credit enhancements can be external or internal. External enhancements include bond insurance or financial guarantees. Internal RMBS credit enhancements include subordination and overcollateralization.

1. Subordination

Subordination refers to a structure in which each class or tranche of certificates has a different right to the flow of payments and the allocation of losses. Credit risk in the pool is thus distributed unequally among the certificate-holders, usually protecting the senior certificates against losses at the expense of junior certificates. Certificates in senior tranches are given a first claim on cash flows and a last position with regard to losses. Only after senior-tranche certificates have been "filled up" does payment flow to more junior tranches. This pattern is followed for all subordinate certificates; once they are filled up, the next in line receives its payments. This is referred to as a “waterfall,” as the payments cascade from the senior tranches to the junior in a fixed order.[15] Because they carry less risk, the more senior class of certificates have higher credit ratings and earn less in interest. In subprime RMBS during 2005 to 2007, subordinate tranches were typically designed to absorb a complete loss on the order of 20% to 30% of the underlying collateral; in Alt-A transactions, the subordinated tranches were generally designed to protect against losses on the magnitude of 5% to 10%.

2. Overcollateralization

Overcollateralization occurs when the total balance on the mortgage loans in the securitization exceeds the total balance on the mortgage loans underlying the certificates issued. This excess collateral insulates the certificates from loss.

D. Securing a Credit Rating

Credit ratings for securities reflect a judgment by credit agencies about the credit risk of owning the security. A higher rating signals a less risky security. Senior certificates in RMBS are usually rated AAA (or triple-A), which is the highest rating level. Junior certificates usually have lower credit ratings. Since the rating of AAA conveys the same credit risk regardless of whether the RMBS are backed by prime or non-prime loans, RMBS backed by non-prime loans necessarily require greater credit enhancement to obtain a AAA rating.

[15] Rules of allocation among the certificates are set out in the PSA. Depending on the terms of the PSA, senior certificates may also receive portions of the cash flows from loans in other SLGs.

Three rating agencies were principally involved in rating the RMBS at issue here: Moody's, S&P, and Fitch. The sponsor, depositor, or the underwriter of an RMBS provides information to rating agencies so that the agencies can evaluate the risk in the pool of loans and issue appropriate credit ratings for the certificates. Such information was contained on loan tapes.

Of particular importance to agencies providing ratings for subprime and Alt-A RMBS were the LTV ratios of the loans in the proposed securitization. In their view, LTV ratios were "key predictors" of foreclosure rates and an LTV ratio of 80% was a particularly critical threshold. According to S&P's criteria for reviewing subprime transactions, loans with LTV ratios between 80% and 90% are one-and-a-half times more likely to be foreclosed than loans with LTV ratios below 80%. And loans with LTV ratios between 95% and 100% are 4.5 times more likely to enter foreclosure than loans with LTV ratios below 80%. Rating agencies also attached importance to the property's occupancy status, since borrowers are more likely to make payments on their primary residence, and to originators' compliance with their own underwriting guidelines, because agencies viewed compliance with an originator's guidelines as assurance that a loan was legitimate.

To assess a securitization, rating agencies relied on the accuracy of the loan tapes provided by the sponsor or underwriter. The agencies did not have access to the loan files or conduct any due diligence to verify the loan tape data. Using loan tape data, the three credit rating agencies used models to forecast foreclosure frequency, expected losses, and cash flows on the RMBS that they rated. The ratings and loss estimates generated by the models were extremely sensitive to loan-level data; if incorrect data was used—data reflecting more favorable loan characteristics—these models would require less credit support than should have been required of the securitization. At times, rating agencies advised sponsors what degree of subordination would be required to obtain a AAA or equivalent rating. Credit rating agencies reserved the right to request additional information about the loans to maintain their ratings or to withdraw their ratings entirely in the event information supplied to them was inaccurate or misrepresented. Analysts at rating agencies also reviewed Offering Documents to confirm that they included representations and warranties attesting to the accuracy of the loan-level information and that the mortgage loans had been originated in compliance with the originators' underwriting guidelines.

E. "Scratch-and-Dent" Loans

RMBS were only as good as their underlying mortgage loans. When, at the time of securitization, loans were known not to comply with originators' guidelines, to have missing documentation, or to have already become delinquent, the loans were referred to as "scratch-and-dent" loans. To obtain AAA ratings, credit rating agencies would typically demand more credit enhancements and structural safeguards like more overcollateralization or higher levels of subordination. RMBS with scratch-and-dent loans typically traded at discounts to par value.

When loans that were acknowledged as scratch-and-dent loans were securitized and sold, non-compliance was reported in Offering Documents, for instance, by referring to the loans as having impaired loan documentation or as loans that have been delinquent or "modified." The disclosure documents might also advise that a specific percentage of the loans were originated with "substantial deviations" from the originators' guidelines, or even specifically state that the loans "violated the underwriting guidelines or program guidelines under which they were intended to have been originated" and describe specific defects such as "the failure to comply with maximum loan-to-value ratio requirements."

F. RMBS Market Dynamics

During the period 2005 to mid-2007, the supply and demand for RMBS increased significantly, and competition among RMBS sponsors was intense. To function at all, the RMBS market required cooperation between entities at all levels of the process. In particular, issuers of RMBS built and strengthened their relationships with originators, who supplied the loans being bundled and sold.

Participants in a securitization were often vertically integrated, meaning that participants like the sponsor, the depositor, and the underwriter, or some combination thereof, were often related or affiliated. Vertical integration meant that the senior individuals working on a particular RMBS at the sponsor, underwriter and depositor were often the same individuals.

II. The Seven At-Issue Securitizations

Defendants sold the GSEs seven certificates ("Certificates"),[16] which in turn were part of the seven separate Securitizations. A brief summary of the relevant facts and circumstances surrounding those Securitizations follows.

Each of the seven Securitizations was issued pursuant to one of three shelf registrations.[17] Each Securitization was described in a set of Offering Documents, consisting of the original Registration Statement, any Amended Registration Statements, a Prospectus, and a Prospectus Supplement. The representations made in the seven Prospectus Supplements, described in detail below, are at the heart of the Nomura Action. In total, three Registration Statements and four Amended Registration Statements were used to issue the seven Securitizations.

As the table below shows, Nomura acted as sponsor and depositor for all seven of the Certificates, and as the sole lead underwriter and seller for two of them. RBS was the sole lead underwriter for three of the Certificates and a co-lead underwriter for a fourth.

[16] Fannie Mae purchased one Certificate in a senior tranche of Securitization NAA 2005-AR6. Freddie Mac purchased Certificates in senior tranches of the six other Securitizations: NHELI 2006-FM1, NHELI 2006-HE3, NHELI 2006-FM2, NHELI 2007-1, NHELI 2007-2, and NHELI 2007-3.

[17] Shelf registrations are pre-approved Registration Statements that allow new securities to be issued upon the filing of a Prospectus Supplement. See 17 C.F.R. § 230.409, .415; *FHFA v. UBS Americas, Inc.* ("*UBS I*"), No. 11cv5201 (DLC), 2012 WL 2400263, at *2 (S.D.N.Y. June 26, 2012).

Securitization	Sponsor	Depositor	Lead Underwriter(s)
NAA 2005-AR6	NCCI	NAAC	Nomura Securities
NHELI 2006-FM1	NCCI	NHELI	Nomura Securities
NHELI 2006-HE3	NCCI	NHELI	RBS & Nomura Securities
NHELI 2006-FM2	NCCI	NHELI	RBS
NHELI 2007-1	NCCI	NHELI	RBS
NHELI 2007-2	NCCI	NHELI	RBS
NHELI 2007-3	NCCI	NHELI	Lehman Brothers Inc.

The Certificates were all offered by means of Prospectus Supplements. Each Supplement bore a "Supplement Date," included a "Cut-off Date," and was filed with the SEC on a "Filing Date." The Supplement Date is the date actually listed on the cover of the Prospectus Supplement; the Cut-off Date is the "date for establishing the composition of the asset pool" in a securitization, *see* 17 C.F.R. § 229.1103(a)(2); and the Filing Date is the date on which the Prospectus and Prospectus Supplement were actually filed with the SEC. The table below provides these dates.

Securitization	Cut-off Date	Supplement Date	Filing Date
NAA 2005-AR6	11/1/2005	11/29/2005	11/30/2005
NHELI 2006-FM1	1/1/2006	1/27/2006	1/31/2006
NHELI 2006-HE3	8/1/2006	8/29/2006	8/30/2006
NHELI 2006-FM2	10/1/2006	10/30/2006	10/31/2006
NHELI 2007-1	1/1/2007	1/29/2007	1/31/2007
NHELI 2007-2	1/1/2007	1/20/2007	2/1/2007
NHELI 2007-3	4/1/2007	4/27/2007	5/1/2007

A summary of the seven Certificates' relevant characteristics, including the Certificates' tranches and their primary SLG, is provided in the table below.[18]

[18] NAA 2005-AR6 differs in some minor, but meaningful ways from the other six Securitizations. For one thing, it produced the only Certificate purchased by Fannie Mae, and is the only Securitization whose depositor was NAAC. More important for purposes of this Opinion is that it was not subject to the enhanced disclosure requirements of Regulation AB, which became effective on January 1, 2006. Accordingly, some of the language in its Prospectus Supplement is different from that appearing in the other six. Where NAA 2005-AR6 differs in these or other ways, this Opinion will note such differences.

Securitization	Tranche	SLG	Loans in SLG	SLG Aggregate Principal Balance
NAA 2005-AR6	III-A-1	III	376	$79,889,908
NHELI 2006-FM1	I-A	1	2,532	$405,436,188
NHELI 2006-HE3	I-A-1	1	3,618	$586,249,148
NHELI 2006-FM2	I-A-1	1	3,891	$677,237,695
NHELI 2007-1	II-1-A	II-1	474	$108,349,253
NHELI 2007-2	I-A-1	1	3,001	$481,674,027
NHELI 2007-3	I-A-1	1	1,896	$334,386,584

Together, the Certificates had an original unpaid principal balance of approximately $2.05 billion, and the GSEs paid slightly more than the amount of the unpaid principal balance when purchasing them. A Freddie Mac trader located at Freddie Mac's headquarters in McLean, Virginia purchased six Certificates; a Fannie Mae trader located at its headquarters in Washington, D.C. purchased the NAA 2005-AR6 Certificate. The purchase prices paid by the GSEs are listed below.

Securitization	Purchase Price
NAA 2005-AR6	$65,979,707[19]
NHELI 2006-FM1	$301,591,187[20]
NHELI 2006-HE3	$441,739,000
NHELI 2006-FM2	$525,197,000
NHELI 2007-1	$100,548,000
NHELI 2007-2	$358,847,000
NHELI 2007-3	$245,105,000

A. Principal and Interest Payments

The GSEs still hold the seven Certificates and have continued to receive principal and interest payments on them. The coupon rates for six of the seven Certificates were tied to the London Interbank Offered Rate ("LIBOR") rate. Six of the Prospectus Supplements stated that "[t]he per annum pass-through rate on the . . . Certificate[] will equal the lesser of (i) the sum of One-Month LIBOR for that distribution date plus" one of two percentages "or (ii) the applicable Net Funds Cap." The exception was NAA 2005-AR6, which provided for an initial fixed interest rate.[21]

[19] This amount includes $316,246 in accrued interest.

[20] This amount includes $41,187 in accrued interest.

[21] The Prospectus Supplement explained that "[t]he initial pass-through rate on the Class III-A-I Certificates is equal to approximately 6.04468% per annum. After the first distribution date, the per annum pass-through rate on the Class III-A-1

The amount of principal and interest on the Certificates received by the GSE from date of exchange through February 28, 2015, as stipulated to by the parties, is provided below.

Securitization	Principal Payments Through 2/28/2015	Interest Payments Through 2/8/2015
NAA 2005-AR6	$42,801,327	$17,517,513
NHELI 2006-FM1	$282,411,183	$23,756,542
NHELI 2006-HE3	$331,937,382	$34,559,137
NHELI 2006-FM2	$346,402,921	$42,099,996
NHELI 2007-1	$53,271,881	8$8,701,219
NHELI 2007-2	$235,700,674	$29,010,757
NHELI 2007-3	$127,924,783	$19,350,587

B. Age of Supporting Loans

There were over 32,000 loans supporting the Seven Securitizations. Of these, 15,806 are in the primary SLGs supporting the seven Certificates. Most of the loans supporting the Certificates were originated months before their securitization.[22] The

Certificates will equal the weighted average of the net mortgage rates of the Group III mortgage loans."

[22] Graham explained that collateral typically stayed on Nomura's books for roughly the duration of Nomura's agreements with originators permitting it to return loans in early payment default, a period he recalls as "three to four months."

table below illustrates that the “time gap” between a loan’s origination and a Securitization’s filing date was over 90 days for almost 2/3 (68.2%) of the loans backing these seven Certificates.[23] For almost 60%, the gap was four months or more.

[23] The total number of loans displayed in the table is only 15,679 instead of the 15,806 underlying the seven Securitizations. Necessary information was unavailable for the remainder of the loans.

Securitization	Loan Count	0-30 days	31 to 60 days	61 to 90 days	91 to 120 days	121 to 150 days	151 to 180 days	Greater than 180 days
NAA 2005-AR6	325	0	29	226	57	0	13	0
NHELI 2006-FM1	2532	0	0	2532	0	0	0	0
NHELI 2006-FM2	3891	0	0	0	0	3891	0	0
NHELI 2006-HE3	3613	0	0	304	1064	538	1201	506
NHELI 2007-1	403	14	125	184	79	1	0	0
NHELI 2007-2	3001	0	1438	0	208	320	458	577
NHELI 2007-3	1914	0	0	35	18	952	61	848
Total:	15,679	14	1,592	3,281	1,426	5,702	1,733	1,931

C. The Certificates' Credit Enhancements

Each Certificate is in a senior tranche of its Securitization, and each Securitization had several credit enhancements designed to shield senior certificates from losses. Among other things, each of these Certificates was protected by from five to eleven subordinated tranches.[24]

For example, in NHELI 2006-FM1, Freddie Mac purchased a Certificate linked to the senior-most tranche, class I-A-1, which was supported by loans from SLG I. That tranche had an initial principal balance of approximately $428 million; the subordinated tranches had a total principal balance of approximately $220 million. All realized losses on Group I loans were to be allocated to the subordinated tranches, until their $220 million principal balance was reduced to zero. Only then would losses begin to affect the senior tranches. Holding a senior tranche Certificate also entitled the GSE to principal payments from a separate SLG: if payments from Group II were made in full on that SLG's associated certificates, any additional cash flow would go to the GSE's senior certificate.

The table below displays the number of tranches subordinate to the GSEs' Certificates for each Securitization, as well as the face value of those subordinate tranches. In each case, a subordinate tranche designated "Tranche X" represented the Certificate's overcollateralization.

[24] One of the Securitizations—NAA 2005-AR6—had a "super-senior" tranche from which the GSE Certificate was purchased.

Securitization	Number of Subordinate Tranches	Face Value of Subordinate Tranches
NAA 2005-AR6	6	$64,412,464
NHELI 2006-FM1	12[25]	$220,837,934
NHELI 2006-HE3	12	$264,970,098
NHELI 2006-FM2	12	$275,696,345
NHELI 2007-1	9	$43,208,528
NHELI 2007-2	11	$237,310,229
NHELI 2007-3	10	$305,662,765

III. Due Diligence

Nomura came late to the RMBS business. It made its first subprime purchase in the spring of 2005, at a time when activity in the RMBS market was already intense, and it exited the RMBS business in late 2007, at a time when the market was imploding. Nomura was an aggregator of mortgage loans that were originated by others. Nomura's Trading Desk purchased the approximately 16,000 loans that populated the seven SLGs backing the GSEs' Certificates from many different sellers. 122 of the loans were purchased individually through Nomura's loan-by-loan channel, and the rest were plucked from 194 trade pools acquired by Nomura ("Trade Pools").

[25] Two of these were "Class B," or "Non-Offered" Certificates, which were not "being publicly or otherwise offered by th[e] prospectus supplement." No distinction is made here between Offered and Non-Offered Certificates for purposes of describing each Supplement's credit enhancements.

Together, these 194 Pools held over 54,000 individual loans.

After it won a bid for a Trade Pool, but before it purchased the Pool, Nomura performed a due diligence review of loans in the Pool. The group designated to conduct due diligence was a small, isolated unit within Nomura that was inadequately integrated into the overall operations of the company. Nomura never created any written due diligence procedures or standards to guide the work of this unit. By and large the unit was beholden to the Trading Desk, which made many of the key decisions that governed the operations of the due diligence unit. And, despite the mistaken assertions of top Nomura officials, the unit responsible for pre-acquisition due diligence had no role whatsoever in reviewing disclosures made in the Prospectus Supplements about the mortgage loans that backed the SLGs.

In conducting its pre-acquisition due diligence, Nomura repeatedly made choices intended to save money and to satisfy the sellers of the loans. Nomura routinely purchased and then securitized loans that had received “failing” credit and compliance grades from its due diligence vendors. It failed to subject thousands of the loans at issue here to genuine credit or valuation diligence, opting instead to use less expensive screening mechanisms. And once the loans were on Nomura’s books—with limited exceptions that are immaterial for present purposes—Nomura performed no further diligence. Nomura neither performed credit nor valuation due diligence once it had determined which loans would populate the SLGs supporting its securitizations, nor did it consider the information gleaned from the credit and valuation due diligence that had been performed on any of those loans before Nomura purchased them. Nor did Nomura use crucial information learned through due diligence when composing its descriptions of loans in the Prospectus Supplements.

RBS's due diligence was no better. Despite serving as lead underwriter on three of the seven Securitizations and co-lead underwriter on a fourth, RBS relied almost exclusively on Nomura's pre-acquisition due diligence results for two of the Securitizations, and the diligence it performed on the loans in the other two Securitizations was perfunctory. This section describes these programs and their failures.

A. Nomura's Due Diligence

At the time that he was Chief Legal Officer ("CLO") for NHA and Nomura Securities, Findlay oversaw the creation of Nomura's due diligence program. But beyond attending some very large meetings with consultants at some point between 2002 and 2004, he remembers nothing about this. And in the period between its creation and its shuttering in 2007, no part of Nomura's due diligence program was ever reduced to writing. Nomura has no written manual or guidelines and no fixed policies to govern its review of loans at either purchase or securitization.

1. Bidding Purpose

Normura's website posted the terms or pricing matrix that Nomura applied when purchasing individual loans. Among the criteria used in the matrix were the loan's LTV ratio at various points compared to the loan amount, for instance, at five step increments between an LTV ratio of 80 and 95. Other criteria included the FICO score, DTI ratio, and owner-occupancy status. According to the matrix, Nomura would pay more for a loan with a lower LTV ratio, a higher FICO score, a lower DTI ratio or that was owner-occupied. Nomura's matrix reflected its understanding of the models used by credit ratings agencies and how they would grade classes of loans in a securitization. It was Nomura's policy not to purchase loans with an LTV ratio over 100% or a DTI ratio over 55%.

The securitization process at Nomura began with the announcement by an originator or seller that it had a pool of loans for sale. The seller sent an email to potential buyers attaching a loan tape. Using the information on the pool sent by the seller, a collateral analyst at Nomura would stratify the data according to various traits, such as the percentage of loans in the pool that fell within different FICO score ranges, thereby creating what Nomura called "strats." The analyst would also load the loan tape data into a central database to track each individual loan on its journey through purchase and securitization. The Nomura database was called the Loan Management System ("LMS").

The loan tape data describing the characteristics of a loan that was entered into LMS was never altered, although it would be later augmented by servicing information if Nomura purchased the loan. Thus, the originator's description of the borrower's FICO score and DTI ratio, the LTV ratio for the property, and the property's owner-occupancy status would not be changed even if Nomura might learn contrary information during pre-acquisition due diligence or while the loan was on its books.

Traders at Nomura then reviewed the strats, which gave them a rough snapshot of the loan pool, and made a decision whether to make a bid for the pool of loans. Through this process Nomura purchased loans in trade pools, which were classified as "mini-bulk" (balance of less than $25 million) or "bulk" (balance of more than $25 million) lots. Roughly 89% of the loans in the seven SLGs came from bulk Trade Pools.[26] With certain loan originators, the Trading Desk entered into agreements that capped the sample size of loans it could review during pre-acquisition due diligence. For example, when purchasing a Fremont Trade Pool, Nomura and Fremont agreed that Nomura would perform due diligence on a 25% sample.

2. The Diligence Group

After Nomura won a bid on a trade pool, it was the responsibility of the Diligence Group, also referred to as the Credit Group or Residential Credit Group,[27] to conduct due diligence on the loans. The Diligence Group coordinated due diligence on the basis of the loan tapes supplied by each originator; it never reviewed the originator's loan files.

[26] Of the 194 Trade Pools that supplied loans to the seven SLGs, 140 were mini-bulk pools, which contributed 1,561 loans to the SLGs, and the remaining 54 were bulk pools, which contributed 14,123 loans to the SLGs.

[27] For consistency, this Opinion uses the phrase "Diligence Group."

The Diligence Group was small. For most of the relevant period, it consisted of just three people. From 2005 to mid-2006, Kohout was the head of the Diligence Group; in mid-2006, he was replaced by Spagna.[28] Throughout, the Group was supervised by Graham in his capacity as the head of the Transaction Management Group. Graham, in turn, was supervised by LaRocca. Kohout, Spagna, Graham and LaRocca all testified at trial; the deposition testimony of Hartnagel and Scampoli was received into evidence.

The Diligence Group was too small to do an effective job, a point that its first manager repeatedly made in writing and in conversation with his colleagues. The Diligence Group also lacked independence. It was the Trading Desk that made the important structural and methodological decisions. The Trading Desk dictated the size of any due diligence sampling and even, in some instances, which methods would be employed in choosing samples and which tests would be run on the samples. As early as April 2005, Kohout warned that the Trading Desk's decisions resulted in "Credit's role in both the sample selection and management of risk on bulk transactions [being] diminished to the point of that of a non effective entity." The Trading Desk was seemingly oblivious to the very serious risks associated with some of its decisions. For example, it proposed that Nomura purchase loans whose files were missing crucial documents, such as final Form

[28] From 2005 to 2006, Hartnagel and Menachem "Mendy" Sabo were the only other members of the Group; in mid-2006, Hartnagel was replaced by Scampoli, a consultant brought in by Spagna.

1003 and HUD-1, and enter a side-letter agreement allowing the seller to produce the missing forms later. Kohout pointed out that this was an invitation to fraud.[29]

As was customary among securitizers, Nomura relied on vendors to perform most of its due diligence work. Nomura's vendors included Clayton, AMC, CoreLogic, and Hansen Quality ("Hansen"). Those vendors sent a continuous flow of voluminous reports to the Diligence Group. The Diligence Group was too leanly staffed to do any careful review of the data. Over and over again, it simply "waived in" and purchased loans its vendors had flagged as defective.

Three types of diligence are of particular importance to the issues in this case, and they are described in detail here. They are credit, compliance, and valuation due diligence. In credit due diligence, the originator's loan files are reviewed to assess whether the loan was originated in compliance with the originator's written underwriting guidelines. Compliance due diligence determines whether the loan was issued in compliance with federal, state, and local laws and regulations. Valuation due diligence assesses the reasonableness of the original appraised value of the underlying property.[30]

[29] Kohout left the conclusion to the imagination, writing, "[T]o re-create a Final 1003, which will be dated after closing........."

[30] Nomura conducted its credit due diligence and compliance due diligence simultaneously using the same vendors and methodology. For purposes of this Opinion, they will be considered together. Two other kinds of diligence were also performed: data integrity diligence checked that the information in Nomura's central LMS database matched the description

3. Credit & Compliance Due Diligence

Nomura conducted its pre-acquisition credit and compliance due diligence in two ways. For single loan acquisitions and some mini-bulk pools, Nomura sent all of the loans to its vendors for credit and compliance review. For larger mini-bulk pools and all bulk pools, Nomura's Trading Desk would dictate a sample size for review. Accordingly, the credit and compliance review for the vast majority of the loans purchased by Nomura was conducted on a sample whose size was dictated by the Trading Desk.

While Nomura witnesses testified that Nomura's Diligence Group could request permission to increase the size of the sample, Nomura presented no evidence of any instance in which such permission was granted. Indeed, the only evidence about a specific request revealed just the opposite. When the Diligence Group asked permission to increase a sample size for a pool of loans originated by Fremont, the Trading Desk refused. Fremont loans were the only loans underlying NHELI 2006-FM1 and NHELI 2006-FM2.

a. Sampling

Nomura generally sampled between 20% and 35% of bulk pool loans. Nomura typically used larger samples from bulk pools when it was buying loans for

given by the originator in the loan file and the Prospectus Supplements, and collateral diligence checked the loan file to ensure that several documents critical to the transfer of title were not missing. These included the original note, mortgage, allonges, assignments, endorsements, and title insurance policies.

the first time from an originator or where the trade pool included unfamiliar loan products.[31]

When selecting the loans for a sample, Nomura did not use random sampling. This made it impossible to extrapolate to an entire pool the results from conducting due diligence on only a sample of the loans. Nor did Nomura, despite its claim at trial, use truly "adverse" sampling. Instead, at the insistence of the Trading Desk, the Diligence Group used S&P Financial Services LLC's LEVELS software to choose at least 90% of the loans in the sample. The LEVELS program relies solely on loan tape information in making its selection of a sample.[32] Kohout complained at the time, and to no avail, that using LEVELS did "not conform to what is generally deemed to be effective by industry standards." As Kohout explained at trial, using LEVELS made it impossible to select a sample based on a prediction of which loans were more likely to have "adverse" characteristics, such as a misstated LTV ratio or DTI ratio, an unreasonable "stated" income, or to find loans that deviated from the originator's underwriting guidelines.

As for the remaining 10% of the sample, however, the Diligence Group did take a stab at using adverse selection. A member of the Diligence Group would look at the loan tape for the trade pool and use his judgment to hand-pick up to 10% of the sample on the

[31] For some of the bulk pools at issue here, Nomura subjected the entire pool or virtually the entire pool to credit and compliance due diligence.

[32] LEVELS was a collateral valuation model that estimated lifetime loss. It was based on historical mortgage performance data, updated with performance trends.

basis of characteristics such as high DTI ratios, borrowers' low FICO scores, and low documentation loans.

b. Instructions to Vendors

Clayton and AMC conducted credit and compliance review for Nomura using the originator's loan file, the originator's written underwriting guidelines,[33] and Nomura's standard bid stipulations or "bid stips." Bid stips are provided to the entity selling the loan pool and list the bidder's minimum requirements for the loans in the pool, such as a defined LTV ratio or FICO score. If a loan in the pool does not meet the bid stips, then the bidder can "kick" the loan out of the pool.

Nomura's standard bid stips for subprime loans were close to the rock bottom requirements in the underwriting guidelines of originators during the period 2005 to 2007, and imposed very little additional screening of the loans. For instance, Nomura's "bid stips" included no DTI ratio greater than 55%, no FICO score less than 500, and no LTV/CLTV ratio over 100%. These were identical to the minimum standards used during this time, as identified by FHFA's expert, by originators in issuing loans. Several of Nomura's other bid stips are immaterial to the issues here.[34] In a few other instances, Nomura's bid stips varied

[33] The vendors did not confirm that the guidelines were the ones used to underwrite the loan; they used the set of guidelines provided to them by Nomura or the originator.

[34] For example, Nomura refused to buy mortgage loans for log homes or loans "secured by properties in Fallon, NV . . . due to arsenic in the water."

slightly from the origination industry's minimum standards. For instance, Nomura barred SISA, NINA, and No Doc loans from first-time homebuyers with an LTV/CLTV ratio over 95%; FHFA's expert, by contrast, identified a blanket 100% LTV ratio ceiling for such loans as the industry's minimum standard.[35]

While Clayton also gave its clients the opportunity to create "overlays" for the vendor to use in reviewing the loans, unlike most of its clients, Nomura refused to provide any credit overlays to Clayton. If Nomura had provided overlays, then Clayton would have flagged any non-compliant loans for closer review by Nomura. Nomura's failure to provide credit overlays was striking since Clayton repeatedly asked Nomura to do so, even escalating its requests to supervisors. On six different occasions over a two month period in the early summer of 2005, Clayton implored Nomura to send an overlay.

Not only did Nomura not provide Clayton with overlays to flag loans requiring more careful review, midway through 2006, Nomura told Clayton that it

[35] In at least one instance, Nomura's bid stips imposed higher standards than those identified by FHFA's expert as the industry's minimum standards: Nomura barred delinquent loans completely, while the minimum industry standards allowed for exceptions based on a specified number of months of missed payments. When it came to the "seasoning" of a borrower's ownership in the case of borrowers seeking to refinance, however, Nomura had a more relaxed approach than the industry's minimum standards: Nomura required only six months of seasoning on cash-out/refinance loans, while the industry's minimum required 12 months seasoning with certain exceptions. "Seasoning" refers to the aging of a mortgage expressed as elapsed time since origination.

needed to relax its due diligence process. Nomura explained that it was revamping its process to "increase approval rate, improve seller satisfaction with the due diligence process, and decrease efforts all around."[36]

Nomura never provided AMC with overlays either. It gave AMC no special instructions for the review of loan files.

c. Credit and Compliance Vendor Procedures

Clayton and AMC hired underwriters to perform the review of and assign a grade to each loan that Nomura sent to it. That review was severely restricted. With one possible exception,[37] the underwriters did not conduct any investigation of the credit quality of the loan beyond a comparison of the documents in the loan file to the originator's underwriting guidelines and Nomura's bid stips. For example, the underwriters did not confirm representations of owner occupancy or employment, investigate credit inquiries appearing on the credit report in the loan file, conduct further credit checks, consult public records, or perform a fraud review. Moreover, on occasion, when underwriting guidelines

[36] The Court has reconsidered its admission of plaintiff's exhibit 1894, a Clayton document further describing the relaxation of Nomura standards in 2006. That document is stricken from the trial record.

[37] There was evidence that underwriters may have on occasion consulted online salary databases to assess the reasonableness of stated income and that at least Clayton also relied on default overlays. None of the parties suggested that either of these processes had any measurable impact on the grading of the loans.

were lengthy, Clayton provided its underwriters with a summary of critical components of the guidelines to speed review.[38]

For both credit and compliance, underwriters graded loans on a scale of "EV1" to "EV3." According to Clayton's underwriting manual, loans graded "EV1" for credit were fully compliant "with all specific loan program parameters," which included compliance with the loan originator's underwriting guidelines and Nomura's bid stips. Loans graded "EV2" had "some deviations," but those exceptions were judged to be either immaterial or offset by "sufficient compensating factors." Loans graded EV3 typically had "substantial deviations" with "insufficient compensating factors to offset the overall risk." Nonetheless, the vendor would list any positive aspects of the loan to bring them to the client's attention. According to Kohout, a final EV3 grade was "fatal."

d. Nomura's Review of Vendors' Results

While diligence was underway, Clayton and AMC sent Nomura a constant stream of reports, often on a daily basis. These arrived in the form of event status reports, which were spreadsheets that listed loans and their corresponding grades; exception detail reports, which were omnibus spreadsheets containing summary data on loan defects; and individual asset summaries, which provided in the space of a few pages a description of a loan's characteristics, defects, and

[38] Concerned as early as September 2005 with its profitability on Nomura projects, Clayton decided that "drastic changes" were in order. To accelerate the underwriting process, Clayton began preparing "hot point summaries," that is, quick-reference cheat-sheets that condensed originators' guidelines.

potential compensating factors. Nomura's three-man Diligence Group never possessed or reviewed any loan files, and indeed it would not have had time to look at them in any event; it relied solely on the summary documents supplied by its vendors.

The Diligence Group had one of two choices to make with respect to loans flagged as EV3 by a vendor: to override or "clear" the identified exceptions, in which case it would "waive" the loan into the pool, or to reject the loan, in which case the loan was supposed to be "kicked out" of the pool. When Nomura advised Clayton that it had waived the defect in a loan graded EV3, it did not provide Clayton with a reason for the waiver. In these situations, Clayton changed the grade from EV3 to EV2W.

Nomura's policy toward waiving in EV3 loans was lenient in the extreme. Over the course of 2006 and the first quarter of 2007, Clayton graded 38% of the Nomura loans it reviewed for credit and compliance as EV3. Nomura waived in 58% of those EV3-rated loans. Given the large number of loans graded EV3 by Nomura, and the high rate of Nomura waivers, all told, Nomura overruled Clayton's grades and waived in 22% of all of the loans Clayton reviewed. The largest categories of waivers were in connection with EV3 grades assigned by Clayton for missing documents, unacceptable property types, and incomplete appraisals.

At trial, Nomura tried to explain these high waiver rates in several ways. It repeatedly argued that its client overlays had caused Clayton to flag many loans as EV3s that otherwise substantially complied with originators' guidelines. There was an insurmountable problem with this argument. Nomura never gave Clayton any credit overlays.[39]

Nor is Nomura's waiver rate explained by its bid stips. As already explained, those bid stipulations essentially reflected the rock bottom standards in originators' underwriting guidelines from that period; they did not impose materially more exacting standards. Tellingly, Nomura never provided any loan-by-loan analysis at trial of the loans flagged either EV3 or EV2W to support its suggestion that Nomura loans may have been assigned these grades even though they did not have substantial underwriting defects.

Finally, some of Nomura's witnesses testified that they waived in loans graded EV3 by vendors because of their individualized review of the loans. Among other things, Nomura provided originators with the opportunity to locate missing documents or to explain why there were sufficient compensating factors to override an underwriting defect. This was described as giving originators an opportunity "to tell their story and why they thought this was a good loan." Of course, depending on the nature of the defect and the character of the originator and borrower, this was an invitation for fraud. In any event, there were simply too many waivers to suggest an individualized, merits-based review of each and every waived-in EV3 loan.

[39] Other Clayton clients did give Clayton these overlays. Because those overlays reflected a client's individualized standards for flagging a loan with an EV3 grade, it is dangerous to try to compare either the EV3 or the waiver rates among Clayton clients.

But while the Nomura waiver rates were extremely high, so were the kick-out rates. Some of the Trade Pools that contributed loans to the seven SLGs had notably high kick-out rates. For example, the Silver State 66 pool, which supplied loans to NHELI 2007-2, had a kick-out rate of 29%, and the WMC SP01 pool, which supplied loans to NHELI 2007-3, had a kick-out rate of 41%. While one Nomura witness asserted that Nomura could increase the size of the sample or walk away from the trade altogether if a trade pool had a high kick-out rate based on something other than technical errors, Nomura provided no evidence of any occasion when it took either of those actions. In fact, the evidence showed that in at least one case, the contrary was true. Nomura drew a sample of second-lien loans from a Trade Pool purchased from originator OwnIt that had "100% CLTV on just about everything." After discovering high rates of bankruptcies and delinquencies in that sample, Spagna insisted that "we need to upsize the due diligence" on an OwnIt pool designated for securitization. The sample size—25%—was never upsized. Almost half of the loans in the NHELI 2007-2 SLG were originated by OwnIt.

The upshot of this process was that while many loans were kicked out of the Trade Pools, many others with identified defects were waived in. These numbers are all the more startling since the vendors' credit and compliance review did not involve, with one possible exception, any independent investigation of the loan. It was essentially restricted to a comparison of the loan file to originators' guidelines and Nomura's bid stipulations. From any point of view, the process could not have given Nomura comfort that the Trade Pools largely contained loans that complied, even generally, with originators' guidelines, or that the loans that they ultimately purchased did so.

During summation, Nomura chose to address its due diligence program only briefly.[40] Its counsel characterized Nomura as being in an "impossible" double bind. He argued that it cannot be true that Nomura's actions in kicking out some bad loans and in waiving-in other loans supported FHFA's negative characterization of Nomura's due diligence process. FHFA argued that the inferior quality of the process and the discovery of non-compliant loans during that process both tended to prove that the SLGs' loans did not conform to their originators' guidelines, even generally.

Nomura's confusion is hard to understand. There was no double bind for Nomura. For starters, it could have designed a different due diligence program. It could have instituted a rigorous due diligence program that examined with care a sample of loans, having used a sampling technique that would permit the results to be reliably extrapolated to the entire pool. But even without that approach, when its chosen due diligence program uncovered a disturbing quantity of non-compliant loans it could have kicked them out, increased its diligence with respect to any remaining loans, and, if necessary, chosen not to purchase the

[40] Nomura and FHFA both made affirmative offers of evidence at trial regarding Nomura's due diligence program. Nomura hoped that such evidence would tend to show that the loans in the SLGs complied with originators' guidelines; FHFA forecast the opposite.

loan pool or to describe its loans accurately, including, if appropriate, as "scratch and dent" loans.

e. Ignored Warning Signs

The reason for Nomura's lackluster due diligence program is not hard to find. Nomura was competing against other banks to buy these subprime and Alt-A loans and to securitize them. As its witnesses repeatedly described and as its documents illustrated, Nomura's goal was to work with the sellers of loans and to do what it could to foster a good relationship with them.

Given this attitude, it is unsurprising that even when there were specific warnings about the risk of working with an originator, those warnings fell on deaf ears. For example, in May 2005, Hartnagel described evidence of fraudulent loans and inadequate underwriting practices at Silver State. Far from limiting its exposure, Nomura continued to purchase and securitize large numbers of Silver State loans, which contributed 15.4% of the loans securitized into the NAA 2005-AR6 SLG in November 2005.

Similarly, in February 2006, the Diligence Group recommended to the Trading Desk that it remove The Mortgage Store, QuickLoan, and Alliance California, among other sellers, from Nomura's "buy/approved" list. One hundred percent of the loans in the The Mortgage Store pools were "repeatedly . . . originated outside of their guidelines." It had "extremely sloppy files"; and its guidelines were no more than "a flux suggestion." Despite these and similar warnings, Nomura continued to buy loans from each of these originators and to securitize them. A few of their loans found their way into each of the seven SLGs backing the GSEs' Certificates, including the five that were securitized after this warning from the Diligence Group.

And in April 2006, Kohout and the Trading Desk exchanged emails about the serious property valuation problems with loans in a People's Choice pool. Nomura had at that point already rejected 90 of the originator's appraised property values, and People's Choice had not even attempted to defend 80 of the 90. Kohout concluded that there was "an inherent flaw" in the People's Choice "origination process." But both the Trading Desk and Kohout expressed concern that testing even more appraisals than was customary might eliminate Nomura from consideration when making future bids for People's Choice trade pools, something it did not care to risk. People's Choice originated 1,672 (46.2%) of the loans in the relevant SLG in NHELI 2006-HE3, which was issued in August.

There are many more disturbing examples from the files of Nomura reflecting its willingness to securitize defective loans. One more will suffice. In September 2006, Nomura withheld due diligence information from its co-lead underwriter RBS. As Nomura was preparing to send a report to RBS showing the results of AMC's due diligence review of loans that would be securitized in NHELI 2006-FM2, Nomura discovered that there were 19 loans still rated as having material deviations. In an email with the subject line "HUGE FAVOR," Nomura's Spagna requested that AMC act "ASAP" and retroactively re-grade the 19 loans as client overrides since Nomura had decided to buy them "for whatever reason." Only after the grades had been altered and the report rerun, did Nomura forward the AMC results to RBS. In a conference call with RBS on that same deal, Spagna reported to a Nomura colleague that he "took the liberty to bullshit" RBS, adding "I think it worked." Spagna could not remember at trial precisely what he had discussed with RBS during that call.[41]

4. Valuation Due Diligence

In another part of its due diligence program, Nomura's vendors analyzed the collateral for the subprime and Alt-A loans. But, here too, Nomura's due diligence program was far from rigorous. Nomura contends that over 90% of the loans it purchased received valuation due diligence. But, in fact, Nomura's vendors performed valuation diligence on fewer than half of the loans that later found their way into the SLGs for the Certificates.

a. Valuation Due Diligence Vendors

Nomura relied on two vendors, CoreLogic and Hansen, to perform its valuation due diligence. The loans would go to one of these two vendors, each of which used different methods. While Hansen performed valuation due diligence on almost all of the loans Nomura sent to it, CoreLogic did not.

[41] Spagna tried unsuccessfully at trial to explain away this email, describing it as an example of his habit of quoting movie lines. But a quotation generally comes in handy only when a particularly piquant line seems relevant to the situation at hand. *See* The Blues Brothers - Quotes, *Internet Movie Database*, http://www.imdb.com/title/tt0080455/quotes ("I took the liberty of bullshitting you, okay?") (last visited May 11, 2015).

Using the loan tapes provided by Nomura, Hansen ran the data for most of the loans submitted to it through its PREVIEW system, which contained an AVM. AVMs are computer programs that compute an appraisal value for a property based on a database of real estate transactions, taking into account factors like recent nearby sales of similar property.

Unlike Hansen, CoreLogic did not run an AVM for most of the loans that Nomura sent it for review. Instead, it used a less expensive, proprietary risk assessment program called HistoryPro to screen loans for further review.[42] HistoryPro assigned each loan an "F-Score" ranging from 0 to 25. Most Nomura loans sent to CoreLogic received an F-Score of 0 and most of those received no further review.[43] As a result, just over half (51.9%) of all loans in the seven SLGs at issue here received a HistoryPro score of 0 and received no valuation due diligence. Loans that HistoryPro scored between 1 and 9 were supposed to be run through CoreLogic's own AVM, but that did not always happen.[44] Loans that were scored 10 or higher

[42] A HistoryPro review of a loan cost $4, whereas upgrading to an AVM or Hansen PREVIEW was $14, or more than three times the cost.

[43] When a loan with an F-Score of zero happened, for whatever reason, to receive further review, those results should have placed Nomura on notice that HistoryPro was not a reliable screening tool. The valuation diligence performed on such loans resulted, on occasion, in valuations for the property that exceeded Nomura's tolerance threshholds.

[44] For example, in the case of one set of 643 loans that Nomura sent to CoreLogic in August 2006, CoreLogic returned AVM values to Nomura for only 27% of the set. This included AVM values for 94% of the loans that received an F-Score of 1 to 9.

were designated for the next stage of review, which was conducted by other Nomura vendors.

b. Nomura Reviews Results; Broker Price Opinions

Typically, if a vendor's AVM produced an estimated value for a property that was greater than Nomura's designated tolerance threshold—10% for subprime loans and 15% for Alt-A loans—or if a loan had received a CoreLogic F-Score of 10 or higher, Nomura sent the loan to another third-party vendor for further review. That further review was a broker price opinion ("BPO") from a real estate broker who typically performed an exterior inspection of that property (a "drive-by")[45] and compared the property to similar properties recently sold in the area. In order to receive an unbiased BPO review, the vendor did not provide the broker with the original appraisal value. With the BPO value in hand, Nomura's vendors would attempt to reconcile the BPO value with the original appraisal value and deliver that "reconciled" estimate to Nomura. This process could involve some "give and take" between the BPO vendor and Nomura. If the resulting "post-review" figure was within Nomura's tolerance thresholds, Nomura would generally buy the loan. If the post-review figure was outside the tolerance thresholds, Nomura gave the loan originator or seller an opportunity to justify the original appraisal value. If that justification was unpersuasive, the loan was supposed to be kicked out of the loan pool. Despite this, as defendants concede,

[45] Some BPOs were performed through inspection of photographs, not a drive-by.

162 loans that received BPO review and exceeded tolerances were nonetheless included in the seven SLGs.

5. Reviews

Nomura received notice from two reviews that its due diligence procedures were faulty. In August 2006—after Nomura had issued three of the seven Securitizations and shortly after it changed the head of its Diligence Group—Nomura hired IngletBlair, LLC ("IngletBlair") to audit its due diligence process. IngletBlair reviewed 189 loans for which Clayton or AMC had already performed credit and compliance review.[46] IngletBlair found that although 109 of the 189 had been graded "EV1" or "EV2" by the vendor, seven of these should have been graded EV3 and another 29 were lacking essential documentation.[47] The Diligence Group was on notice, in other words, that even the loans graded EV1 and EV2 might have fundamental underwriting defects. Nomura took no action to upgrade its due diligence procedures as a result of IngletBlair's findings.

In July 2007, shortly after Nomura had sponsored the last of the seven Securitizations, Nomura commissioned a post-closing credit and valuation fraud review on the loans underlying NHELI 2007-1. NEHLI 2007-1 had issued about six months earlier.

[46] Among the 189 audited loans were 39 mortgage loans included in the SLGs backing the GSEs' Certificates.

[47] At trial, Nomura suggested that the IngletBlair results may not have been instructive since the auditor was working from servicing files, which may have been incomplete. Whatever the limitations of the audit, Nomura did not point to any steps it took following the audit to address its conclusions.

The review focused on 104 loans that were in default, half of which came from just one originator: Silver State. The review found that almost 20% of these troubled loans exhibited a "high probability" of fraud.

6. Purchasing the Loans

After Nomura had completed its diligence review, it created a spreadsheet for the trade pool listing the loans that Nomura planned to purchase and those that it was kicking out. As discussed above, originators were given an opportunity to convince Nomura to purchase a loan despite its identified defects.

Once it made its final decision about which loans to purchase, Nomura updated its LMS database to identify the loans it had purchased. During the time Nomura owned the loans, it also continued using the LMS system to track basic information regarding the servicing of the loans, including such things as prepayments of mortgages and delinquency rates. The data for the Prospectus Supplements' Collateral Tables[48] was taken from the LMS database. Nomura did not, however, place any information obtained through its due diligence review into the LMS system. For instance, the fact that an AVM review or BPO produced a different appraisal value for a property than that reflected on the originator's loan tape was never added to the LMS system.

7. Selecting Loans for a Securitization

Nomura's Trading Desk bundled together loans from among those that Nomura had purchased and

[48] As discussed below, the Collateral Tables are sets of tables with statistics in the Prospectus Supplements.

placed them into securitizations to sell to investors. The Trading Desk pulled together loans that were on Nomura's books based on collateral type, such as subprime or Alt-A, and then used a computer program to predict what rating the rating agencies would give each tranche of the Nomura-pooled loans.

The Trading Desk would then notify Nomura's Transaction Management Group, which would begin preparing marketing documents for the securitization. With the help of outside counsel, the Transaction Management Group drafted Offering Documents for the securitization, including its Prospectus Supplement. Despite speculation by a few Nomura witnesses at trial that the Diligence Group may have been consulted in some undefined way during the securitization process, the Diligence Group had no role whatsoever in the securitization process and did not review or approve the information included in the Prospectus Supplements.

Indeed, there would have been little to be gained by consulting anyone from the Diligence Group. After all, no diligence information about a particular loan was ever entered onto the LMS system**.** Nomura has shown no evidence of a separate system for tracking the due diligence done on each loan, and therefore of no database that would permit it to assemble and review the due diligence results for each of the loans it selected for inclusion in an SLG.[49] And while there was data about the diligence performed on a particular trade pool, that information was of limited utility since

[49] Because Nomura made no such effort, it is unnecessary to address the limitations on inferences that could be fairly drawn from such a database.

a trade pool's due diligence could not be reliably extrapolated to the population of the pool, and the loans populating a single securitization could be, and routinely were, taken from many different trade pools. In sum, Nomura had no reliable way to extrapolate the results from its due diligence efforts to an SLG, made no effort to do so, and never even thought about doing so. Even if its pre-acquisition due diligence had been adequate, once the link between the trade pool and SLG was broken, there was no way Nomura could reasonably rely upon the results of that pre-acquisition due diligence in making representations in the Prospectus Supplements.

8. Data Integrity Due Diligence

Again, after taking loans from various trade pools and bundling them into a securitization, Nomura did not conduct additional credit or valuation due diligence. It did, however, check the data disclosed in the Supplements against the data stored in the LMS database.

In addition, Nomura retained Deloitte to compare, for a sample of the securitized loans, the data in the LMS system to the information in that loan's loan file.[50] In this data integrity review, known as an "agreed-upon procedures" ("AUP") review, Deloitte recalculated certain data points and then recalculated certain aggregate data figures that were disclosed in the Prospectus Supplements. These data points typically included FICO score, appraised value,

[50] Deloitte did not select the sample; rather, Nomura provided the sample in the form of a computer-generated mortgage loan data file.

owner-occupancy status, LTV ratio, and CLTV ratio. Deloitte's review, however, was limited to checking the integrity of the data in the Prospectus Supplement.[51] It did not perform an audit of the accuracy of the underlying data.

Deloitte's AUP reviews typically identified around ten percent of the loans in each sample with discrepant data or that were missing documentation necessary for review. Once Deloitte's review was complete, however, Nomura did not extrapolate its findings regarding data errors in the sample to the securitization's SLG as a whole.

9. Obtaining the Credit Ratings

Nomura's Transaction Management Group was responsible for obtaining credit ratings from the three major rating agencies. The Transaction Management Group sent loan tapes with data drawn directly from LMS to the rating agencies for analysis. In other words, key data points, such as LTV ratios, owner-occupancy status, DTI ratios, and FICO scores, were those supplied by originators. Ratings agencies did not test the accuracy of the information on the loan tapes and relied on it as accurate.

In conducting their ratings analysis, the rating agencies incorporated loan tape data into their models and produced a rating for each tranche of the securitization. At times, a rating agency might indicate to Nomura that in order for a senior tranche

[51] Deloitte's AUP letters stated that Deliotte was "not requested to, and . . . did not, perform any procedures with respect to the preparation or verification of any of the information set forth on the Loan Documents."

to receive a AAA rating, subordinate tranches equal to a certain balance would need to be placed below it. Nomura was aware that Freddie Mac and Fannie Mae would purchase tranches with only a AAA rating, and Nomura would structure securitizations with AAA tranches so that the GSEs might be interested in purchasing a certificate.

B. RBS's Due Diligence

RBS served as the sole lead underwriter for three of the seven Securitizations and as the co-lead underwriter for a fourth. Because RBS did not purchase these loans from the originators, its only opportunity for performing due diligence on the loans arose when it joined the securitization as an underwriter. But, RBS did not perform its own credit or valuation due diligence on NHELI 2006-HE3 or NHELI 2006-FM2, the first two Securitizations that RBS entered with Nomura.

1. NEHLI 2006-HE3 and NEHLI 2006-FM2

With respect to NEHLI 2006-HE3, where RBS served as co-lead underwriter with Nomura Securities, Nomura sent RBS one page with summary statistics regarding some Trade Pool due diligence. This document included four lines of data from Nomura's pre-acquisition due diligence on Trade Pools for the two largest originators for the Securitization.[52]

[52] Nomura also provided RBS with a general description of its due diligence practices. But Nomura refused to give RBS complete access to Nomura's information about the loans. When RBS asked for a complete list of the originators for the loans, Nomura flatly refused to identify originators contributing fewer than 5% of the loans in the Securitization.

Judging that the summary statistics seemed to be "in-line with subprime loans," RBS's Diligence Group[53] asked Nomura for statistics for the loans, including "LTV, FICO, DTI, PPP [prepayment penalty], Property Types."[54] Nomura provided an "overall snapshot," which appears to have been a spreadsheet with the LMS data that would be used to populate the Collateral Tables for the Prospectus Supplement, and ten minutes later Farrell indicated that it looked "ok." This was the closest that RBS ever got to an analysis of the loans in the Securitization's SLGs.

In its second transaction with Nomura, NHELI 2006-FM2, the SLGs were populated exclusively with loans from Fremont. Despite being the sole lead underwriter, and despite being aware of a "big spike" in repurchasing activity for Fremont loans (suggesting Fremont was originating a substantial number of defective loans), RBS performed no credit or valuation due diligence whatsoever on this Securitization.[55]

[53] As with Nomura, RBS's Diligence Group was also known by different names, including the "Credit Group." It is referred here to as the "Diligence Group."

[54] The one-page due diligence summary for the Trade Pools was just that, a summary. But it was also an unreliable summary. It represented that AVMs had been performed on 100% of the loans in the Trade Pools purchased from the two largest originators. That is unlikely to be true, given the reliance on CoreLogic's HistoryPro to screen loans for submission to AVMs. In addition, the summary reflected that 90 loans had been kicked out of the People's Choice Pool for failing "property" due diligence, without revealing, as described above, that Nomura had significant concerns about the reliability of the entirety of the People's Choice origination practices when it came to property valuation.

[55] In August 2006, RBS was considering holding Fremont to its "published guidelines rather than guidelines plus exception."

Instead, RBS got spreadsheets from Nomura describing the pre-acquisition due diligence done on the two Trade Pools from which these loans were drawn. These documents included the results of AMC's expedited re-grading of nineteen loans that Nomura had purchased from Fremont "for whatever reason" despite being graded as non-compliant. Notably, this was also the Securitization on which the head of Nomura's Diligence Group "took the liberty to bullshit" RBS during a conference call between the sponsor and underwriters.

2. NHELI 2007-1 and NHELI 2007-2

For the two Securitizations upon which it actually did credit and valuation due diligence—NHELI 2007-1 and NHELI 2007-2—RBS served as lead underwriter. The RBS diligence review for these two Securitizations resembled the Nomura pre-acquisition due diligence program in certain critical respects. Like Nomura, RBS had no written due diligence guidelines and provided no formal training program for its due diligence employees. It typically conducted due diligence on a sample of the loans, but had no reliable basis for extrapolating the results of the due diligence review to the entire population from which the sample was drawn, and never made any attempt to do so. Nor did RBS integrate its due diligence with the disclosures in the Prospectus Supplements. Its due diligence team had no role in reviewing the accuracy of representations in Prospectus Supplements and did not understand that its work was in any way

RBS would later refer to Fremont as "FraudMont" and "the king of EPDs" or early payment defaults.

connected to the representations that would be made in Prospectus Supplements. As was true for Nomura, there was no one at RBS who acted to ensure that the representations in the Prospectus Supplements that are at issue in this case were truthful.

a. Sample Selection

The RBS Diligence Group was responsible for proposing samples on which to conduct due diligence. In making those proposals, it used what it termed adverse sampling,[56] and for a smaller number of loans, what it termed semi-random sampling. RBS gave greater scrutiny to loans when it was purchasing the loans and sponsoring the securitization than when it was operating solely as an underwriter in securitizations sponsored by another bank. When it served solely as an underwriter, RBS typically performed credit and compliance due diligence on a 5-10% sample and drive-by appraisals on a small random sample.

The Diligence Group had the ability to request an "upsize" of samples, but there is no evidence that such a request was ever made and approved. For example, Farrell did request permission in January 2007 from an RBS banker to select a due diligence sample of 25% of the loans from NHELI 2007-2 because the loans in the Securitization were "crap." But that upsizing did

[56] One proposed adverse sample included all loans with an original balance of over $1 million, some of the loans with FICO scores of 520 or lower, all loans seasoned 12 months or more, all loans without a minimum DTI ratio requirement, and all "no doc" loans.

not happen; only a 6% sample was taken. As an RBS banker explained, RBS "didn't own the pool."[57]

b. Due Diligence

Any due diligence review of the samples that was done was performed by RBS vendors and sent to the RBS Diligence Group. But that group was understaffed and performed only a cursory review of the reports. It chose to waive in virtually every loan flagged as having material defects.

With respect to NEHLI 2007-1**,** the time stamps on Clayton reports indicate that Farrell took just over an hour to waive in all but three of the thirty-three loans that Clayton graded EV3. Farrell has no recollection of this transaction. It appears Farrell reviewed the Clayton spreadsheet and quickly made his choices.[58] He even waived in loans that Clayton's spreadsheet flagged as missing documentation material to both credit and compliance.

If Farrell had chosen to do an individualized assessment of the loans, he would not have had any loan files or originator guidelines to review. Instead, he would have relied on the Clayton-prepared

[57] At trial, Farrell speculated that he may have been startled by the poor quality of the loans because he was more accustomed to Alt-A loans and not "used to" working with subprime loans. This explanation was not credible. Farrell had worked at Clayton from 2002 to 2006, when he joined RBS. This exchange occurred in January 2007, near the end of the wave of securitization of subprime loans.

[58] The Clayton spreadsheet identified two of the three loans that Farrell did not waive in as a $1 million loan missing material documentation and a loan with a zero balance. The third loan was the last in the list and may have simply been overlooked.

individual asset summaries ("IAS") for a loan. These documents, running typically two to four pages, describe material features of a loan, its defects, and its potential compensating factors. As he demonstrated at trial, Farrell liked to work with a physical copy of the IAS and circle any compensating factors with pen in hand. Leaving aside whether Farrell would have immediately noticed the email and printed the documents IAS forthwith, whether he would have had the opportunity to work exclusively on this project during the hour, and whether it is even possible to individually review thirty-three IASs in an hour without working with an uncommon ferocious intensity, Farrell's testimony left no doubt that his wholesale waiver was not the result of careful consideration.[59]

With respect to NEHLI 2007-2, RBS's treatment of the vendor reports was much the same. All of the 50 loans designated EV3 by Clayton for credit deficiencies were waived in.

RBS also performed restricted valuation diligence. It commissioned "drive-by" appraisals on properties for a sample of loans for both of the Securitizations. For the nine such appraisals of properties whose loans appeared in the relevant SLG in NHELI 2007-1, eight had lower appraisal values than the originators' values, five had recalculated LTV/CLTV ratios that moved above 80%, and one had a recalculated LTV ratio of 116%. Despite these

[59] Demonstrating at trial how quickly he could review an IAS for one of his waived-in loans, Farrell misidentified the amount of cash reserves and simply brushed off other material problems with the loan.

results, the originators' LTV ratios appeared in the Offering Documents.

For NHELI 2007-2, drive-by appraisals were performed on forty-four properties whose loans appeared in the relevant SLG. The results of the drive-by appraisals indicated that thirty-one of the forty-four properties were initially overvalued, nine had recalculated LTV/CLTV ratios that moved above 80%, and ten had recalculated LTV/CLTV ratios over 100%. Again, each of these loans was securitized, and no representations in the Supplements were changed.

3. Fraud Review

In 2007, RBS commissioned a fraud review on one of the four Securitizations, NHELI 2006-HE3. This was a Securitization for which RBS did no independent credit and valuation due diligence. In February 2007, about six months after the NHELI 2006-HE3 Securitization issued, RBS determined that its delinquency rate made it the "worst performing deal" on its books and targeted it for a fraud review to support a "put back" of the loans, meaning a request that Nomura repurchase them. After reviewing a sample of 263 loans, RBS informed Nomura that 43 were fraudulent, including misrepresentations of income, indebtedness, and owner occupancy. Twenty-nine loans had "data discrepancies," including discrepancies between the loan file and loan tape on DTI ratio, FICO, and other loan or borrower characteristics. Four had both fraud and data discrepancies. Spagna recalled that Nomura eventually repurchased some, but not all of these loans. Nomura sponsored one more of the seven Securitizations after receiving this notice from RBS.

C. The Loan Pools for the Seven Securitizations

Since a decision in this case must be reached separately for each GSE Certificate, it is useful to look at the results of any due diligence performed on loans that found their way into the SLGs supporting the seven Certificates.[60] As would be expected from the preceding discussion, credit and valuation due diligence was done on only a portion of the loans in the SLGs and there is no basis to extrapolate those results to the remainder of the SLG. In any event, for whatever reason, loans that had been flagged for due diligence were frequently not actually reviewed. For those that were reviewed, many loans flagged by vendors as having material defects were waived in or found their way into the SLG without any record of a waiver. Accordingly, taken together with the other evidence described above, the results of the due diligence review give no assurance that materially defective loans were not securitized, and indeed show just the opposite.

[60] It should be emphasized that Nomura did not have ready access to any of this analysis since it had no system for tracking due diligence loan by loan. The data presented here were compiled by FHFA's expert, Cipione, using all the due diligence documents produced by defendants and their vendors during discovery. Defendants' expert Mishol undertook a similar but less exhaustive project. Among other things, Mishol was not asked to compile information on client waivers of vendor findings of infirmity. In contrast to Cipione, Mishol was also unfamiliar with how to access, interpret, or explain information from the database compiled by his organization. Because of these and similar limitations, Cipione's data and testimony are more helpful.

Altogether, just under 40% of the loans in the SLGs received credit due diligence. The figures per SLG are as follows:

Securitization	Loans in SLG	SLG Loans Subject to Credit Due Diligence	Percentage of SLG Loans Subject to Credit Due Diligence
NAA 2005-AR6	376	252	67.02%
NHELI 2006-FM1	2,532	669	26.42%
NHELI 2006-HE3	3,618	1,967	54.37%
NHELI 2006-FM2	3,891	837	21.51%
NHELI 2007-1	474	335	70.68%
NHELI 2007-2	3,001	1,346	44.85%
NHELI 2007-3	1,914	756	39.50%
TOTAL	15,806	6,162	38.99%

Of those loans that received credit due diligence, roughly 73% were graded EV1 or its equivalent and roughly 18% were graded EV2 or its equivalent. Of the remaining, roughly 9%, two-thirds were waived in and assigned the grade EV2W and one-third were securitized as EV3s. The EV2W and EV3 figures, as a percentage of the diligenced loans, are as follows:

Securitization	EV2W Credit Grade (Count/Percentage)	EV3 Credit Grade (Count/Percentage)
NAA 2005-AR6	21 / 8.33%	6 / 2.38%
NHELI 2006-FM1	38 / 5.68%	0 / 0.00%
NHELI 2006-HE3	150 / 7.63%	59 / 3.00%
NHELI 2006-FM2	14 / 1.67%	18 / 2.15%
NHELI 2007-1	12 / 3.58%	38 / 11.34%
NHELI 2007-2	109 / 8.10%	33 / 2.45%
NHELI 2007-3	29 / 3.84%	14 / 1.85%
TOTAL	373 / 6.05%	168[61] / 2.73%

As for valuation due diligence, roughly 57% of the loans received no AVM review, no BPO, or had no "post-review value," referring to the value Nomura selected after the BPO reconciliation process. This was principally due to the fact that CoreLogic performed

[61] Defendants' expert Mishol found that 418 of all loans ultimately securitized had EV3 grades for credit and/or compliance.

the bulk of the valuation due diligence for Nomura and it assigned an F-Score of "0" to almost 60% of the loans. The numbers per SLG are as follows:

Securitization	SLG Loans in DB[62]	Loans with No AVM, BPO, or Final Value	Percentage
NAA 2005-AR6	325	134	41.2%
NHELI 2006-FM1	2,532	1,604	63.3%
NHELI 2006-HE3	3,617	1,942	53.7%
NHELI 2006-FM2	3,891	2,433	62.5%
NHELI 2007-1	403	104	25.8%
NHELI 2007-2	3,001	1,603	53.4%
NHELI 2007-3	1,914	1,187	62.0%
TOTAL	15,683	9,007	57.4%

Nomura had set a 10% tolerance threshold for appraisals of properties supporting subprime mortgages. Over 38% of the subprime loans in five of the SLGs that were subjected to an AVM and had an

[62] "DB" refers to the database that was created by Cipione to collect all of the information that could be located about the due diligence on the loans in the SLGs. As reflected on this table, the database or DB includes valuation information on 15,683 of the 15,806 loans in the SLGs.

AVM outside the 10% threshold, received no BPO review.[63] The figures per SLG are as follows:

Securitization	AVM Values Below 10% Threshold	AVM Values Below 10% with No BPO	Percentage
NAA 2005-AR6	n/a	n/a	n/a
NHELI 2006-FM1	329	161	48.9%
NHELI 2006-HE3	470	178	37.9%
NHELI 2006-FM2	487	178	36.6%
NHELI 2007-1	n/a	n/a	n/a
NHELI 2007-2	344	115	33.4%
NHELI 2007-3	148	47	31.8%
TOTAL	1,178	679	38.2%

Taking the AVM values and BPO values obtained by Nomura from its vendors—that is, the two independent valuation assessments available to Nomura before it determined its final values—and

[63] The other two Securitizations were backed by Alt-A mortgages, which were subject to a 15% tolerance threshold. The percentage of loans that were subjected to an AVM, whose appraisal was more than 15% higher than the AVM value, and that received no BPO for NAA 2005-AR6 was 21.4% (9); it was 15.4% (4) for NHELI 2007-1.

using those values to recalculate the LTV ratios for just those loans within the SLGs, over 19% of the loans that received AVM or BPO values had LTV ratios greater than 100%. The numbers per SLG are as follows:

Securitization	Loans with AVM & BPO Values	AVM & BPO LTV Over 100	Percentage
NAA 2005-AR6	35	1	2.9%
NHELI 2006-FM1	170	29	17.1%
NHELI 2006-HE3	299	79	26.4%
NHELI 2006-FM2	348	41	11.8%
NHELI 2007-1	22	4	18.2%
NHELI 2007-2	264	70	26.5%
NHELI 2007-3	115	18	15.7%
TOTAL	1,253	242	19.3%

Each SLG also had loans with Nomura post-review values whose recalculated LTV ratios exceeded 100. The number per SLG are as follows:

Securitization	SLG Loans with Final Values	Final Value LTV Over 100	Percentage
NAA 2005-AR6	63	0	0.0%
NHELI 2006-FM1	303	8	2.6%
NHELI 2006-HE3	613	43	7.0%
NHELI 2006-FM2	626	26	4.2%
NHELI 2007-1	56	4	7.1%
NHELI 2007-2	452	46	10.2%
NHELI 2007-3	265	24	9.1%
TOTAL	2,378	151	6.3%

The results found in the database created by defendants' expert Mishol in this regard were less conservative: he found that of the 2,119 SLG loans with "final values," 211—or 10%—had final value LTV ratios over 100.[64]

[64] Notably, apart from a passing mention, Mishol's direct testimony does not discuss recalculated LTV ratios at all. Indeed, at trial, he was unable to explain how to calculate LTVs. He does discuss BPOs whose variations were outside tolerance; ultimately he found that 162 SLG loans had BPOs that fell outside tolerance thresholds.

IV. The Offering Documents

Each of the seven Certificates was sold to the GSEs by means of two documents: a Prospectus and a Prospectus Supplement.[65] These were the Offering Documents in which defendants represented the qualities of the Certificates and the underlying mortgage loans to investors; these are also the documents that FHFA alleges contain four categories of material falsehoods or misrepresentations. Generally, each Prospectus Supplement contains detailed disclosures regarding the nature of the loans in the SLGs underlying the offering, while the accompanying Prospectus contains descriptions, definitions, explanations and qualifications for the disclosures made in the Supplement. A more detailed discussion of the contents of the documents follows.

A. The Supplements' "Summary" Section

Each of the seven Prospectus Supplements begins in its first few pages with the instruction that investors "should rely only on the information contained in this document." Similarly, each Supplement states on its final page that potential investors "should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus."[66]

[65] *See FHFA v. Bank of Am. Corp.*, No. 11cv6195 (DLC), 2012 WL 6592251, at *5 (S.D.N.Y. Dec. 18, 2012).

[66] Six of the seven Prospectus documents similarly state on the third page that investors "should rely only on the information in this prospectus and the accompanying prospectus supplement."

After these introductory pages, the Supplements provide a "Summary" that offers "a very broad overview of the certificates offered by [the] prospectus supplement and the accompanying prospectus." Among the information included in this Summary are the date the Supplement was issued; the Cut-off Date for fixing the composition of loan pools in the Securitization; the identities of the depositor, the seller, and other key figures in the transaction; and the names of specific originators. The Summary section also states that the senior tranche certificates described in the Supplement—including the seven Certificates at issue here—"will not be offered unless they receive ratings at least as high as" AAA ratings or their equivalent from third-party rating agencies such as S&P and Moody's. They further explain that "[i]n general, ratings address credit risk" and that "[t]he ratings of each class of Offered Certificates will depend primarily on an assessment by the rating agencies of the related Mortgage Loans . . . and the subordination afforded by certain classes of certificates." The Summary section concludes with one or more pages that report summary statistics for various attributes of the loans in each SLG, as well as aggregate statistics for the Securitization as a whole.

B. Collateral Tables

Each Prospectus Supplement then supplies sets of tables with statistics ("Collateral Tables") that disclose the "Characteristics of the Mortgage Loans" in each of the SLGs supporting that Securitization.

The exception is the Prospectus accompanying the Supplement for NAA 2005-AR6, which omits that directive.

The Collateral Tables provide data on more than a score of features of the loans within an SLG. These features include LTV ratios and the owner-occupancy status for the loans within the SLG. Examples of two such tables, which are taken from the Supplement for NHELI 2006-FM2, are reproduced below.

Original Loan-to-Value Ratio
of the Group I Mortgage Loans

Original Loan-to-Value Ratio (%)	Number of Mortgage Loans	Aggregate Remaining Principal Balance	% of Aggregate Remaining Principal Balance	Weighted Average Mortgage Rate (%)	Nonzero Weighted Average FICO	Weighted Average Original LTV (%)	Weighted Average Stated Remaining Term	Full/Alt Doct (%)
Less than or equal to 50.00	100	$15,620,836	2.31%	8.878%	585	40.49%	354	57.24%
50.01 - 55.00	40	7,755,893	1.15	8.143	609	53.08	355	65.88
55.01 - 60.00	76	14,401,288	2.13	8.806	577	57.66	355	48.05
60.01 - 65.00	122	24,549,828	3.62	8.978	576	63.55	355	47.30

65.01-70.00	157	32,313,906	4.77	8.828	579	69.12	355	49.30
70.01-75.00	212	44,141,324	6.52	8.734	577	74.06	355	54.88
75.01-80.00	1,531	324,418,693	47.90	8.134	633	79.85	356	51.15
80.01-85.00	221	48,119,274	7.11	8.291	607	84.65	355	73.49
85.01-90.00	387	78,315,654	11.56	8.535	619	89.70	355	79.10
90.01-95.00	127	23,093,603	3.41	8.608	630	94.67	354	76.62
95.01-100.00	918	64,507,394	9.53	10.734	650	99.90	350	53.87
Total/Weighted Average	3,891	677,237,695	100.00%	8.590%	620	80.58%	355	57.36%

Occupancy Status of the Group I Mortgage Loans								
Occupancy Status	Number of Mortgage Loans	Aggregate Remaining Principal Balance	% of Aggregate Remaining Principal Balance	Weighted Average Mortgage Rate (%)	Nonzero Weighted Average FICO	Weighted Average Original LTV (%)	Weighted Average Stated Remaining Term	Full/ Alt Doct (%)
Owner-Occupied	3,628	$630,190,865	93.05%	8.569%	619	80.72%	355	56.90%
Investor	247	43,162,888	6.37	8.932	635	78.51	355	64.63
2nd Home	16	3,883,941	0.57	8.099	637	80.99	355	49.95
Total/ Weighted Average	3,891	$677,237,695	100.00%	8.590%	620	80.58	355	57.36%

As the tables demonstrate, Supplements disclose the principal balance and percentage of loans in the relevant SLG with LTV ratios below 50% and in five point increments up to 100%. In no case was there a disclosure of LTV ratios greater than 100%. The Collateral Tables also provided the percentage the mortgage loans in the relevant SLG for residences that were "owner-occupied," an "investment," and a "second home."

The Supplements explicitly provide that the characteristics of the loans listed in the Collateral Tables, including LTV ratios and owner-occupancy status statistics, are correct as of each Supplement's "Cut-off Date."[67] The NHELI 2006-FM2 Supplement, for instance, states that "[a]s of the Cut-off Date, the Mortgage Loans will have the characteristics as set forth" in the Collateral Tables. The LTV ratio in the Collateral Tables is labelled, however, as the "Original Loan-to-Value Ratio." The Collateral Tables list not just the percentage of loans with these characteristics as of the "Cut-off Date," but also the "Cut-off Date Principal Balances" related to the characteristic. The Cut-off Date is, in each instance here, roughly a month before the Supplement Date for the RMBS. Each Securitization along with its corresponding Cut-off Date and Supplement Date is listed below.

SECURITIZATION	CUT-OFF DATE	SUPPLEMENT DATE
NAA 2005-AR6	11/1/2005	11/29/2005
NHELI 2006-FM1	1/1/2006	1/27/2006
NHELI 2006-HE3	8/1/2006	8/29/2006
NHELI 2006-FM2	10/1/2006	10/30/2006
NHELI 2007-1	1/1/2007	1/29/2007
NHELI 2007-2	1/1/2007	1/30/2007
NHELI 2007-3	4/1/2007	4/27/2007

[67] As explained above, the Cut-off Date refers to the "date for establishing the composition of the asset pool" in a Securitization. 17 C.F.R. § 229.1103(a)(2).

All seven of the Supplements explain that "[m]ortgage loans with higher loan-to-value ratios may present a greater risk of loss than mortgage loans with loan-to-value ratios of 80% or below." All seven indicate whether loans with LTV ratios above 80% were insured or not.

The Prospectus for each Securitization explains that for purposes of determining the LTV ratio, "[t]he 'Value' of a Mortgaged Property, other than for Refinance Loans, is generally the lesser of (a) the appraised value determined in an appraisal obtained by the originator at origination of that loan and (b) the sales price for that property." The Prospectus adds that "[u]nless otherwise specified in the prospectus supplement, the Value of the Mortgaged Property securing a Refinance Loan is the appraised value of the Mortgaged Property determined in an appraisal obtained at the time of origination of the Refinance Loan." Finally, according to the Prospectus, "[t]he value of a Mortgaged Property as of the date of initial issuance of the related series may be less than the Value at origination and will fluctuate from time to time based upon changes in economic conditions and the real estate market."

C. Loans "Were Originated" Generally in Accordance with Guidelines.

The Prospectus Supplements also include representations that "[t]he Mortgage Loans . . . were originated generally in accordance with the underwriting criteria described in this section."[68]

[68] This language or its equivalent appears in six of the seven Prospectus Supplements. The seventh, NHELI 2006-FM1,

Those originators contributing more than 10% of the mortgage loans in an RMBS are identified by name, along with the percentage of the mortgage loans that they contributed. For example, the Supplement for NAA 2005-AR6 identifies Alliance Bancorp, Silver State, and Aegis Mortgage as the originators of approximately 21%, 12%, and 11%, respectively, of the loans within the Securitization by aggregate principal balance as of the Cut-off Date for the Prospectus Supplement.

The sections of each Prospectus Supplement addressed to underwriting describe both the process by which a borrower applies for a mortgage loan and the process through which the application is reviewed and approved. For example, the Prospectus Supplement for NAA 2005-AR6 describes the information the borrower must supply to the loan's originator as follows:

> Generally, each borrower will have been required to complete an application designed to provide to the original lender pertinent credit information concerning the borrower. As part of the description of the borrower's financial condition, the borrower generally will have furnished certain information with respect to its assets, liabilities, income . . . , credit history, employment history and personal information, and furnished an authorization to apply for a credit report which summarizes the borrower's credit

includes only a detailed description of the underwriting guidelines used by Fremont, the sole originator for that RMBS.

> history with local merchants and lenders and any record of bankruptcy. The borrower may also have been required to authorize verifications of deposits at financial institutions where the borrower had demand or savings accounts.

The Supplements then explain that the originator, having received an application with the pertinent data and authorizations, proceeds to review the application. This analysis includes a determination that the borrower's income will be sufficient to carry the increased debt from the mortgage loan. The Prospectus Supplement for NAA 2005-AR6 explains in pertinent part:

> Based on the data provided in the application and certain verifications (if required), a determination is made by the original lender that the borrower's monthly income (if required to be stated) will be sufficient to enable the borrower to meet their monthly obligations on the mortgage loan and other expenses related to the property such as property taxes, utility costs, standard hazard insurance and other fixed obligations other than housing expenses. Generally, scheduled payments on a mortgage loan during the first year of its term plus taxes and insurance and all scheduled payments on obligations that extend beyond ten months equal no more than a specified percentage not in excess of 60% of the prospective borrower's gross income. The percentage applied varies on a case-by-case basis depending on a number of

> underwriting criteria, including, without limitation, the loan-to-value ratio of the mortgage loan.

The section of the Supplements addressed to the underwriting process used by loan originators also explains the process used to ensure that there is security for the issued loans, for instance by requiring some borrowers to obtain hazard or title insurance or because an appraisal has shown that the mortgaged property itself provides adequate security. For instance, the Supplement for NAA 2005-AR6 states:

> The adequacy of the Mortgaged Property as security for repayment of the related Mortgage Loan will generally have been determined by an appraisal in accordance with pre-established appraisal procedure standards for appraisals established by or acceptable to the originator. All appraisals conform to the Uniform Standards of Professional Appraisal Practice [USPAP] adopted by the Appraisal Standards Board of the Appraisal Foundation . . . .

Six of the Supplements disclosed that loans might have been originated under "modified standards," which relaxed certain documentation requirements:

> Certain of the Mortgage Loans have been originated under reduced documentation, no-documentation or no-ratio programs, which require less documentation and verification than do traditional full documentation programs. Generally, under a reduced documentation program, verification of either a borrower's income or assets, but not both, is

> undertaken by the originator. Under a no-ratio program, certain borrowers with acceptable compensating factors will not be required to provide any information regarding income and no other investigation regarding the borrower's income will be undertaken. Under a no-documentation program, no verification of a borrower's income or assets is undertaken by the originator. The underwriting for such Mortgage Loans may be based primarily or entirely on an appraisal of the Mortgage Property, the loan-to-value ratio at origination and/or the borrower's credit score.[69]

The Supplements' Collateral Tables disclose the proportion of loans originated with modified standards.

Six of the seven Supplements note that "certain exceptions to the underwriting standards" described would be "made in the event that compensating factors are demonstrated by a prospective borrower"; the seventh said substantially the same.[70] All but one of

[69] NHELI 2006-FM1 contains similar language in reference to Fremont, the sole originator for that Securitization. It notes that that originator's guidelines allow for "three documentation types, Full Documentation . . . , Easy Documentation . . . , and Stated Income."

[70] The Supplement for NHELI 2006-FM1 represented that the sole originator for that RMBS applied its guidelines "subject to various exceptions" and that it was "expected that a substantial portion of the mortgage loans may represent such underwriting exceptions."

the Supplements also note that the underwriting standards for the loans were less stringent than those applied by the GSEs. For instance, the Supplement for NAA 2005-AR6 explains that the underwriting standards applicable to the loans

> typically differ from, and are, with respect to a substantial number of Mortgage Loans, generally less stringent than, the underwriting standards established by Fannie Mae or Freddie Mac primarily with respect to original principal balances, loan-to-value ratios, borrower income, credit score, required documentation, interest rates, borrower occupancy of the mortgaged property, and/or property types. To the extent the programs reflect underwriting standards different from those of Fannie Mae and Freddie Mac, the performance of the Mortgage Loans thereunder may reflect higher delinquency rates and/or credit losses.[71]

If specific originators contributed more than 20% of the loans in any RMBS**,** six of the Prospectus Supplements also described in considerable detail the underwriting guidelines of those originators.[72] For

[71] While the Supplement for NHELI 2006-FM1 did not contain this language, it, like all six others, warned that "[t]he underwriting standards applicable to the Mortgage Loans, which are described in this prospectus supplement . . . may or may not conform to Fannie Mae or Freddie Mac guidelines."

[72] The exception is NAA 2005-AR6. It was issued in November 2005; as noted, Regulation AB, which imposes the requirement

example, the Prospectus Supplement for NHELI 2006-HE3 devoted approximately seven pages to a description of the guidelines used at People's Choice, which had contributed 38.19% of loans to the Securitization by aggregate principal balance as of the Cut-off Date.

When an individual originator's guidelines are extensively described, that description also typically includes the statement that the loans were "generally" originated in accordance with those guidelines or otherwise states that the originator did not necessarily follow its guidelines for every loan. The Supplements for both Fremont-backed Securitizations—NHELI 2006-FM1 and NHELI 2006-FM2—state, "All of the mortgage loans were originated or acquired by Fremont generally in accordance with the underwriting criteria described in this section. The following is a summary of the underwriting guidelines believed by the depositor to have been applied with some variation by Fremont." A few paragraphs later, the Supplements for NHELI 2006-FM1 and NHELI 2006-FM2 list compensating factors that may warrant exceptions on a case-by-case basis to the Fremont guidelines when the borrower does "not strictly qualify[] under the risk category guidelines" but is nonetheless "qualified to receive a loan." The two Supplements add that "[i]t is expected that a substantial portion of the mortgage loans may represent such underwriting exceptions."

that certain underwriters' guidelines be described, only became effective on January 1, 2006.

Along these same lines, the Supplement for NHELI 2007-2 states that Ownit, which originated 42.38% of the loans in that Securitization, "provides loans to borrowers . . . in accordance with" the guidelines described, but that the guidelines were "designed to be used as a guide . . . [and] no single characteristic will approve or deny a loan." The Supplement for NHELI 2007-3 similarly represents that with respect to originator ResMAE a "substantial portion of the Mortgage Loans represent such underwriting exceptions" where compensating factors exist.

D. Risk Advisories

The Supplements also periodically provide advisories about the nature of the Securitization and its risks. Each, for example, contains the admonition to "consider carefully" or "carefully consider" the risk factors described in the Supplement.[73] Each also contains a disclosure that there may be changes in the characteristics of the loan pools. Each Supplement states that no substantial changes to any SLG are expected after the Cut-off Date, and the threshold in each is given as five percent. Five of the Supplements also state that notice will be given if any "material characteristic" meaningfully changes by five percent:

> If, as of the Closing Date, *any material pool characteristic differs by 5% or more* from the description in this prospectus supplement, revised disclosure will be provided either in a

[73] In fact, each Supplement except for NHELI 2006-HE3 contains this language on its first page.

> supplement or in a Current Report on Form 8-K.[74]

(Emphasis added.)

The Prospectus Supplements also contain various warnings to potential investors that poor performance of the underlying loans could cause losses. For example, each Supplement states that "[i]f substantial losses occur as a result of defaults and delinquent payments [on the underlying loans], you may suffer losses." Five of the seven Supplements add that

> [i]n the event that the mortgaged properties fail to provide adequate security for the Mortgage Loans, and the protection provided by the subordination of certain classes is insufficient to cover any shortfall, you could lose a portion of the money you paid for your certificates.

The remaining two Supplements contain a slightly different version of this language, stating that investors "could lose *all or* a portion of the money you paid for your certificates." (Emphasis added.)[75]

Six of the seven Supplements further caution that variability in property prices for these non-prime loans may affect the Securitizations' performance:

> Investors should note that changes in the values of Mortgaged Properties may have a greater effect on the delinquency, foreclosure,

[74] The two Supplements omitting this language are NAA 2005-AR6 and NHELI 2006-FM1.

[75] The two Supplements containing this version of the language are NHELI 2006-FM2 and NHELI 2006-HE3.

> bankruptcy and loss experience of the Mortgage Loans included in the Mortgage Pool than on mortgage loans originated in a more traditional manner. No assurance can be given that the values of the related Mortgaged Properties have remained or will remain at the levels in effect on the dates of origination of the related Mortgage Loans.

And each Supplement notes that, in certain specified states or regions that have "a significant concentration of properties underlying the Mortgage Loans," "economic conditions . . . may affect the ability of borrowers to repay their loans on time" and that "declines in the residential real estate market . . . may reduce the values of properties located in those" states or regions, "which would result in an increase in the related loan-to-value ratios."

The Supplement for NHELI 2007-3 contains a specific disclaimer regarding the loans originated by ResMAE, which contributed 77.6% of the loans to the relevant SLG, and which filed for bankruptcy shortly before the issuance of the Supplement:

> The Depositor is aware that the originators of approximately 79.04% of the Mortgage Loans, by aggregate principal balance as of the Cut-off Date, have filed for bankruptcy protection under the United States Bankruptcy Code. These originators include ResMAE Mortgage Corporation, which originated approximately 77.61% of the Mortgage Loans, by aggregate principal balance as of the Cut-off Date.
>
> Any originator whose financial condition was weak or deteriorating at the time of

> origination may have experienced personnel changes that adversely affected its ability to originate mortgage loans in accordance with its customary standards. It may also have experienced reduced management oversight or controls with respect to its underwriting standards. Accordingly, the rate of delinquencies and defaults on these Mortgage Loans may be higher than would otherwise be the case.

V. Sample Selection

As mentioned above, there are almost 16,000 loans in the seven SLGs supporting the GSEs' Certificates in the Nomura Action. The Nomura Action was one of the smallest among the sixteen coordinated FHFA actions and FHFA requested approval early in this litigation to proceed to trial based on an analysis of a sample of the loans supporting the Securitizations. Having given the parties an opportunity to test FHFA's proposed sample selection procedures under *Daubert* standards, approval was given to FHFA to proceed to trial in the sixteen coordinated actions with an analysis of a representative sample drawn from the loans in each Certificate's SLG. *See FHFA v. JPMorgan Chase & Co.*, No. 11cv6188 (DLC), 2012 WL 6000885, at *4-11 (S.D.N.Y. Dec. 3, 2012). A sample of 100 loans for each SLG permits results to be stated with a 95% confidence level, *i.e.*, with maximum margins of error of +/- 10 percent. *Id.* at *5.[76] The 10% margin of error,

[76] FHFA's expert Cowan chose a 10% rather than a 5% margin of error as a reasonable compromise between statistical precision and practicality. To achieve a modest increase to a 5% margin of

however, only occurs if the percentage of the sample having a relevant characteristic is found to be precisely 50%. As findings deviate from that point, the margin of error narrows.

Defendants were provided with an opportunity to challenge the admissibility of Cowan's methodology to the extent it was further disclosed and to challenge the weight accorded to Cowan's testimony based on his sample selection. *Id.* at *9, *11. Their second *Daubert* motion regarding Cowan's statistical extrapolations was denied on February 13, 2015. *FHFA v. Nomura Holding Am., Inc.*, No. 11cv6201 (DLC), 2015 WL 685231, at *2-3 (S.D.N.Y. Feb. 13, 2015).

Cowan selected the loans that composed the seven Samples, relying largely on the loan tapes. Using a technique known as stratification, Cowan used each loan's FICO score to sort each SLG's loan population into four strata, and then drew 25 loans at random from each stratum. Cowan tested his Samples against the corresponding SLGs on eleven separate metrics to ensure that they were adequately representative of the relevant loan populations.

Defendants argue that Cowan's sampling methodology is unreliable because it necessarily

error would have required a sample size of over 400 loans per SLG. The production of loan files and their associated underwriting guidelines was an enormous undertaking in this litigation: The original sample size across the sixteen lawsuits was close to 50,000 loans, and increasing it by a multiple of four would have required the production of almost 200,000 loan files. Besides the expense and burden of a production of this size, it would almost certainly have required substantially more time to bring these cases to trial.

excluded loans from some originators. They contend that he should instead have performed his sampling originator-by-originator. Defendants have not shown that such an approach would have been either feasible or particularly informative. After all, the claims in this case are not organized by originator; they rely on defendants' representations regarding different characteristics of all the loans within an SLG, such as LTV ratios and owner-occupancy status. In addition, many originators contributed only a handful of loans to a Securitization. Cowan's random sampling insured that originators contributing many loans—and thus with a comparatively major influence on the quality of the SLG—had many loans represented in the Sample; conversely, originators contributing few loans—and thus with a comparatively minor influence on the quality of the SLG—had few if any loans represented. Because FHFA aimed to assess the quality of the SLGs generally, Cowan's sampling was appropriate to that task.

For six of the seven Samples, the parties were able to find a sufficiently complete loan file for all or almost all of the Sample loans to permit a re-underwriting of the loan.[77] In the case of one SLG—NAA 2005-AR6—Cowan was required to supplement his original Sample because many of the loan files could not be located for the originally designated 100 Sample

[77] Two Samples were evaluated in their entirety: those of NHELI 2006-FM1 and NHELI 2006-FM2. NHELI 2006-HE3, 2007-1, 2007-2, and 2007-3 had final Sample sizes of 99, 98, 98, and 97, respectively.

loans.[78] Cowan conducted the same representativeness and reliability checks on the augmented Sample. As noted, the NAA 2005-AR6 Sample ultimately included 131 loans that could be re-underwritten by experts.

While sufficiently complete loan files to permit re-underwriting were located for 723 of the 796 Sample loans, FHFA's appraisal expert Kilpatrick lacked sufficient information to assess the appraisals for 124 of the 796 Sample loans. The number of loans for which Kilpatrick analyzed the appraisals for each of the Samples is as follows:

SECURITIZATION	SLG	ORIGINAL SAMPLE SIZE	AVM ESTIMATE AVAILABLE
NAA 2005-AR6	III	196	129
NHELI 2006-FM1	1	100	94
NHELI 2006-HE3	1	100	88
NHELI 2006-FM2	1	100	95
NHELI 2007-1	II-1	100	92
NHELI 2007-2	1	100	88
NHELI 2007-3	1	100	86
TOTALS	-	796	672

After FHFA's re-underwriting and appraisal experts performed their analyses, Cowan extrapolated those experts' findings to the relevant SLG.

[78] The parties could not locate loan files for 53 of the original 100 Sample loans. Cowan selected another Sample of 96 loans for the SLG and the parties were able to locate enough loan files to permit re-underwriting of 131 loans for this SLG.

Defendants challenged several of Cowan's extrapolations, arguing that the analyzed Samples were not representative of the corresponding SLGs' populations. FHFA has shown that the final Samples are sufficiently representative to produce results from the sampling that may be reliably extrapolated to the entire SLG population.

With respect to FHFA's re-underwriting evidence, defendants challenge as unrepresentative only the Sample for the NAA 2005-AR6 SLG. This was the Sample that was expanded because so many of the files for the original Sample loans could not be located. Cowan ensured that both the initially selected loans and the supplemental loans were randomly selected and subjected to the same representativeness tests. To the extent that any bias might have been introduced into the final 2005-AR6 Sample, it was to make the expert's findings more conservative.[79] Indeed, Hunter found the material breach rates for NAA 2005-AR6 to be the lowest of the seven Securitizations.

With respect to FHFA's appraisal evidence, defendants challenge Cowan's extrapolations for four of the seven SLGs.[80] For these four Samples, defendants argue that the Sample used by Kilpatrick

[79] Although those loans whose files could no longer be located, or whose files were so incomplete that re-underwriting could not proceed, were more likely than not loans that suffered from significant underwriting defects, Cowan's extrapolation made no such assumption. Instead, he assumed that they were missing at random.

[80] Defendants argued that Kilpatrick's appraisal results could not be extrapolated for NAA 2005-AR6, NHELI 2006-HE3, NHELI 2007-2, and NHELI 2007-3.

may have been too incomplete to provide a reliable basis for an extrapolation to the entire SLG. Defendants argued that loans not included in Kilpatrick's final Samples might all share a common characteristic and that, by their omission, the Samples might be biased in some way. But a comparison of the LTV ratios recorded in the loan tape data with the Sample loans' LTV ratios demonstrates that the final Samples' LTV ratios for each SLG were entirely representative of the LTV ratios on the loan tapes. Since these sets of Samples were being used to create an LTV ratio with an appraisal value in the denominator, this was a complete rebuttal to defendants' suggestion that the Samples were somehow biased.

Finally, it is telling that defendants presented no evidence that a bias actually existed in the Samples that were used for the re-underwriting or for the appraisals. For instance, defendants' statistics expert Barnett did not conduct any representativeness tests at all or apply any established methodology for correcting bias and present those results.[81] Instead, defendants relied solely on their efforts to undermine the reliability of FHFA's expert's methodology. They did not, however, succeed in showing that either the sampling or the extrapolation methodologies employed by Cowan were anything but sound and firmly established in the field of statistics. Like many of FHFA's experts, Cowan was an impressive expert

[81] Barnett did offer representativeness test results on behalf of defendants in other FHFA coordinated actions, but not here.

who applied his considerable skills to the challenges of this case with integrity and rigor.

VI. Appraisals

One of the categories of misrepresentations alleged by FHFA pertains to LTV ratios. These ratios were reported in the Collateral Tables of the Prospectus Supplements and are also a component of any analysis of whether the originators complied with their underwriting guidelines in issuing the mortgage loans. LTV ratios are calculated in the Supplements by dividing the amount of the residential mortgage loan by the value of the property that collateralized the loan, which is defined in each Prospectus as the lower of the sales price or the appraised value.

According to federal regulations governing appraisal standards for federally related transactions, "[a]ppraisal means a written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date[], supported by the presentation and analysis of relevant market information." 12 C.F.R. § 225.62(a). According to the same regulation:

> Market value means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

> (1) Buyer and seller are typically motivated;
>
> (2) Both parties are well informed or well advised, and acting in what they consider their own best interests;
>
> (3) A reasonable time is allowed for exposure in the open market;
>
> (4) Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
>
> (5) The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Id. § 225.62(g). Even though these regulations did not govern the appraisals at issue here, the parties relied on these and similar standards when describing the requirements for an appraisal.[82]

As will be explained in more detail below, to establish a misrepresentation with respect to the LTV ratios set forth in the Prospectus Supplements, FHFA bore the burden of establishing both that the original value derived from an appraisal (and hence an LTV ratio based on that appraisal) was inflated (objective falsity), and that the appraiser did not believe the original appraised value to be accurate (subjective falsity). The Court finds that FHFA carried this burden with respect to at least 184 of the 672 Sample

[82] Defendants moved into evidence the Interagency Appraisal and Evaluation Guidelines appearing at 75 Fed. Reg. 77,450 (Dec. 10, 2010).

loans, which is approximately 27% of the Sample and, with extrapolation, 27% of the SLG population.

First, there was strong evidence that a significant percentage of the original appraisals for the Sample properties did not reflect the actual values of the properties. To the extent they could be measured, the original appraisals for the Sample properties had an upward bias of 8.92%, on average. There were more than three times as many inflated appraisals as understated appraisals. This means that the original appraisals systematically overvalued the properties, and that the overvaluation was not due to random chance. The average inflation bias per SLG ranged from over 5% to over 15%.

Of the 672 Sample loans, FHFA proved that at least 208 of their appraisals (or approximately 31%) were materially inflated (using an inflation threshold of 15.1%), and that for at least 184 of these inflated appraisals (or approximately 27% of the 672), the appraisals were non-credible. The table below shows the breakdown for each of the seven SLGs. The final column reflects non-credible appraisals. “Credibility” is a term of art in the appraisal industry, as further discussed below.

Securitization (SLG)	Number of Sample Loans in Securitization	Number of Sample Appraisals Inflated by at Least 15.1%	Non-Credible Appraisals Inflated by at Least 15.1%
NAA 2005-AR6 (3)	129	27 (21%)	25 (19%)
NHELI 2006-FM1 (1)	94	29 (31%)	26 (28%)
NHELI 2006-HE3 (1)	88	30 (34%)	27 (31%)
NHELI 2006-FM2 (1)	95	38 (40%)	34 (36%)
NHELI 2007-1 (2)	92	19 (21%)	17 (18%)
NHELI 2007-2 (1)	88	37 (42%)	31 (35%)
NHELI 2007-3 (1)	86	28 (33%)	24 (28%)
Total	672	208 (31%)	184 (27%)

The Court finds that a showing of an appraisal's non-credibility is strong circumstantial evidence that at the time the appraiser prepared the appraisal she did not believe in the value reflected therein. That strong circumstantial evidence has been buttressed by other evidence, also described below.

As discussed above, the Offering Documents highlighted the percentage of the underlying loan pools that had LTV ratios at or below 80%. It was well understood at the time that LTV ratios over 80% signaled a substantial increase in risk. An LTV ratio over 100% indicates that the property was "underwater" at the time of its sale. The Supplements overrepresented the number of loans with LTV ratios below 80%, underrepresented the number of loans with LTV ratios over 80%, and falsely represented that none of the loans had LTV ratios over 100%.

As set forth in the table below, extrapolating the impact of the inflated and non-credible appraisals to each SLG, substantially more loans had LTV ratios above 80% and above 100% than originally represented in the Offering Documents.

SLG	Less than 80 LTV		Between 80 and 100 LTV		Over 100 LTV	
	Original	Extrapolated	Original	Extrapolated	Original	Extrapolated
NAA 2005-AR6 (3)	100.0%	82.2%	0.0%	8.5%	0.0%	9.3%
NHELI 2006-FM1 (1)	79.8%	61.7%	20.2%	28.7%	0.0%	9.6%
NHELI 2006-FM2 (1)	80.0%	62.1%	20.0%	25.3%	0.0%	12.6%
NHELI 2006-HE3 (1)	62.5%	46.6%	37.5%	36.4%	0.0%	17.0%
NHELI 2007-1 (2)	89.1%	73.9%	10.9%	16.3%	0.0%	9.8%
NHELI 2007-2 (1)	61.4%	50.0%	38.6%	29.5%	0.0%	20.5%
NHELI 2007-3 (1)	66.3%	51.2%	33.7%	33.7%	0.0%	15.1%
Total	78.6%	62.5%	21.4%	24.4%	0.0%	13.1%

The extrapolations[83] indicate that over 13% of the loans were underwater, compared to the 0% reported

[83] The Court adopts Cowan's extrapolations, which were based on Kilpatrick's findings, also adopted by the Court, as discussed

in the Offering Documents. There is also a dramatic shift in the LTV range below 80%. The Offering Documents, on average, reported roughly 79% in this range, while Kilpatrick's analysis shows that the number plummets to roughly 63%. This was due to the increases in the numbers of loans with LTV ratios over both 80% and 100%. The swings for NAA 2005-AR6 and NHELI 2006-FM1 are particularly stark in the range between 80% and 100%.

To prove both the extent to which appraisals were inflated and the extent to which appraisers subjectively disbelieved the figures they rendered, FHFA relied principally on Kilpatrick, whose findings the Court substantially adopts here, as described in more detail below. Kilpatrick's testimony was corroborated in several ways by other trial evidence.

below. Cowan used a classical estimator, which is, as its name suggests, a "classical" and uncontroversial statistical technique used to estimate the value of a binary variable in a larger population. Essentially, the classical estimator takes the proportion of a certain value in a representative random sample and applies that proportion to the population. For example, assuming a population of 100 loans and a representative sample of 10 loans, if 9 (9/10) of the appraisals in the sample were non-credible, it can be confidently stated that 90 (90/100) of the appraisals in the population are non-credible. As Cowan used the classical estimator to show the relevance of the non-credibility findings at a population level, the table above shows both the applicable percentage for the Sample and the extrapolation to the population. Moreover, the 13.1% figure represents the lowest estimate of non-credible appraisals creating underwater loans, because Cowan presumed that all appraisals not tested for credibility were in fact credible. Defendants' expert Barnett attempted to call Cowan's extrapolation methodology into doubt, but on cross-examination his argument was shown to rest on demonstrably false assumptions.

After Kilpatrick's evidence and defendants' criticisms of it are discussed, that additional evidence is summarized.

A. Kilpatrick

Kilpatrick concluded that he had sufficient information to evaluate the original appraisals for 672 of the 796 Sample properties.[84] Using his proprietary Greenfield AVM, or "GAVM," Kilpatrick concluded that 208 of the 672 appraisals were inflated by at least 15.1%. In other words, the original appraised value of each of those 208 properties was at least 15.1% higher than the value of the property at the time of the original appraisal as estimated by the GAVM. Kilpatrick's choice of the 15.1% threshold is notable: The Appraisal Institute, a professional organization of appraisers, at one point used a 10% threshold as a gating mechanism for reviewing discrepancies between appraisals, and Kilpatrick adopted a figure a full 5.1 percentage points above that.[85]

Kilpatrick further evaluated 205 of the 208 inflated appraisals with his credibility assessment model ("CAM") to determine whether the original appraisals were "credible." That an appraisal is non-credible is, in at least this case, circumstantial

[84] Kilpatrick did not have sufficient information to assess the accuracy of the original appraised values for 124 properties. For example, original appraisals were missing for about two-thirds of those properties. In addition, Kilpatrick required enough data regarding comparable properties to run his proprietary automated valuation model.

[85] Nomura itself used a 10% AVM gating mechanism for subprime loans to designate those appraisals that should be subjected to further review.

evidence that the appraiser did not believe her appraised value for the property to be accurate. Kilpatrick concluded that, at a conservative credibility threshold, 184 of the 205 original appraisals were non-credible.

1. Greenfield AVM

In the first stage of his analysis, Kilpatrick used the GAVM to identify inflated appraisals. As explained above, an AVM is a computer program that employs statistical models to ascertain estimates of the market value of real property. AVMs draw from a larger pool of comparable property sales than traditional appraisal methods by culling information from databases and analyzing many sales observations. AVMs are commonly used as screening tools to identify appraisals that warrant closer review. Indeed, defendants' due diligence vendors used AVMs in screening the appraisals of some of the properties in the Trade Pools to target appraisals for further investigation. Defendants' AVM expert, Kennedy, explained that "an AVM can be used as a sorting tool to get to a group of properties that you want to take a more in-depth look at."

a. The Mechanics of the Greenfield AVM

Kilpatrick designed and built the method and code for the Greenfield AVM. The Greenfield AVM consists of two valuation sub-models, which are separately run and whose results are compared to arrive at a single final value.[86] Using a standard

[86] The two sub-models are an ordinary least squares log-linear regression model ("OLS sub-model") and a log-linear OLS sub-

regression technique, the sub-models compare the actual sales price of comparables against up to six hedonic characteristics[87]: tax assessed value ("TAV"), bathrooms, year built, lot size, square footage, and time adjustments, and in the case of one of the sub-models, additional spatial variables.[88] The GAVM limits the sales observation data to one year prior to the appraisal date of the Sample property and the geographically closest sales that are within the same county as the Sample property. Kilpatrick used a minimum of 100 and a maximum of 2,000 comparables for each Sample property. Before running his models, Kilpatrick filtered certain data from his vast dataset.[89] One of these filters was criticized by defendants and is discussed below.

model with an additional trend surface component ("OLSXY sub-model").

[87] Hedonic characteristics are property characteristics determinative of value. *Cf. In re Elec. Books Antitrust Litig.*, No. 11md2293 (DLC), 2014 WL 1282293, at *9 n.15 (S.D.N.Y. Mar. 28, 2014) ("A hedonic pricing model—'hedonic' from the Greek meaning pleasure, as the method relates to consumers' desires—measures the effect of various product attributes on price.").

[88] Kilpatrick acquired the data for his Greenfield AVM from CoreLogic, on which defendants relied in performing their own due diligence work.

[89] The filters eliminated sales where required data (such as date or location) were missing, sales for properties other than single-family residences or condominiums, sales before 2003 or after 2007, and sales coded as non-arm's length, or non-grant deed, transactions. Where there were more than 2,000 comparables, Kilpatrick limited the total number of comparables to the 2,000 geographically closest. He would not run the GAVM with fewer than 100 comparables.

b. Confirming the Accuracy of the Greenfield AVM

The GAVM served as a reliable gating mechanism to identify a set of materially inflated appraisals. Its reliability as a screening tool and its accuracy were confirmed through a series of tests.

In one test, Kilpatrick compared the GAVM estimated values with the actual sales prices of subject properties. Focusing on the middle 90% of the subject sales (in other words, excluding the 5% of the subject sales at the low tail of the distribution and the 5% of the subject sales at the high tail of the distribution), the GAVM predicted the sales price to within 1.26% on average.[90]

In another series of tests, Kilpatrick compared the performance of four commercially available AVMs used by defendants' expert Kennedy to the performance of the Greenfield AVM, again using the

[90] Kilpatrick concluded that the 5% of the sales properties at each of the tail ends of the distribution reflects "sales transactions that were not the result of arm's length sales or are otherwise the product of biased or other non-market value transactions." Kilpatrick reached this conclusion in part based on his analysis of the performance of the Greenfield AVM on sale property transactions in other cases in this coordinated litigation involving similar types of sale properties from the same timeframe. For example, the GAVM predicted the middle 90% of sales prices of the Goldman Sachs Sample loan sales transactions to within -1.9% on average with a 15% forecast standard deviation ("FSD"), the Ally Sample sales transactions to within 0.9% on average with a 14% FSD, and the HSBC Sample sales transactions to within -2.3% with a 14% FSD. The FSD is the average difference between the GAVM prediction and the actual sales price, where the difference is squared to avoid offsetting positive and negative differences.

middle 90% of the subject sales. The Greenfield AVM was conservative and predicted slightly higher market values than each of the four commercial AVMs used by Kennedy.

Moreover, when applied to *all* of the Sample loans' appraisals, each of the four commercial AVMs predicted higher average inflation of the original appraisals than the GAVM predicted. The four commercially available AVMs reported average appraisal errors exceeding 10%, as compared to the more conservative 8.92% calculated by the Greenfield AVM. That comparison is reflected in the following chart[91] submitted by Kilpatrick:

[91] None of the four commercial AVMs was able to produce an AVM value for each of the 672 subject properties. But three of them, as reflected in the chart, produced values for almost all of the properties.

Appraisal Error: (Appraisal -AVM)/ AVM	Greenfield AVM	Collateral Analytics AVM	Real Info AVM	Data Quick CMV-P AVM	Data Quick CMV-AE AVM
Properties Valued	672	662	496	669	670
Average Appraisal Error	8.92%	10.14%	12.30%	10.24%	12.62 %
Median Appraisal Error	6.28%	5.88%	7.99%	5.99%	6.27%
Standard Deviation of Appraisal Error	23%	26%	22%	21%	36%

The median appraisal error was essentially consistent across all five AVMs, between 5.88% and 7.99%, with the Greenfield AVM calculating a median appraisal error of 6.28%.

The defendants did not ask their expert Kennedy to defend the credibility of the 208 appraisals identified by the GAVM as suspect. Of the 208 appraisals that the GAVM found to be at least 15.1% inflated, Kennedy had results from at least one of the four commercial AVMs for 181 of them. For 180 of the 181, the commercial AVMs that evaluated them also estimated values that were lower than the original appraised values.[92] During cross-examination, defendants' expert Hedden was forced to concede that if evaluated on the standard chart produced by his company to display the performance of AVMs along a number of metrics, the GAVM would approach the range of the chart marked "excellent."

c. Defendants' Criticisms of the GAVM

i. Daubert Challenge

On December 5, 2014, defendants moved pursuant to Fed. R. Evid. 403, 702, and *Daubert v. Merrell Dow Pharm.*, 509 U.S. 579 (1993), to exclude Kilpatrick's testimony. The motion was granted in part, excluding Kilpatrick's opinions regarding the subjective beliefs of appraisers. *FHFA v. Nomura Holding Am., Inc.* ("*Kilpatrick Opinion*"), No. 11cv6201 (DLC), 2015 WL 353929, at *6 (S.D.N.Y. Jan. 28, 2015). The Opinion noted that defendants' attacks on the reliability of the GAVM and CAM methodologies went only to the weight, not the admissibility, of the proffered testimony. *Id.* at *4. The trial evidence has confirmed that finding.

At trial, defendants renewed their *Daubert* motion directed to the reliability of Kilpatrick's methods. As explained below, none of defendants' multilayered attacks on the GAVM (or the CAM) succeeds in showing that Kilpatrick's tools for analyzing appraisal inflation and the credibility of the

[92] Measured by various metrics, the commercial AVMs supported the GAVM's appraisal values. For instance, for 24 of the 53 appraisals evaluated by three of the four commercial AVMs (or 45%), at least two of the commercial AVMs agreed with the GAVM.

original appraisals were unsound. Kilpatrick's testimony "both rest[ed] on a reliable foundation and [wa]s relevant to the task at hand." *Daubert*, 509 U.S. at 597. When subjected to close examination at trial, his tools were shown to be conservative, careful instruments that were well-designed to ferret out appraisal bias and to be of assistance to the finder of fact in making assessments about appraisals. At heart, the ultimate test for the Greenfield AVM is whether it succeeded in isolating a subset of inflated appraisals for more in-depth analysis. It did, and none of defendants' criticisms contends otherwise. In fact, Nomura's own AVM results (from Nomura's limited valuation diligence) found average appraisal error in the Nomura loans at essentially the same rate as did the GAVM.

Defendants note that the Greenfield AVM was developed recently and has not been made available to the appraisal industry. It has, therefore, not survived the test of time or independent testing. At base, the GAVM meets the *Daubert* standard even though it has not been peer reviewed. There are several commercial AVM products that are widely used, and across many metrics the Greenfield AVM outperforms each of them. In fact, across the metrics of average and median sales error, the Greenfield AVM was more conservative than the other commercial AVMs, as it predicted slightly higher market values.

In response to a question from the Court, Kilpatrick explained that he did not use a commercially available AVM for his work in this case because he knew that, at the end of the day, he would have to testify and would be called upon to explain his valuation process: He wanted to use a valuation model that he understood and would be able to explain under oath. In fact, Kilpatrick explained that he reads USPAP Standard Rule 6 to oblige an appraiser to be familiar with an AVM's inputs, filters, calibration, and with the statistical characteristics of its outputs. Kilpatrick explained that he would not have been able to speak to any of those topics with regard to the commercial, "black box" AVMs. By contrast, Kilpatrick developed the GAVM himself and used its underlying hedonic and automated valuation models throughout his academic and professional careers.

Defendants offered many attacks against the mechanics of the GAVM, the most significant of which are addressed below. None of their arguments or evidence, however, succeeded in showing that the GAVM was an unreliable screening tool. The GAVM performed reliably as a gating mechanism for sending suspect appraisals on for closer review under the CAM, and those aspects of its design and performance criticized by defendants do not ultimately impact its ability to perform that basic function. The closer review under the CAM confirmed that it had performed as intended, indeed admirably. In the overwhelming majority of cases, the inflated appraisals flagged by the GAVM were indefensible and provide strong circumstantial evidence of impropriety by the appraisers who performed them.

ii. Variable Omission

Defendants assert that the Greenfield AVM suffers from omitted variable bias. When important variables are omitted from a regression analysis, the analysis loses its predictive value. *See, e.g., Freeland* *v. AT & T Corp.*, 238 F.R.D. 130, 145 (S.D.N.Y. 2006) (noting effect of omitting variable from regression analysis). Defendants' experts, Hausman and Isakson, identified several variables including views, swimming pools, school quality, access to public transportation, number of bedrooms, garage size, and lot size, which they asserted had been improperly omitted.

This argument was not persuasive. It is true that "[f]ailure to include a major explanatory variable that is correlated with the variable of interest in a regression model may cause an included variable to be credited with an effect that actually is caused by the excluded variable." Federal Judicial Center, *Reference Manual on Scientific Evidence* 314 (3d ed. 2011). But, as significantly, "[p]erforming a multiple regression analysis requires selecting only some of the multitude of characteristics that are possible trial predictors because including too many variables can preclude measurement of the characteristics that are valid predictors." Leandra Lederman, *Which Cases Go to Trial?: An Empirical Study of Predictors of Failure to Settle*, 49 Case W. Res. L. Rev. 315, 327 n.49 (1999).

Defendants' expert incorrectly identified lot size as an omitted variable. As explained above, lot size is already one of the hedonic characteristics used by the Greenfield AVM. Defendants also failed to show that adding the number of bedrooms as a variable would have appreciably altered the estimated values produced by the GAVM. The square footage of the home, a characteristic used by the Greenfield AVM, serves as a proxy for the number of bedrooms and effectively captures the value associated with the number of bedrooms. Tellingly, defense expert Hausman testified that the effect of treating the number of bedrooms as a required variable increased the GAVM predicted value by only approximately 0.6% on average. Finally, Kilpatrick used TAV as a proxy variable for environmental features such as the view from a property, swimming pools, school quality, and access to public transportation. There was no showing by defendants that these intangibles could be or are variables typically used in AVMs or that the use of TAV in connection with 100 to 2,000 comparables in close proximity to the subject property was not an acceptable proxy for these features.

iii. Negative Coefficients

Defendants' expert Isakson claimed that the GAVM often produces regression coefficients for its housing characteristic variables that violate implicit price theory, because in some regressions the submodels have coefficients that are less than zero for key housing characteristics. This would appear to be inconsistent with a characteristic that represents a feature of a house that buyers desire, such as extra bathrooms. The four variables to which Isakson pointed are year built, living area, lot size, and number of bathrooms.

Kilpatrick explained, however, that a coefficient for a variable might be negative in a given case to counterbalance an exaggerated TAV coefficient. Kilpatrick offered the following persuasive example: A local tax assessor might say that each additional bathroom beyond the first one in a house adds $1,000 in value. Kilpatrick's data, however, might show that each additional bathroom actually adds only $800 in value. In that scenario, the coefficient for the number-of-bathrooms variable would be negative to reflect the marginal adjustment.

iv. Inclusion of TAV as a Variable

Defendants vigorously attack the GAVM's use of TAV as a variable. Among other things, as they point out, there is no uniform system employed by local jurisdictions for tax assessments, some jurisdictions do not update TAVs frequently, and some jurisdictions base TAVs only on an external review of the property. Moreover, the GAVM included TAV data that post-dated the original appraisal that the GAVM was evaluating.

The TAV served as a proxy variable for hard-to-measure aspects of property value, such as the view and the general upkeep and condition of the house and property. Kilpatrick was able to allay the specific concern about TAV data post-dating the original appraisal by filtering the data to exclude any house rebuilt after 2009 and by testing for "regime shifts" in tax assessment that may be linked to rebuilding that occurred before 2009 by correlating TAV to sales prices of the comparables within one year prior to the time of the original appraisal.

Tellingly, defendants conducted no robust test to affirmatively show that TAV was not an appropriate variable. In contrast, Kilpatrick conducted statistical analyses on each and every TAV data point to determine the degree to which it was correlated with actual sales prices.[93] Moreover, as defendants

[93] Defendants intended to undermine Kilpatrick by eliciting that he did not undertake certain activities mentioned in federal

themselves admit, commercial AVMs utilize TAV and federal government guidelines recognize that they may properly do so, so long as the TAV exhibits that a "valid correlation exists between the tax assessment data and the market value." Interagency Appraisal and Evaluation Guidelines, 75 Fed. Reg. 77,450, 77,469 (Dec. 10, 2010).[94] Indeed, Isakson admitted that TAV data is "good source of data."

v. CV Filter

Defendants levy criticism against Kilpatrick's use of one of his several data filters, the Cross-Validation Filter ("CV Filter"). The CV Filter turned the GAVM sub-models on each of the 100 to 2,000 comparables, using all of the remaining comparables in the same county to estimate the value of the comparable under review. If the log of the predicted value of the comparable property under review deviated from the log of the actual sales price by at least 25%, Kilpatrick excluded that comparable from his dataset before running his regression models on the subject property. In Kilpatrick's judgment, the deviation reflected that the sales price for that comparable was "not consistent

guidelines for using a TAV to develop an evaluation. But those guidelines are not applicable to Kilpatrick's work in this case. The guidelines provide guidance to regulators of the mortgage lending process, and that guidance might "flow through" to real estate appraisals performed on collateral for loans from regulated institutions.

[94] A Fannie Mae document on AVMs introduced by defendants at trial also contemplates the use of TAVs in AVMs, as it says that "AVMs are statistically-based computer programs that use real estate information such as comparable sales, property characteristics, *tax assessments*, and price trends to provide an estimate of value for a specific property." (Emphasis added.)

with the hedonic characteristics reported in the available data."

Isakson makes several criticisms of the use of the CV Filter. But, again, defendants have done nothing to convince the Court that the GAVM's use of the CV filter biased it to reach more aggressive results. As explained by Kilpatrick, the CV Filter is a type of well-recognized leave-one-out statistic, routinely used to eliminate outliers in econometrics. Defendants' econometrics expert, Hausman, did not argue that as a matter of principle the use of such a filter was improper here. Additionally, Kilpatrick consistently used the CV Filter without alteration throughout the duration of the various proceedings in these coordinated actions.

vi. GAVM's Performance Vis-à-vis Four Commercial AVMs

Responding to the evidence that the GAVM performed well when compared to the four commercial AVMs on which defendants' experts had relied, defendants sought to undermine that comparison with expert testimony. To do so, however, their expert presented misleading testimony. He chose to use a faulty dataset and omitted a key comparator on which he had previously relied but which undermined his thesis. When the correct dataset is used, and all reliable measurements are considered, the evidence shows that the GAVM performs well as a gating mechanism and produces, if anything, conservative results.

Defendants' expert purported to compare the GAVM with four commercial AMVs and to determine that the GAVM was the poorest-performing AVM across six of eight metrics.[95] His analysis and reliability were undermined when it was revealed during cross-examination that his comparison figures included a miscoded sale,[96] as had been already been pointed out to him over three months earlier during his deposition.[97] When that error is eliminated, the results of the comparison of the AVMs change substantially on certain metrics.[98]

Moreover, whereas in the expert's earlier work in this case he presented "median error" as a relatively reliable measure of predicative error, and as one that "provide[s] clear definition to overall performance above/below the benchmark value," he omitted that metric when constructing his comparisons for this trial. It turns out that the median error of the GAVM when it was used to value the same properties as the other four AVMs was the lowest of the five. While the expert had performed that head-to-head comparison

[95] The eight metrics for measuring predictive accuracy included mean percentage error, mean absolute error, and standard deviation of error.

[96] The miscoded sale was easy to spot. The GAVM produced a value of $1,349,877, while the sales amount was $194,440. Kilpatrick discovered that the data used by the GAVM related to a group of single-occupancy units, not a single property.

[97] The miscoding error had been presented to the expert at his deposition on November 5, 2014. He ignored the error and presented his original study as part of his direct testimony on February 20, 2015.

[98] Removing the miscoded loan dropped the mean absolute error rate for the GAVM from 17% to 15.1%, and reduced the standard deviation from 39.8% to 20.7%. These updated figures were comfortably in keeping with the figures for the four commercial AVMs along these metrics.

in charts that he had created before trial, he chose not to submit that comparison as part of his direct testimony.[99]

Considering all of the expert testimony, and the several ways in which one may compare AVM performance, FHFA succeeded in showing that the GAVM was a reliable AVM and that it performed well when compared to commercially available AVMs. Indeed, the GAVM presented a more conservative assessment of appraisal inflation.

vii. Attacks on AVMs Generally

In another attempt to undermine the soundness of the GAVM, defendants argued that AVMs generally are unreliable. Defendants introduced a document setting out Fannie Mae's current position on using AVMs as a substitute for an appraiser's individual inspection and appraisal of a property. This argument is largely a red herring. FHFA has not relied, and the Court does not rely, solely on the GAVM to assess the original appraisals of the Sample properties that it contends have inflated appraisal values. Kilpatrick did an intensive review of each of those properties using his CAM methodology before making his final

[99] In fact, the expert acknowledged that mean absolute error rate, a metric that he did include in his table and one along which the GAVM was reportedly outperformed by the commercial AVMs, is slightly less precise than the median error rate. Not only was the mean absolute error rate that was presented in the expert's table exaggerated on account of including the miscoded loan, but during cross-examination he acknowledged that the table does not reflect head-to-head comparisons, as each of the AVMs was valuing a somewhat different set of properties, and that a head-to-head comparison tightens up the mean absolute error differentials between the five AVMs.

assessment of the reliability of their original appraisal values. In any event, Fannie Mae's cautionary language does not suggest that the GAVM fails as a reliable gating mechanism here.

Fannie Mae's document states, "At present[100] . . . we believe AVMs have generally not evolved sufficiently to *fully* replace traditional appraisals and human judgment for the origination of first lien mortgages." (Emphasis added.) The document goes on to report:

> AVMs have three principal limitations:
>
> • First, they are dependent upon the accuracy, comprehensiveness, and timeliness of the data they use. Data issues can include incomplete public records, insufficient sales of properties with comparable features within a specified geographic area, and a lag between the time when the market data are current and the AVM uses the data to generate an estimate of value.
>
> • Second, AVMs cannot be used to determine the physical condition and relative marketability of a property.

[100] Fannie Mae's assessment expressly leaves open the possibility that in the future AVMs may have a larger role in the origination process. Properly constructed and applied AVMs would have at least one advantage over individual appraisals; they would not be subject to pressure from property owners, brokers, and originators, and their results could be confirmed by purchasers of mortgages without the expense associated with an appraisal review or BPO.

> • Third, AVMs can never fully incorporate the breadth of knowledge and judgment of a skilled appraiser.[101]

Fannie Mae's document, however, also acknowledges the "strengths" of AVMS relative to traditional real estate appraisals. Those strengths are "speed, reduced costs, consistency, and objectivity. . . . [A]n AVM can significantly reduce the time it takes to obtain an estimate of value and reduce the costs associated with the traditional appraisal process."

Moreover, as discussed above, defendants' own expert, Kennedy, noted the virtues of using an AVM as a sorting tool. And Kennedy was even quoted in a 2007 article in the *Magazine of Real Estate Finance* as saying that "[t]here is going to be a backlash against traditional appraisal processes because of inherent biases as this meltdown continues forward. This will probably mean more volume for AVMs because of its [sic] unbiased nature."

viii. Statistical Errors

Finally, defense expert Hausman offered several statistical attacks on the calculations Kilpatrick made using the GAVM results, including that Kilpatrick

[101] Freddie Mac also takes the view that its own AVM should not serve as "a replacement" for an appraisal. With regard to the first limitation identified by Fannie Mae, as Kilpatrick explained, this limitation can be tested, as he did with his Greenfield AVM. With regard to the second, Kilpatrick noted that AVMs can be used to test the extent to which physical condition and marketability have an impact on sales price, if the AVM uses a good proxy variable for physical condition and marketability, like TAV. And with regard to the third limitation, Kilpatrick testified that an AVM can inform the opinion of a skilled appraiser.

used an unreliable level of statistical significance in comparing the original appraised value to the Greenfield AVM value, and that Kilpatrick erred in the method he used to transform a natural logarithm of the sales price into a predicted value in dollar terms.

At the end of the day, however, it is unnecessary to confront with specificity Hausman's criticisms. Hausman acknowledged that his academic work has not focused on AVMs, that he has never constructed an AVM, that he is not a participant in the AVM industry, and that his testimony was not based on a comparison of the GAVM to any other AVM, including the four commercial AVMs discussed by the other experts for defendants. Nor does his statistical critique relate to the core functionality of the GAVM as used in this litigation. The GAVM was used in the first instance to identify those properties whose appraisals deserved closer review, and it is to that review that the Opinion turns next. If it had not performed that first task well, its AVM values would not have been used to recalculate LTV ratios.

To sum up, the Greenfield AVM succeeded in identifying a subset of the 672 appraisals that deserved further review. While defendants have mounted a vigorous attack against the Greenfield AVM, there is no evidence that any AVM currently used in the field would have performed better when assessed with the rigor applied by the impressive array of experts assembled by defendants. It is telling that defendants themselves have historically relied upon AVMs to identify a set of appraisals deserving further scrutiny. FHFA has shown that Kilpatrick's AVM has performed at least as reliably as those on which defendants and others in business typically rely in making important decisions.

2. The CAM

There were 208 properties in the Sample whose original appraised values were at least 15.1% higher than the value estimated by the Greenfield AVM. These 208 original appraisals were directed to the CAM, which Kilpatrick created to evaluate the degree to which the original appraisals were "credible," which is a term of art under the USPAP. The CAM is a deterministic scoring methodology designed to evaluate the degree, if any, to which the appraisals deviated from USPAP and what Kilpatrick describes as applicable appraisal standards and practices. Because Kilpatrick did not have sufficient information to do his CAM evaluation for three of the 208 properties, 205 appraisals were evaluated with the CAM. Kilpatrick concluded that 184 of the 205 properties had appraisals that were not only inflated, but also non-credible. The Court adopts Kilpatrick's assessment. Coupled with other evidence explored below, these findings of non-credibility under the CAM present sufficient circumstantial evidence of bias to permit a determination that the appraisers produced appraisals that they knew did not accurately describe the value of these properties.

a. USPAP

Appraisals are based on a comprehensive set of prescribed procedures performed by licensed and certified appraisers. The procedures are developed and monitored by the Appraisal Institute and are contained in its Code of Professional Ethics ("Code of Ethics") and in the USPAP. Although not in effect during the time period at issue in this action, under current law, as enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376 (2010), "appropriate standards for the performance of real estate appraisals . . . shall require, at a minimum—that such appraisals shall be subject to appropriate review[102] for compliance with the Uniform Standards of Professional Appraisal Practice." 12 U.S.C. § 3339(3).

Even during the relevant time period, USPAP constituted the generally accepted professional appraisal industry standards. USPAP first went into effect in 1989 and has been revised regularly since that time. The appraisals at issue here were performed between 2003 and 2006, and Kilpatrick relied principally on the 2005 USPAP, in particular its Standards 1 and 2, as representing the recognized industry standards during the relevant timeframe.

USPAP Standard 1 is entitled "Real Property Appraisal, Development," and provides: "In developing a real property appraisal, an appraiser must identify the problem to be solved and the scope of work necessary to solve the problem, and correctly complete research and analysis necessary to produce a credible appraisal." The Rules accompanying Standard 1 refer to credible appraisals and the

[102] USPAP recognizes an appraisal review as a process whereby a reviewer develops an opinion as to the completeness, accuracy, adequacy, relevance, and reasonableness of the reviewed work. In other words, an appraisal review is the process by which an independent professional passes judgment on certain specific elements in another appraiser's appraisal report.

credibility of the appraisal results. Appraisal Found., *Uniform Standards of Professional Appraisal Practice and Advisory Opinions* 17-22 (2006 ed.).

USPAP Standard 2 is entitled "Real Property Appraisal, Reporting," and provides: "In reporting the results of a real property appraisal, an appraiser must communicate each analysis, opinion, and conclusion in a manner that is not misleading." The Rules accompanying Standard 2 dictate what an appraisal report must contain in order not to be "misleading." *Id.* at 23-31.

The 2006 USPAP defined the term "credible" as "worthy of belief." Its comment explains that "[c]redible assignment results require support, by relevant evidence and logic, to the degree necessary for the intended use." The definition was added to the 2006 USPAP because the concept of credibility is "central" to USPAP. As the Appraisal Standards Board explained in its published answers to the "most common questions" about the changes it made to the 2006 USPAP, the term "credible" had been a central concept in USPAP prior to 2006, and the definition added to the USPAP in 2006 "is not really different from common usage." Appraisal Found., *2006 USPAP and Scope of Work* 2, *available at* http://www.ncua.gov/Legal/Documents/Regulatory%20Alerts/RA2006-04Encl2.pdf; *see also* Appraisal Inst., *The Dictionary of Real Estate Appraisal* 49 (5th ed. 2010).

b. The CAM Questions

Kilpatrick attempted to distill the USPAP's requirements and the appraisal industry's standards into a series of thirty-one questions, which were designed to evaluate whether an appraisal complied with the fundamental requirements of USPAP and other standards of practice applicable at the time the original appraisals were performed. Because of the quantity of appraisal reviews that had to be conducted over the breadth of this coordinated litigation, the distillation of pertinent appraisal requirements into a series of concrete, pointed questions made sense. It permitted Kilpatrick's team to gather relevant data for many different properties using uniform standards and permitted Kilpatrick to supervise and review that work effectively. There is no suggestion that Kilpatrick failed to supervise and review that work with care.[103]

Kilpatrick's thirty-one CAM questions pertain to five general topics: reporting, transaction history, analysis, market trends, and comparables. The questions essentially track the information that appraisers are required to include on the URAR, one of the most common forms used for real estate appraisals, which has sections devoted to the subject property, sales contract, neighborhood, site, improvements, appraiser's approach, and any additional information. The thirty-one CAM questions are anodyne and factual. For instance, the first question is: Are the legal address and parcel ID sufficient to identify the subject?

c. Gathering CAM Answers

[103] Defendants in these coordinated actions deposed Kilpatrick for forty-eight hours. Nomura called to the stand four experts to address Kilpatrick's work alone.

To obtain answers to the CAM questions, Kilpatrick relied principally on his staff at Greenfield and on research provided by licensed appraisers associated with two appraisal firms who worked in the vicinity of the Sample properties. Kilpatrick instituted quality-control checks and appended the collected data to files for each of the examined properties.

The researchers were provided the first page of the original appraisal report. The first page provides identifying information about the subject property and neighborhood, but it does not include the actual analysis or opinion of value. The researchers were directed to gather from local Multiple Listing Services ("MLS") real estate data regarding the nearest nine comparable sales, in terms of time and distance, to the original appraisal. Appraisals typically use information regarding three or four comparables. The Greenfield staff gathered additional data from both the original appraisal reports and loan files, and from public sources, such as tax assessment data, maps, and aerial and street-level photographs.

d. CAM Scoring

Kilpatrick applied a score to each of the thirty-one CAM questions when answered in the negative. Kilpatrick chose scores that he believed reflected the importance of the question to an appraisal's credibility and the degree to which a negative response evidenced a deviation "from appraisal standards, guidance, and practice." For instance, Kilpatrick identified six questions to which a negative answer amounted to a substantial major error under USPAP Rule 1-1(b),[104] and thus gave greater weight to negative responses to those questions. Specifically, they received a score of over 8; by comparison, negative answers to most questions received scores between 2 and 6.

Even though Kilpatrick believed that a negative answer to any one of these six questions, standing alone, could raise serious questions about the credibility of the appraisal, he set a credibility threshold above that point. After performing a number of calculations, and choosing to be conservative, Kilpatrick selected a credibility threshold of 20.[105]

[104] USPAP Standards Rule 1-1(b) provides, "In developing a real property appraisal, an appraiser must not commit a substantial error of omission or commission that significantly affects an appraisal."

[105] Kilpatrick defined the threshold of credibility as the mean CAM score of the six major error questions added to the mean CAM score of the other twenty-five questions. This worked out to a threshold of 14.13. In other words, according to Kilpatrick, any appraisal evincing a CAM score greater than 14.13 contains a sufficient magnitude and frequency of errors to render the appraisal not credible. To be conservative, however, Kilpatrick added the average score of the six major error questions to twice the average of the remaining questions, as this sum would constitute the score from a series of violations of no less than three questions: one of the major error questions and two of the other questions. This approach was indeed conservative, as the USPAP contemplates that a series of individually insignificant errors can become significant in the aggregate. *See* USPAP Standards Rule 1-1(c) ("In developing a real property appraisal, an appraiser must not render appraisal services in a careless or negligent manner, such as by making a series of errors that, although individually might not significantly affect the results of an appraisal, in the aggregate affects the credibility of those results.").

e. Kilpatrick's Conclusions from the CAM Study

Setting the threshold at 20, Kilpatrick concluded that 184 of the 205 appraisals failed. For the sake of argument, Kilpatrick also accepted all of defendants' expert Hedden's specific criticisms of the CAM findings for individual property appraisals (discussed below). When he did so, there was very little difference in his findings. Kilpatrick initially testified that accepting Hedden's specific complaints moved only twelve appraisals from over the twenty-point threshold to under it. The Court's own findings in this regard are detailed below.

As reported in the table presented at the outset of this section of the Opinion, looking just at the universe of appraisals deemed non-credible by the CAM, and recalculating their LTV ratios by using the lesser of the original appraised value, the GAVM estimated value, or the sales price in the denominator of the ratio, there was a sizeable shift in those ratios. There was a significant migration of the recalculated ratios to LTV ranges above 80% and above 100%.

Defendants, through Hausman and Isakson, contend that Kilpatrick's method of populating the LTV denominator —taking the lesser of the Greenfield AVM value, the original appraised value, or the sales price of the property—reflects an error known in econometrics as censoring. Hausman suggests that the preferred course would have been the use of only the Greenfield AVM value in the denominator. This would result in a balancing out of any negative and positive errors in the Greenfield AVM values.

But Kilpatrick's approach, taking the lesser value, is standard industry practice, and is similar to the formula described in each Prospectus as the basis for their reported LTV ratios. As explained in those documents, the denominator was generally the lesser of the sales price or the original appraised value.

f. Defendants' Critiques of the CAM and its Results

Defendants made a limited effort to defend the 184 original appraisals identified by the GAVM and CAM as inflated and non-credible. They offered virtually no affirmative evidence to suggest that these were defensible appraisals. For instance, they did not conduct appraisal reviews, a traditional tool used in the appraisal industry to review the reliability of original appraisals. Nor did they elect to perform anything like the comprehensive CAM analysis, which brought together a wealth of data about each of the subject properties and their comparables. Defendants chose instead to launch a general attack on the validity of the CAM, and to take issue with CAM findings in the case of 114 of the 184 properties. They principally relied on a single expert and four testifying appraisers to cast doubt on the reliability of Kilpatrick's CAM analysis. None of these efforts was successful.[106] This Opinion first explains why the

[106] As noted above, at trial defendants renewed their *Daubert* motion directed to the reliability of Kilpatrick's methods. Like the GAVM, Kilpatrick's CAM passes *Daubert* muster even in the absence of peer review. FHFA was faced with the novel task of proving that thousands of appraisals across sixteen lawsuits were rendered by appraisers who did not subjectively believe in the values they were reporting. Such a task calls out for expert modeling, and, while defendants argue about Kilpatrick's CAM

testimony given by defendants' expert failed to undermine the CAM, and then addresses the testimony provided by the four appraisers.

i. The Failure of Hedden's Project

There were several problems with the testimony of defendants' appraisal expert Hedden. One was his lack of engagement with the assignment. Another is the very limited scope of the testimony that he provided. And a third is the standard that he applied. Each of these was fatal to him providing helpful, much less persuasive, testimony.

In contrast to Kilpatrick's hands-on engagement with his work in this case, Hedden did not devote the time or care necessary to this assignment to provide reliable opinions. It appears that one of Hedden's colleagues at FTI was responsible for organizing the work that was performed on this project and for supervising the FTI employees who worked on this engagement. That colleague was the person who chose which of Kilpatrick's CAM analyses would be subjected to fieldwork. That colleague decided to study only 40 of the 184. Given this lack of involvement, it was not surprising that Hedden had difficulty answering many of the very legitimate questions posed at trial and had to admit that he had not examined critical documents.

The second overarching failure with Hedden's testimony was its limited scope. Hedden did not offer any testimony to defend even one of the 184

scoring threshold, the weight he assigns various questions, and his application of the CAM to specific appraisals, defendants did not show that the CAM as a model is unreliable under *Daubert*.

appraisals. Instead, he limited his testimony to a generalized critique of the CAM and, although Hedden's team at FTI evaluated every single one of Kilpatrick's 1,428 CAM findings, Hedden's trial testimony addresses findings relating to only 114 of the 184 appraisals deemed non-credible by the CAM. That meant that Hedden made no specific criticism of the CAM results in the case of 70 of the 184 appraisals.

Moreover, many of the loans "discussed" in Hedden's direct testimony simply appear in one or more of three tables in his affidavit that list the appraisals that failed Questions 29, 30, and 31 by what Hedden deemed to be insubstantial margins. Notably, only one of these questions, Question 29, is one of the six "major error" questions. These three questions read:

> (29) Was the average price per square foot ("PPSF") of the comps in the appraisal report less than or equal to the average PPSF of the comps available in the market at the time of the appraisal?
>
> (30) Was the average site square footage ("SSF") of the comps used in the appraisal report less than or equal to the average SSF of the comps available in the market at the time of the appraisal?
>
> (31) Was the average gross living area ("GLA") of the comps used in the appraisal report less than or equal to the average GLA of the comps available in the market at the time of the appraisal?

These questions provided relatively easy fodder for Hedden's attacks: Because they ask whether one average number is less than or equal to another average number, Hedden, through his tables, could simply point out that even very small differences in the numbers could cause an appraisal to fail a particular CAM question.

To assist in his critique of the 184 appraisals, Hedden's colleague at FTI retained the services of iMortgage Services ("iMS") to answer a limited set of questions concerning the original appraisals for just 40 of the 184 inflated appraisals.[107] Presumably, Hedden's colleague chose the 40 original appraisals that he considered most defensible, although his absence from trial provided no opportunity to explore his selection criteria. It is therefore telling that Hedden ultimately chose to criticize the CAM findings in the case of only 33 of these 40. The iMS reports in connection with 7 of the 40 original appraisals apparently provided no ammunition to criticize the CAM results.

Even in those instances in which Hedden relied on information developed from the iMS reports, that work was far less illuminating than the detailed and rigorous reports returned by Kilpatrick's researchers. iMS represented that it hired licensed appraisers to fill in responses to roughly eight questions.[108] The iMS

[107] On the eve of trial, FHFA filed a *Daubert* motion to exclude the expert testimony of Hedden, arguing that he served as the mouthpiece for anonymous appraisers engaged by iMS. The Court denied that motion from the bench during the final pretrial conference, leaving it to FHFA to cross-examine Hedden on his process.

[108] While the researchers used by Kilpatrick's team were each identified by name to defendants, the iMS researchers remained anonymous. FHFA had no means, therefore, to check whether

Reports tend to be about two to three pages and contain very limited instructions. In contrast, the researchers who gathered the data for the CAM were given a four-and-a-half page set of instructions and completed reports that ran around eight pages on average. In undertaking a comparison, the iMS Reports did not impress. Kilpatrick's researchers completed signed, detailed, rigorous forms that are easy to understand and analyze and that transparently provide the information supporting the CAM findings. By contrast, the iMS Reports offer anonymous, undetailed, generalized comments, which do not appear to be guided by any comprehensive set of instructions.[109]

Hedden and defendants argue that Hedden limited his discussion of the CAM results to 114 of the 184 appraisals for the sake of brevity. This rings hollow. No page limitations were placed on witnesses' trial affidavits and defendants had every incentive to mount the most comprehensive attack possible against the CAM. There is a far more likely explanation for Hedden's limited testimony: He in fact found very little that he could say in defense of the 184 appraisals and in criticism of the CAM findings. This conclusion is supported by the very structure of Hedden's testimony. In no instance does Hedden present a holistic examination of a property, its original appraisal, and the CAM results. Instead, he

they were appraisers with valid licenses in the jurisdictions in which they were working or their own disciplinary records.

[109] Examples of the iMS reports and the reports completed by Kilpatrick's researchers were submitted to the Court during pretrial motion practice.

makes scattershot arguments about particular aspects of the CAM and refers to a portion of a CAM report about an appraisal to support his theme.

The decisions regarding the credibility of the 184 appraisals, and the states of mind of their appraisers, must be made on each appraisal and for each appraiser, even if that is not the approach taken by defendants. Therefore, to review Hedden's analysis with care, the Court pulled together from every portion of Hedden's testimony, including from each of his three tables, the comments he made about each original appraisal and its CAM analysis. At the Court's request, FHFA provided the Court binders containing each of the 205 appraisals reviewed by the CAM. The Court went through each appraisal, one by one, and evaluated Hedden's criticisms, if any, of Kilpatrick's CAM finding for that appraisal. In only a handful of instances did the Court have any doubt about the substance of Kilpatrick's findings. Were the Court to perform its own extrapolation, it would use at least 180 of Kilpatrick's 184, dropping at most four as a result of Hedden's criticisms. But a maximum of a four-appraisal disparity is too small to make a material difference in the Court's findings.

In performing the above-described analysis, the Court did not consider itself bound by Kilpatrick's twenty-point threshold. If Hedden successfully challenged the application of the CAM analysis to a particular appraisal when that appraisal was examined holistically, the Court would omit that appraisal from its finding of non-credibility, even if adopting Hedden's criticism did not move the CAM score below the twenty-point threshold.[110]

As they did elsewhere in this case, defendants aimed to present the Court with a single choice: adopt Kilpatrick or adopt Hedden. If confined to defendants' choice, the Court would unhesitatingly adopt Kilpatrick over Hedden. Kilpatrick's work was far more rigorous and complete and his testimony was far more credible. But, as noted, the Court also found that its own loan-by-loan analysis confirmed Kilpatrick's analysis in the overwhelming majority of appraisals even after each of Hedden's criticisms regarding an appraisal was examined with care**.**

Finally, the value of Hedden's testimony was severely undercut by his testimony that it is the job of

[110] As a further check, the Court began with Kilpatrick's spreadsheet—moved into evidence by FHFA—that lists the score each appraisal received for each CAM question. If Hedden's testimony mentioned a loan's appraisal in connection with his criticism of a particular CAM question, the Court subtracted from that loan's final CAM score the number of points that had been awarded based on its failing that particular CAM question. After conducting this additional project, CAM scores moved from above Kilpatrick's twenty-point threshold to below it for only 9 of the 184 non-credible appraisals.

In keeping with their strategy throughout the trial, defendants sought to prevent the Court from evaluating the evidence on a loan-by-loan basis. As already mentioned, the organization of Hedden's testimony did not readily lend itself to such an evaluation, and defendants objected (successfully) when FHFA propounded a table that listed by loan number all 184 non-credible appraisals and displayed how the CAM scores would change if Hedden's criticisms were adopted. In short, the excluded table performed the analysis that the Court independently undertook.

an appraiser to start with a presumption that the sales price is the right price and to try to find comparables to support that presumption. Operating from such a presumption runs a serious risk that the appraised value will not be legitimate. Indeed, the practice of backing into the sales number may explain why, as noted below, so many of the appraisals for the purchase money mortgages in the Sample were identical to the sales price and why upon careful examination they appear to be inflated appraisals. As is discussed further below, some of defendants' own witnesses rejected Hedden's notion that an appraiser should begin with a presumption in favor of the sales price; they bemoaned the practice of backing into the sales price as a systemic problem in the industry.

ii. Field and Desk Reviews Are Preferable.

Hedden attacked the CAM as unnecessary since, according to him, there are well-accepted alternative methods for evaluating appraisals, specifically field and desk reviews.[111] It suffices to note that the availability of alternative methods for reviewing appraisals does not, standing alone, render the CAM inadequate. Using a single witness who supervised closely a uniform examination of roughly 200 appraisals under a single set of standards is helpful to a fact-finder if those standards are appropriate to the task.

[111] Defendants could have but did not conduct field or desk reviews of the 205 appraisals that Kilpatrick evaluated with the CAM.

iii. The CAM Is Not Derived from USPAP.

On direct, Hedden argued that "none" of the thirty-one CAM questions "are based on USPAP requirements." He also pointed out that the CAM has been neither peer reviewed nor validated by others in the industry. Following his cross-examination, however, Hedden abandoned the argument that the CAM is not derived from the USPAP. He admitted that "generally speaking . . . the nature of the [CAM] questions . . . do go the credibility of an appraisal," and are generally sourced from the URAR. On cross-examination he was marched through many of the fields on the URAR form to illustrate that they are directly reflected in the CAM questions.

The CAM is sufficiently tethered to the USPAP and the principles that guide appraisals and appraisal reviews to be useful here. Kilpatrick explained in detail the bases for his formulation of the thirty-one questions, and those explanations were successful in supporting the use of the CAM as a means of measuring the reliability of scores of appraisals.

iv. The CAM Weightings Are Flawed and the Threshold of Twenty is "Frivolous."

Hedden maintained at trial that the CAM was too rigid and mechanistic. He contended that the weightings and scores of the CAM are illogical for two principal reasons. First, according to Hedden, the design and application of the CAM's scoring methodology fail to differentiate between minor and major errors, such as the degree to which an appraiser errs in reporting comparable sales transaction data.

But this appears to be mainly a theoretical problem; Hedden identifies only two such errors, pointing to instances where an original appraiser misreported a comparable sales price by less than 1%.

Second, according to Hedden, because several CAM questions are interrelated, the CAM may fail an appraisal on multiple questions, even though the reason for those failures depends on the same data. This double counting could inflate the number of appraisals found to be non-credible. As is the case with many of Hedden's criticisms, the force of this one is dampened by the fact that even when it is accepted, an immaterial number of Kilpatrick's evaluations are affected. In other words, double counting was not a real issue in Kilpatrick's actual results. In conducting its review of the 184 appraisals that Kilpatrick says failed the CAM, the Court was on the lookout for errant double counting.

Beyond these problems, Hedden contends that the threshold of twenty for a non-credible appraisal is frivolous. He points out that the maximum negative score, 186.11, is far above 20. Hedden notes that USPAP does not impose any rigid threshold and says that there is no uniform, one-size-fits-all approach to appraisal review.

As explained above, however, Kilpatrick has justified his use of the twenty-point threshold, as it corresponds to a negative response to no less than a minimum of three questions of the CAM: one of the major error questions and two of the other questions. And, as is also explained above, setting the bar at this level is conservative under the USPAP, which would consider one major error in the appraisal to be problematic. Moreover, as has been noted, the Court did not consider itself bound by Kilpatrick's twenty-point threshold when it pulled together each of Hedden's analyses and examined them on a loan-by-loan basis. It is also worth observing, that many of the appraisals were so error-ridden that their CAM score was far above 20. Indeed, the mean score among the 205 appraisals was 43.67 with a median of 44.12. The vast majority of the appraisals that scored more than 20 scored more than 30, and more than half of the appraisals that scored more than 20 scored more than 40.

Moreover, had defendants thought that closely and carefully looking at the CAM scoring would be helpful to their cause, they would have done so through Hedden. They did not. Hedden admitted that his direct testimony did not offer any specific opinions regarding what might be inappropriate about the aspects, categories, and priorities used in Kilpatrick's scoring methodology. Moreover, at the time of his deposition, Hedden did not understand how the CAM questions were scored, had not studied the CAM's code, and did not understand the types of limitations or buffers that were placed on the questions' scores.

v. Errors in Application

Hedden's team also identified errors in the application of the CAM questions. Hedden lists four types of errors: mathematical errors in calculating percentage thresholds; mathematical errors in determining whether a number is within a particular range; overlooking accurate information; and faulting an appraisal for not containing information required by the CAM in instances where the requisite information does not exist.

As noted above, Kilpatrick's results and conclusions do not materially change even accepting all of Hedden's specific criticisms of the CAM findings. The majority of Hedden's criticisms are directed at just three questions -- Questions 29, 30, and 31 -- only the first of which is graded "8" under CAM. Questions 30 and 31 were graded 5.015 and 4.64, respectively.

Even when a specific attack made by Hedden was well taken—and the Court examined each of them—they only made a difference on the margin for any particular appraisal. Hedden acknowledged during his cross-examination that throwing out the findings he specifically challenged in his direct testimony moved the CAM score from above to below the twenty-point threshold in just a small number of the 184 appraisals. Hedden's individual complaints are ultimately of little importance since the appraisals were so deeply flawed and error-ridden.

3. Futile Attempts to Discredit Kilpatrick

In addition to the criticisms of Kilpatrick discussed above, during cross-examination defendants spent a surprising amount of time eliciting testimony about some of Kilpatrick's past mistakes. To render his expert opinions in these coordinated actions, Kilpatrick endeavored to become a certified appraiser in all fifty states. As part of certain states' applications that he signed under oath, Kilpatrick answered "no" to questions about whether he had ever been charged with a criminal offense and certified that he had never had a civil judgment entered against him, when, in fact, he has faced civil judgments and a criminal charge in the past. The civil judgments grew out of events from the 1980s, and the criminal charge arose in connection with a payment dispute from twenty-five years ago between Kilpatrick, who was building houses at the time, and one of his subcontractors.

Kilpatrick has taken steps to remedy false answers on any applications he submitted, including writing letters to each state on whose application he made a false statement. Kilpatrick seemed genuinely remorseful for not having disclosed in the first instance details of his past that he wishes to forget. The Court found this entire line of cross-examination to be unhelpful in determining whether the 184 appraisals are credible as measured by USPAP and in determining the weight to give to Kilpatrick's expert testimony—specifically, to his GAVM methodology and his CAM findings.

B. Petition

The CAM findings were not the only circumstantial evidence of subjective falsity offered by FHFA. The above-mentioned 2007 petition sent to Congress by approximately 11,000 appraisers complained of perceived pressure to produce inflated appraisals and represented their belief that great damage was being done to the economy and homeowners. The petition is an extraordinary document. Eleven thousand citizens were willing to affix their signatures to a document to bring a problem in their very profession to the attention of their national legislature. The reputational risk of signing such a document was enormous. Of the 11,000 signatories, there were 33 appraisers who had conducted 35 of the appraisals on the Sample properties. Of the 35 appraisals, 11 were subjected to the CAM methodology and 10 of the 11 were determined by Kilpatrick to be non-credible.[112]

Notably, Hedden had been aware of the petition when it was circulated in 2007 and reported that he was not surprised when he learned of its existence, because pressure from interested parties is simply "part of what appraisers are faced with on a regular basis." Indeed, Hedden commented that the signatories "were right to have gone to Washington to say there is pressure out here and it's not a good thing." That being said, Hedden like every other appraiser at trial testified that he had "yet to find any real evidence" of people having "actually succumbed to the pressure." The 184 appraisals are evidence to the contrary.

Defendants' expert Kennedy also testified that it was general knowledge in the field that pressure was exerted on appraisers to inflate their appraisals during the time period relevant to this case. In fact, pressure on appraisers was discussed at conferences at which Kennedy spoke, and, as noted above, in 2007 he was quoted in the *Magazine of Real Estate Finance* as saying that "[t]here is going to be a backlash against traditional appraisal processes because of inherent biases as this meltdown continues forward."

[112] Also confirming the prevalence of feelings of pressure in the industry was the 2007 National Appraisal Survey that identified beliefs about industry valuation pressure and its effect on the outcome of property values.

C. Appraisers Used Sales Amounts for Subject Properties as Predetermined Values for Establishing the Appraisal Value.

The widespread phenomenon of shifting appraisal values up to at least match sales prices functions as further confirmatory evidence of pervasive pressure in the industry leading to bad faith appraisals. According to the USPAP itself, "accepting an assignment with the price in an agreement of sale, option, or listing or a sale price in a settled transaction as a predetermined value in the assignment violates USPAP." Where an appraiser is performing an appraisal in connection with a sales transaction in which a property is being purchased (as opposed to the refinancing of an existing loan), although the appraiser is required to receive and analyze the sales contract, the appraiser is expected to perform his or her own objective assessment of the true market value of the property and should not "back into" a sales number.

Despite that principle, the appraised value exactly matched the sales price for 97 of the 306 (or 32%) purchase-money mortgages in the Sample. This high proportion of appraisals matching perfectly with the predetermined sales amount is confirmatory circumstantial evidence that appraisers failed to provide truly independent valuations, which supports the inference that the appraisers did not subjectively believe the appraisals when making them.

D. Defendants' Four Appraiser Witnesses

In an effort to diminish the probative value of FHFA's appraisal evidence, defendants called four appraisers. The idea, presumably, was to show that, although the CAM labeled these appraisals "non-credible," the appraisals were defensible and the appraisers honestly believed in the appraised values at the time they were rendered. This project largely backfired. Taken together, the testimony from the four appraisers actually had the effect of confirming the reliability of the CAM and the evidence that the appraisers who performed the 184 appraisals did not actually believe in the valuation work reflected in their reports. Thus, their uniform testimony that they stood behind their appraisals counted for little.

Two of the four witnesses did not actually conduct the appraisals; their role was to review the work of less experienced appraisers. Schall is the owner of Island Preferred Inc. Appraisal and Marketing Solutions, located in New York.[113] Defendants called him to testify despite the facts that he had not performed the appraisal that seemed to be at issue and that the appraisal turned out not to be among the 184 found wanting under the CAM. Schall had supervised a trainee who conducted the appraisal, but did not visit the property, nor did he catch a significant error made by the apprentice in describing one of the comparables. Moreover, other properties with much lower sales prices could have been selected as the comparables but were not.

Like Schall, it turned out that Clagett, from Berlin, Maryland, did not perform the original

[113] Schall had been contacted by defendants at least three times, beginning in the summer of 2014, before offering to testify in this action. When defendants first contacted him, they were looking for the trainee who had actually performed the appraisal.

appraisal at issue.[114] Instead, he had simply completed a one-page review of the original appraisal, without ever performing an interior inspection himself. The review was basically a checklist and did not purport to be an independent opinion of value.

The two witnesses who actually performed the appraisals at issue were from Florida. Morris is from Homestead, Florida and performed one of the 184 appraisals that failed the CAM. She explained that the contract price for the property was $310,000, but that she offered a lower appraised value—$305,000. The GAVM estimated the value of the property at the relevant time as $217,952.

Platt, from Melbourne, Florida, also completed one of the 184 appraisals that failed the CAM analysis. Platt appraised the property at $170,000, whereas the GAVM estimated the value at $93,314.[115] Multiple problems with Platt's appraisal were explored at trial. The first series of issues had to do with his description of the subject property itself. He listed the property as having sold for $12,500 on June 6, 2006, when in fact the property had sold on that date for $50,000, or *four times* the amount listed by Platt. According to Platt's report, the subject property then sold for $70,000 on June 9, 2006, three days after having sold for $50,000, but nothing in Platt's appraisal report reflected any evaluation of whether that sale was evidence of "flipping." Then, as of September 7, 2006, just three

[114] Also similar to Schall, when defendants first contacted Clagett, they thought that he had personally performed the appraisal.

[115] Because this was a refinance and not a purchase-money loan, there was no relevant sales price.

months later and at a time when Platt admitted the market had stabilized, Platt appraised the subject property at $170,000, or nearly 2.5 times what it had sold for approximately three months earlier. Platt's report indicated that the jump from $70,000 to $170,000 was attributable to a complete renovation, but admitted that no permits had been filed in connection with the alleged renovation. Cross-examination cast serious doubt as well on the integrity of Platt's choice of comparables.

The appraiser witnesses confirmed the existence of pressure on appraisers in the period at issue to reach predetermined values of properties. Schall identified three of the signatories on the petition as appraisers who had once been associated with his company; he admitted that both he and his staff "experienced pressure to provide predetermined appraisal values." For his part, Platt had been trained by an appraiser who signed the petition. At the time that Platt performed the appraisal here, he worked for a company at which 90% of the appraisal work was conducted for mortgage lenders and financial institutions. Morris testified to having experienced, throughout her whole career, pressure to provide predetermined value opinions to avoid being blacklisted. Morris added, however, that adoption of the Home Valuation Code of Conduct, described above, helped reduce this pressure. When questioned by defense counsel, however, Morris backtracked and explained that the pressure was "not very extensive at all." Not altogether surprisingly, each of the witnesses who described this pervasive pressure to deliver a predetermined appraisal figure, adamantly denied that he or she had ever succumbed to that pressure or knew anyone who had.

The credibility of their work as appraisers and their testimony as witnesses was undercut by other exaggerations. They performed hundreds of appraisals apiece each year during the housing boom, but assured the Court that they never took shortcuts and in fact spent many hours on each and every appraisal. Clagett reported that he performed more than 700 appraisals each year in the period of 2005 to 2008, and took about five to six hours on each of them. Platt performed about 300 to 400 appraisals each year in 2005 and 2006, taking a minimum of four to five hours to perform each one despite the fact that he was also working fulltime as a fireman. For the period of 2004 through 2008, Morris conducted approximately 600 appraisals per year, which is about 12 per week. To justify those numbers, Morris claimed to have worked long hours seven days a week.

Finally, it is worth noting that Morris provided testimony that directly contradicted defendants' expert Hedden's characterization of the function of an appraisal. Morris readily agreed that "it is important for an appraiser to reach an independent valuation of the subject property," that an appraiser is not meant to start with the presumption that the sales price is the price at which she should arrive, and that it would be improper for an appraiser to simply "back into" the sales price. Confronted with Advisory Opinion 19 of the 2006 edition of USPAP, Morris finally agreed that USPAP itself provides that "accepting an assignment with the . . . sale price in a settled transaction as a predetermined value in the assignment violates

USPAP." Similarly, Morris agreed with the following statement from the Appraisal Institute: "We take offense with the notion that an appraisal is only good if it happens to come in at the sales price. That mentality helped cause the mortgage meltdown to being with. The fact that the value reflected in the appraisal does not match the sales price is not the fault of the appraisal but a result of the market today."

E. Defendants' Due Diligence

As explained above, during the securitization process defendants performed valuation diligence on some of the properties by running an AVM and/or using a BPO. As noted, defendants' expert Mishol found that 10% of all the loans in the SLGs that were actually tested through a full valuation review had a final LTV ratio of more than 100%. Although this figure cannot be extrapolated, it provides further confirmatory evidence of the Court's findings with respect to appraisal defects.

Yet even when defendants arrived, following those processes, at a "reconciled value" different from the original appraised value, defendants never entered such values in the LMS system, and never relied on such values in creating disclosures for the Prospectus Supplements. The Prospectus Supplements informed investors that the LTV ratios were calculated using "the lesser of (a) the appraised value determined in an appraisal obtained by the originator at origination of that loan and (b) the sales price for that property." To avoid relying on a number they had reason to believe was false, defendants could have also included the reconciled value as a third option if it was lower than either the original appraised value or the sales price. They chose not to do so.

* * *

In sum, FHFA proved that 184 appraisals did not accurately reflect the value of the appraised property and that the appraisers who conducted them did not subjectively believe in the values they rendered. The appraisal evidence showed a substantial increase in the number of LTV ratios appearing above both 80% and 100% compared to the figures disclosed in the Collateral Tables of the seven Prospectus Supplements.

VII. Underwriting Guidelines

A second category of misrepresentations alleged by FHFA concerns representations regarding the origination and underwriting of the loans within the SLGs backing the Certificates. FHFA established that the originators deviated significantly from their own underwriting guidelines when approving the loans in the SLGs, and that those deviations were not offset by factors that compensated for the deviations. For this reason, the representations in the Supplements regarding underwriting were false.

The deviations FHFA established were not trivial. They went to the heart of the underwriting process. Because of these deviations, originators had no adequate basis to find, for far too many of the borrowers, that the borrower was credit-worthy, had the ability and desire to make the mortgage payments, or that the collateral for the loan was adequate, among other things. The loan files and other documents demonstrate just the opposite. Borrowers misrepresented their income, credit history and assets, and their relationship to the property, or originators ignored obvious red flags that, when investigated, would have led to a denial or modification of the loan.

Measured conservatively, the deviations from originators' guidelines made anywhere from 45% to 59% of the loans in each SLG materially defective, with underwriting defects that substantially increased the credit risk of the loan. The table below shows, by Securitization, the Court's conclusions regarding the proportion of materially defective loans in each of Cowan's Samples.[116]

[116] Using the classical estimator, the proportions of materially defective loans represented in these results may be extrapolated to the population at large. Thus, the percentages in the table above represent not only the proportion of materially defective loans in the Samples, but the proportion of materially defective loans in each SLG, as well.

SECURITIZ ATION	SAMPLE SIZE	NUMBER MATERIALLY DEFECTIVE	PERCENTAGE MATERIALLY DEFECTIVE
NAA 2005-AR6	131	61	47%
NHELI 2006-FM1	100	59	59%
NHELI 2006-HE3	99	50	55%
NHELI 2006-FM2	100	53	53%
NHELI 2007-1	98	46	47%
NHELI 2007-2	98	49	50%
NHELI 2007-3	97	44	45%
TOTAL	723[117]	362	50%

The principal trial evidence from which these conclusions and data are drawn are the loan files for the 723 Sample loans, associated documents, and the parties' expert analyses.[118] The conclusions drawn from the analysis of that evidence are confirmed by other trial evidence. For example, and as already described, defendants' own due diligence reviews

[117] As noted above, re-underwriting analysis could not be performed on every loan in the Sample.

[118] Because of an objection from defendants, certain additional documentation that would have further explained Hunter's analysis of the loan files was not received into evidence.

found material flaws with loans that found their way into these SLGs, and with other loans coming from the same Trade Pools.

After a description of the process that FHFA's expert used to conduct his analysis of the loans, defendants' principal critiques of that process will be discussed. Then, the process the Court used to arrive at the calculations described above will be explained.

Before embarking on these descriptions of the evidence and process, however, it is important to observe that defendants' response to Hunter mirrors their response to Kilpatrick. Defendants have not presented affirmative evidence that the originators of the loans actually complied with their own underwriting guidelines when originating loans, or with even the more summary descriptions of the underwriting process contained in the Prospectus Supplements. They did not identify their own sample of loans drawn from the SLGs and have an underwriting expert assess the originators' compliance with underwriting guidelines; and they did not have their own expert re-underwrite FHFA's Sample loans.[119] Instead, they relied, as they are entitled to do, on an attack on FHFA's evidence. It is,

[119] While defendants' expert characterized his teams as "re-underwriters" and he purported at the very end of his testimony to have "re-underwritten" the loans at issue, he did not perform that task. He restricted himself to simply reviewing the defects identified by FHFA's expert and searching for compensating factors. He did not identify any separate defects, rely on materials which would ordinarily be a part of a re-underwriting review, or do any comprehensive comparison of a loan to an originator's guidelines.

of course, FHFA's burden to show that the loans at issue here were not originated generally in accordance with applicable guidelines. As the following discussion demonstrates, it carried that burden.

A. Hunter's Re-Underwriting Review

Hunter conducted a forensic re-underwriting review of 723 of the 796 Sample loans. The number 723 includes either 100 or close to 100 of the Sample loans for six of the seven SLGs, and 131 Sample loans for the relevant SLG in NAA 2005-AR6.[120]

In his review, Hunter compared the loan file for each loan to the originator's guidelines and, in some instances, to minimum industry standards ("Minimum Standards") that Hunter distilled from the many guidelines he examined and from his professional experience. Hunter's review was holistic, taking into account both the ways in which a loan application did not meet an originator's underwriting guidelines and any factors that might excuse or compensate for that failure. Even when there was no documentation in the loan file that reflected compensating factors considered by the originator, Hunter made his own examination and would not enter a finding of a defect where he determined that adequate compensating factors existed. After completing each review, Hunter determined the impact of any identified underwriting defects on the credit risk of the loan, ultimately identifying a

[120] The reasons and process for choosing the 131 Sample loans for NAA 2005-AR6, and the implications of that choice for extrapolating results from the review of the Sample loans, have already been discussed.

subgroup of 482 loans that were, in his judgment, materially defective.

Where FHFA and defendants stipulated that a set of documents was the best representation of a Sample loan file, Hunter used that file for his review. Where there was no stipulation, Hunter pursued a re-underwriting review if the file contained at least 100 pages and a significant number of seven core documents.[121] In the case of 73 of the Sample loans, Hunter did not have sufficient material to conduct the re-underwriting.[122]

Where the parties did not stipulate to an applicable set of underwriting guidelines, Hunter attempted to use originators' guidelines that were dated between 30 to 90 days prior to the closing of the loan. In the case of 37 loans, the originators' relevant guidelines were unavailable, and Hunter relied exclusively on the Minimum Standards to re-underwrite the loan. On occasion, Hunter used the Minimum Standards to supplement an originator's guidelines. In total, Hunter used the Minimum Standards in re-underwriting 180 of the 723 loans; only 240 of Hunter's 1,998 defect findings are premised on the Minimum Standards.

Hunter's 59 Minimum Standards were the most lenient standards employed for subprime and Alt-A

[121] The seven documents were the borrower's signed final loan application, a credit report, a completed appraisal report, a completed, final HUD-1 Settlement Statement, TIL disclosure, executed promissory note, and mortgage or deed of trust.

[122] The overwhelming majority of the 73 Loans were from NAA 2005-AR6.

loans between 2002 and 2007.[123] The Minimum Standards include, for example, the requirements that a property's LTV/CLTV ratio not exceed 100%, that a borrower's DTI ratio not exceed 55%, and that a subprime borrower's FICO score not exceed 500. Even when Hunter found that a loan failed to comply with a Minimum Standard, Hunter looked for compensating factors that could offset the failure. As Hunter pointed out, and as many of defendants' witnesses conceded, however, certain defects—such as LTV ratios over 100% and borrower fraud—were not curable, and no compensating factor could offset them.

Hunter concluded that 87% of the 723 Sample loans that he examined had at least one guideline defect, and almost 66% had an increased credit risk because of the defects.[124] In many cases, originators failed to investigate critical information. For example, for many of the 723 Sample loans, following up on recent credit inquiries for the borrower that appeared in the loan file's credit reports revealed information that would have been available to the originator that increased a borrower's credit risk. More generally, many of the loan files had "red flags" regarding potential misrepresentations of income, employment,

[123] To confirm that these standards were indeed minimal industry standards, Hunter compared them to the guideline requirements of New Century, WMC, Countrywide, and Long Beach, who were responsible for originating large volumes of subprime and Alt-A loans during the relevant period and were generally known to have had very lenient origination requirements.

[124] Some of these defects were based on LTV ratios as determined by Kilpatrick's GAVM. As described below, the Court did not adopt these findings wholesale.

debt obligations, housing history, or occupancy status. Virtually all of these red flags, upon investigation, revealed information that rendered the loan materially defective.

B. Forester's Audit of Hunter's Work

Defendants' principal attack on Hunter's findings came in the form of expert testimony from Forester. Based on his teams' audit of Hunter's findings,[125] Forester testified that "at most" 40, or 5.5%, of the 723 Sample loans had substantial underwriting defects. For the remainder of the loans, Forester concluded that a reasonable underwriter at the time of origination "could have found" that the loans satisfied the originators' underwriting guidelines. In so concluding, Forester was careful not to opine that sufficient evidence exists to find that those loans were indeed underwritten generally in compliance with the originators' underwriting guidelines.

Forester made several critical choices that weakened the value of his testimony. The most prominent of these errors was his choice to ignore available documentation outside the loan file because such documentation was not in the loan file. Forester took this position even when the documents demonstrated that the borrower had lied to the originator and a diligent originator could have uncovered the deceit.

[125] In contrast to Hunter's hands-on engagement with this re-underwriting process, Forester relied heavily on his research teams to examine loan files and to provide the critique of Hunter's findings.

A second major flaw is related to the first. Forester presumes that the originator investigated all red flags appearing in the loan files. This is true even when such an investigation should have prevented the loan from issuing because the investigation would have disclosed that the borrower was not being truthful, had substantial additional debt, was not going to occupy the home despite representing that it would be her primary residence, or was not currently living in the home she was seeking to refinance as her purported primary residence.

Forester's presumption that the originator must have investigated the red flags in the loan file, even when there is no evidence that the originator did so, rests on defendants' assertion that the passage of time has made it difficult to locate a complete loan file. It is certainly true that the collection of loan files in 2012 and 2013 for loans originated between 2005 and 2007 has proven to be challenging. Even when it was the practice to image loan files and store them electronically, pages may be missing. Handwritten notes made at the time of origination on the back of a document before the document was imaged could also be missing. But Forester essentially presumed that all originators were diligent even when there is overwhelming evidence to the contrary.

This approach fails to grapple with two critical points. Underwriting guidelines required that red flags be investigated and that exceptions to underwriting criteria be documented. Documentation was critical so that supervisors and each of the units within an originator, including its auditors, could examine the file and determine what had been done.

Documentation was also critical because these loans were originated to be sold, and the file would be leaving the originator's offices. It is, therefore, improbable in the extreme—and untenable to presume—that every originator diligently followed up on all red flags and merely failed to document its efforts. Moreover, Forester's presumption fails to survive Hunter's careful analysis showing not just the existence of red flags, but also the existence of material information that would have been available to the originator if those red flags had been investigated and that would have led in the ordinary course to the loan being issued (if at all) on different terms.

A third overarching problem with Forester's analysis relates to missing underwriting guidelines. Although it is undisputed that every originator had written underwriting guidelines, Forester refused to offer any substantive critique of Hunter's findings emanating from his use of the Minimum Standards. Instead, Forester automatically "cleared" all associated defects. For similar reasons, Forester cleared defects associated with some loans underwritten under Nomura's own guidelines.[126] In

[126] For some loans originated under Nomura's own underwriting guidelines, Forester stated that "the applicable guidelines for the subject loan have not been identified" and therefore "plaintiff's analysis of this loan is not meaningful nor can a reliable conclusion be reached that the loan was inconsistent with guidelines." This is all the stranger when, in Forester's Dashboard Reports, Forester's claim is juxtaposed with Hunter's chapter-and-verse citation of Nomura guidelines. In response to the Court's question, Forester explained that these conclusions resulted from defendants' failure to supply him with the

other words, Forester assumed that such loans were properly underwritten, regardless of how suspect or risky the loans appear.

Another overarching problem is that Forester (as was also true for Hedden's testimony regarding appraisals) did not make a holistic evaluation of each loan. It is not uncommon for a loan with one serious defect to have several serious defects, reflecting a wholesale abandonment of any genuine underwriting effort. Thus, considered in the context of Hunter's entire analysis of a defective loan, many of Forester's complaints become essentially irrelevant.

C. Defendants' Objections to Hunter's Re-underwriting

Defendants have made many objections to Hunter's analysis. The five most important of those objections are addressed below.

1. Hunter Applied the Originator's Guidelines Too Strictly.

Defendants argue that Hunter applied the originators' guidelines too strictly. Defendants assert that, in doing so, Hunter improperly substituted his own judgment for the judgment of the originators, who were applying the "customs and practice" of their industry in the "real world" as it existed in 2005 to 2007. Defendants point to the emphasis in certain originator's guidelines that loans should be originated

applicable Nomura guidelines. Similarly, many of his team's findings note that "Plaintiff did not cite any guidelines" even where Hunter explicitly stated that "the Lender's guidelines" were relied upon for that finding, and the specific guideline is identified in one of Hunter's previous findings.

using a "common-sense approach," that brokers should originate "loans that make sense," and that the objective of underwriting should be evaluation of "the borrower's overall credit and capacity."

Defendants are wrong for many reasons. First, they mischaracterize Hunter's methodology: Hunter did not "nitpick"; rather, he consistently applied the originators' guidelines as written. And "common sense" is, in virtually every instance, on Hunter's side when one examines a specific loan. Repeatedly, the borrower lacks "overall credit and capacity," there are so many red flags or deficiencies that common sense counsels against origination, or there are defects that cannot be cured, such as a borrower's misrepresentation of income or debt. It is also no criticism of Hunter to say that he was stricter in applying an originator's guidelines than the originator itself where the originator ignored its guidelines. Tellingly, if defendants believed that a more flexible re-underwriting approach would have been tenable and productive for them, they had the opportunity to conduct such a review and present their findings.

2. Minimum Standards

Defendants object to Hunter's reliance on Minimum Standards in his re-underwriting. But it is undisputed, even if they cannot now be located, that each of the originators had written underwriting guidelines at the time that they issued the loans. Underwriting guidelines gave structure to the inquiries conducted by many individual underwriters in the many offices of an originator and allowed originators to sell mortgage loans in pools with a single set of representations about the quality of the underwriting process and the loans' characteristics.

Where an originator's guidelines had not been located by the parties, or where an originator's located guidelines assumed (in Hunter's view) that a particular step in the underwriting process had been taken, Hunter relied on the Minimum Standards. With perhaps a single exception,[127] the evidence at trial showed that Hunter succeeded in distilling the rock bottom requirements for qualifying subprime and Alt-A loans during the period at issue here.

The confirmation of the existence of the 59 Minimum Standards came from every conceivable source, including from defendants' trial witnesses, defendants' business records, and the many origination guidelines received into evidence and relied upon by the trial witnesses, including the guidelines from the ten originators that contributed the largest number of loans to the SLGs. Forester himself admitted there are steps that should "always be performed" by originating underwriters. He represented that in those cases where no guidelines were available, he had nonetheless undertaken to determine whether an LTV ratio or DTI ratio was reasonable based on his understanding of what constituted a "minimal level of guidelines" and his "broad experience." While Forester misdescribed his work for defendants, in giving this testimony he

[127] One of Hunter's Minimum Standards provides that "[t]he property's CLTV ratio may not exceed 90% for an investment property." Defendants pointed to one set of Fremont guidelines that permitted non-owner-occupied properties to have CLTV ratios of up to 100%.

confirmed the obvious: minimal underwriting standards existed and their content is known.

For example, in February 2006, Nomura's due diligence unit identified subprime originators' "common Mortgage Underwriting criteria" as including DTI ratio over 55%, FICO scores over 500, and LTV ratios less than 100%. These same criteria showed up in Nomura's 2006 bid stipulations. At trial, the head of a Nomura unit confirmed the existence of every Minimum Standard on which he was questioned, which was dozens.

At trial, defendants largely confined their attack on the 59 Minimum Standards to just three. Defendants focused most of their attention on the Minimum Standard that provides that a borrower's DTI ratio may not exceed 55%. Nomura's bid stipulations required exactly that, as did the guidelines of many originators. Five of the Prospectus Supplements explain, however, that some originators permitted on a case-by-case basis DTI ratios of up to 60%.[128] This is not inconsistent with Hunter's Minimum Standard. A DTI ratio Minimum Standard of 55% was sufficient for loan approval; it did not require an originator to find compensating factors on a loan by loan basis to approve a higher DTI ratio.

[128] The passage reads, "Generally, scheduled payments on a mortgage loan during the first year of its term plus taxes and insurance and all scheduled payments on obligations that extend beyond ten months equal no more than a specified percentage not in excess of 60% of the prospective borrower's gross income. The percentage applied varies on a case-by-case basis depending on a number of underwriting criteria, including, without limitation, the loan-to-value ratio of the mortgage loan."

A second Minimum Standard on which defendants focused requires an underwriter to examine “payment shock,” which is defined as existing when a borrower’s new payment obligation will exceed “150 percent of the borrower’s current housing expense.” Some originators’ guidelines, however, permitted payment shock of up to 200%, while others included nothing on the issue at all. But the guidelines permitting a 200% payment shock did so only when compensating factors existed. In any event, Hunter used the Minimum Standard regarding payment shock as a red flag to trigger a close examination for compensating factors.

Finally, defendants were critical of the Minimum Standard that a “lender must investigate whether the borrower sought (and/or obtained) credit that was not listed on the borrower’s origination credit report,” and that such “investigation include an inquiry into any credit inquiries within 90 days preceding the loan application.” (Emphasis added.) But, it was a universally acknowledged requirement in the relevant period that originators had to obtain a borrower’s credit report before issuing a subprime or Alt-A loan, examine it, and investigate red flags. Defense counsel admitted as much at summation. Boiled down to its essence, the parties’ disagreement was limited to whether originators had to examine every credit inquiry made close to the time a borrower applied for the mortgage loan, since some of those inquiries may reflect no more than a borrower shopping for the best mortgage rate.[129]

[129] One set of originator guidelines required underwriters to investigate credit inquiries, but added that such inquires “around

3. Using BLS Data to Assess Reasonableness of Income

Many of the loans within the SLGs were "stated income" loans. This fact was so significant to investors that the Prospectus Supplements presented data regarding the proportion of such loans in the SLGs. Defendants contend that Hunter should not have rejected the stated income as unreasonable for 75 such loans. They principally complain that in doing so Hunter relied on historical data from the U.S. Bureau of Labor Statistics ("BLS"), which the originators did not use.

If a mortgage loan was issued pursuant to a stated-income program, then the borrower did not have to provide documentation, such as tax returns or pay stubs, to verify her report of income. But that did not relieve originators of their obligation to assess whether the borrower was credit-worthy and capable of repaying the loan. Therefore, originators' guidelines required underwriters to verify the reasonableness of the stated income by, for instance, verifying employment.

During the period between 2005 and 2007, there were some online tools with local wage data for certain occupations that were available to originators. Those databases contain only current data, however, and do not permit a search to be conducted in 2015 to confirm wage rates eight to ten years ago. Accordingly, as part of his examination of the reasonableness of stated income, Hunter relied on historical BLS data.

the date of the loan application" generally did not require an explanation.

BLS data is collected by the federal government based on survey responses from employers. The reported statistics come from a large sample collected over three years; data from the previous three years are combined annually to estimate salaries for the previous year. BLS data are extremely granular: They provide by percentile the salaries for a vast number of specific occupations in various industries, and the salaries are available on a national, regional, state, or county-wide basis. The BLS statistics do not reflect salary ranges above $187,200 and do not include categories of earnings other than wages, such as bonuses and tips. As defendants point out, the Commissioner of the BLS has stated that BLS data is not a tool for establishing "prevailing wages"—the average salaries actually paid to workers in a given occupation and region—and cannot identify any particular employer's wage rates.[130]

Defendants overstate Hunter's reliance on BLS data. To assess the reasonableness of borrowers' income, Hunter examined all of the information in the loan file about a borrower's education, employment, and duration of employment, and reviewed the borrower's assets, liabilities, and disposable income.[131] He also looked for any information in the loan file

[130] *Promoting the Accuracy and Accountability of the Davis-Bacon Act: Hearing Before the Subcomm. on Workforce Protections, H. Comm. on Educ. and the Workforce*, 113th Cong. 9-11 (2013) (statement of Erica L. Groshen, Commissioner, Bureau of Labor Statistics).

[131] This accords with Forester's own description of a wholly proper evaluation of income reasonableness when the evaluation is limited to an examination of data in the loan file.

reflecting that the originator had verified the employment or income. Thus, Hunter's consultation of historical BLS data was only one step among many. And Hunter was conservative in using BLS data, comparing borrowers' stated income only to the 90th percentile of income recorded by the BLS, the highest available figure. Even then, Hunter did not typically find a credit risk where the loan file included information indicating that the income reported was accurate. Hunter's reliance on BLS data was entirely reasonable in the circumstances.

4. Owner Occupancy

One of the alleged misrepresentations on which FHFA relied in filing this action was the representation in the Prospectus Supplements that a reported percentage of the properties were owner occupied as of the Cut-off Date. Defendants assert that, for several reasons, the Court should ignore Hunter's analysis of borrowers' occupancy status.

It is universally recognized that owner occupancy is a critical factor in assessing credit risk. Mortgage lenders and investors understand that borrowers have a greater incentive to make their mortgage payments when the failure to do so risks the loss of the family home. Thus, originators offer loans for borrowers that are or will be using the property as their primary residence on different terms than borrowers who own or seek to own the property as a second home or as an investment. For example, an originator might have a lower LTV/CLTV ceiling for investment properties. Accordingly, a borrower's statement that she is living in the home she seeks to refinance or that she intends to live in the home she is buying with the mortgage money are important representations and originators may not ignore red flags indicating that a borrower is misrepresenting owner-occupancy status.

Defendants do not take issue with any of these observations. They did attempt at trial, however, to demonstrate that Hunter misidentified five of forty-two loans as loans reflecting owner-occupancy misrepresentations. In fact, defendants succeeded in raising serious questions about only one of the five.

Defendants have a second, more theoretical complaint about Hunter's analysis of owner occupancy. For those mortgages that were being used to buy a primary residence (as opposed to refinance one), defendants contend that everyone, including investors, understood that the data in the Collateral Tables referred to nothing more than a borrower's "intent" to occupy the property at the time a loan is originated. There are two observations to be made about this.

First, defendants do not indicate how many of the forty-two loans with identified owner-occupancy defects were "purchase-money" loans. Most of the examples they used at trial in examining Hunter were refinancing loans. As defendants admitted at trial, originators should have verified that borrowers were actually occupying the properties they were seeking to refinance as their purported primary residence.

Second, defendants are wrong about the import of the representation in the Prospectus Supplements. As previously explained, the Supplements represent owner-occupancy status as of the Cut-off Date. *FHFA v. Nomura Holding Am., Inc.* ("*Owner-Occupancy Opinion*"), No. 11cv6201 (DLC), 2015 WL 394072, at

*3-4 (S.D.N.Y. Jan. 29, 2015). The Supplements do not represent only a borrower's intention at the time the borrower applied for the mortgage. *Id.* At the time of securitization, this statement of fact is made by those issuing and underwriting the securitization. *Id.* Defendants do not dispute that originators had an obligation to chase down any red flags indicating that a borrower was not going to use a property as her primary residence.[132] In context, investors were entitled to understand that originators and securitizers had confirmed that the loan was for an owner-occupied property.

Finally, Forester argues that the evidence that originators chased down all the red flags and confirmed occupancy status may simply be missing from the loan file. A determination of whether red flags regarding occupancy status existed and whether they were investigated may be made only on a loan by loan basis, and this the Court has done.

5. Post-Origination Documents

Defendants object to Hunter's consultation of documents that were not in existence at the time of loan origination. Defendants calculate that Hunter's reliance on such documents "affected" 289 loans. It was entirely appropriate for Hunter to rely on post-origination evidence when making a finding of an underwriting defect.

[132] The availability of accurate information about residency at the time of securitization would be relevant to a due diligence defense, but it is not relevant to a finding that a representation in the Supplements was untrue as of the Cut-off Date.

Broadly speaking, there are two kinds of post-origination evidence at issue here. One kind is documents generated in the present containing the very same information that an originator could have been obtained or generated back in 2005 to 2007. A credit report is an example of such a document; a report generated in 2015 contains entries dating back years that would have been seen in a credit report printed out then.

With respect to this category of documents, defendants emphasize that at least some of the post-origination documents contain disclaimers regarding accuracy. For example, the LexisNexis Accurint reports—which Hunter uses for 15 loans—compile data from third party sources and contain the following disclaimer:

> The Public Records and commercially available data sources used on reports have errors. Data is sometimes entered poorly, processed incorrectly and is generally not free from defect. This system should not be relied upon as definitively accurate. Before relying on any data this system supplies, it should be independently verified.

Such stock disclaimers, however, do not render these reports devoid of evidentiary value or make them inadmissible. Indeed, defendants themselves routinely rely on such reports. Forester also relies on such reports in conducting post-origination loan reviews as part of his ordinary business.

A second kind of post-origination evidence is information that came into existence after the origination and securitization of the loan and that would not have been available to even the most diligent underwriter. For example, a 2014 bankruptcy filing may contain a list of residences and be compelling evidence that the borrower never occupied the property for which the mortgage loan was issued. Defendants contend that the Prospectus Supplements only referred to an originator's process of adhering to its underwriting guidelines and did not assure investors that the loans actually met the criteria within those guidelines. Accordingly, they argue, a statement cannot be shown to be false based on evidence unavailable to the originator.

It was entirely appropriate for FHFA to rely on such post-origination evidence. As previously explained in addressing a *Daubert* motion, FHFA has the burden to prove the falsity of the representations it has placed in issue in this case and may rely on post-origination evidence to do so.

> In representing that the loans were originated in accordance with their Originators' guidelines, the Prospectus Supplements represent that the loans within each SLG did in fact meet the criteria set forth in their Originators' guidelines. That is a representation of fact. It provided assurance to investors that the loans were of a certain quality. In making this representation in the Offering Documents, the defendants assured investors that they had conducted a sufficient examination to confirm its accuracy and understood that they would be held strictly liable if the

> representation were false, absent recourse to an applicable statutory defense.

Hunter Opinion, --- F. Supp. 3d ---, 2015 WL 568788, at *10. If defendants had been able to present an affirmative defense of due diligence at trial, then the historical unavailability of the information would be relevant.[133] Thus, none of the five principal objections made by defendants to Hunter's work undermines the probative force of that work.

6. Originator Deposition Testimony

In an attempt to cast doubt on Hunter's analysis, defendants also offered, through current and former employees, the deposition testimony of four originators regarding their underwriting practices. They are Fremont, Quicken, Wells Fargo, and WMC.[134] This testimony does not undercut Hunter's analysis or, as discussed below, the Court's own conclusions about the loans at issue.

Three originators were only minor contributors of loans to the relevant SLGs. When the record of Nomura's own due diligence performed on the originators' Trade Pools is examined, there is no reason to believe that these loans were any more free of defective underwriting than the other loans in the SLGs. Wells Fargo, for example, contributed only 8

[133] The term "due diligence" is used in this Opinion to refer to the affirmative defense of reasonable care under Section 12 of the Securities Act. 15 U.S.C. § 77*l*(a)(2).

[134] The fifth deponent testified only to ResMAE's document retention policies. As discussed below, the Court largely disregarded purported defects based on the absence of key documents from the loan files offered in evidence at trial.

loans to the NHELI 2007-2 SLG. None of these received credit and compliance due diligence, and of the two that received valuation due diligence, one original appraisal was deemed unreliable. WMC contributed 148 of the loans in the NHELI 2007-3 SLG. WMC's sole Trade Pool had a kick-out rate of approximately one-third. Quicken contributed 129 loans to the SLGs in NHELI 2006-HE3 and NHELI 2007-2. Almost half of the Quicken loans subjected to credit and compliance due diligence by Nomura were waived in by Nomura after an initial finding of credit defects. Confirming Quicken's poor underwriting practices, Hunter found numerous serious defects in those Quicken loans that were sampled. Under these circumstances, it is impossible to credit Quicken's assertion that "overall we had a very low defect rate."

The remaining originator is Fremont, which is the sole originator for NHELI 2006-FM1 and NHELI 2006-FM2. The Fremont deponent was not an underwriter but a securitization structurer working in the capital markets group. His sanguine descriptions of Fremont's quality-control processes are starkly contradicted by the results of not only FHFA's re-underwriting review of the Fremont SLGs, but by defendants' own experience with Fremont. RBS came to call Fremont "Fraudmont." A post-facto review ordered by RBS found that 45% of the examined Fremont loans showed signs of fraud. And Nomura's examination of the Fremont Trade Pools for NHELI 2006-FM2 yielded kick-out rates of 17% and 21%, respectively, far above what it considered the norm.

D. The Court's Review

As just described, defendants made a strategic choice to present a series of discrete attacks on Hunter's methodology. They sought to so thoroughly undermine confidence in Hunter's re-underwriting program that it could be rejected wholesale. By the time of summation defendants made their position explicit. They argued that the Court should reject Hunter's analysis in its entirety because he had not sufficiently disaggregated his findings. According to defendants, only an expert can make a judgment about whether there was increased credit risk as a result of defects in loan origination. That, they say, is a task that may not be performed by the fact finder.

If limited to the stark choice between Hunter's expert testimony and Forester's, the Court would unhesitatingly accept Hunter's. Hunter engaged in a careful loan by loan analysis. His methodology was essentially sound. He was an impressive witness, with intimate familiarity with the task he had undertaken and the reasons for his decisions. He responded forthrightly to defense counsel during cross examination. In contrast, Forester was not as well-informed about the files at issue here or even all aspects of his teams' work. Many of his critiques of Hunter's analysis failed because Forester imposed too narrow a scope on his assignment. Finally, because Forester did not take a holistic approach and examine loan-by-loan the credit risk associated with all re-underwriting defects, his potshots at Hunter's methodology made it impossible to evaluate their actual impact on the material defect rates for an SLG.

But there is no need to limit artificially a fact finder's review of record evidence. A defective loan could have so many separate underwriting defects that it would still be materially defective even if one or more of Forester's arguments was compelling. The Court's review of the record evidence has confirmed that Hunter's analysis was essentially sound.

Informed by the testimony given by both Hunter and Forester and other trial evidence, the Court reviewed each of Forester's Dashboard Reports for the 482 loans that Hunter determined was materially defective. A Dashboard Report, which Forester's teams created for each loan, consists of a cover page describing significant characteristics of the loan and several additional pages in which Hunter's detailed findings—reproduced verbatim in the Dashboard from the spreadsheet Hunter created—are juxtaposed with the detailed responses from Forester's teams. The Dashboard Reports also list all potential compensating factors identified by Forester and his teams. These documents—along with the original loan files and underwriting guidelines -- were available for the Court's loan-by-loan, defect-by-defect review.

Each Dashboard Report was reviewed, and the merit of each of the experts' arguments about the compliance or non-compliance of each loan with the originator's underwriting guidelines was assessed. The Court made several assumptions, however, in performing this review. First, only the 184 loans that Kilpatrick concluded failed the CAM were considered to have appraisal defects, as opposed to the larger number identified by Hunter as defective based on the GAVM. Second, Hunter's findings that loan files were missing "key documents" were ignored.[135] Third, to the extent that Hunter relied on a finding that the originator had failed to follow through on credit inquiries that appeared in the loan file's credit report, and those credit inquiries were clustered around the loan application date, the defect finding was also ignored. Finally, any references to loan tape defects were ignored.

During the loan-by-loan analysis, the Court was alert to any assertion in the Dashboard Reports that Hunter had made calculation errors,[136] misread or misapplied guidelines, or relied on only minor deviations from guidelines. To the extent that Hunter relied on a post-origination document that defendants challenged because it typically bore a disclaimer of reliability, Hunter's use of the information from the document was evaluated in the context of that loan's overall condition. It should be noted, however, that the vast majority of credit reports that drove Hunter's analysis were those that were found in the original loan file and that the originator had the opportunity to inspect and act upon.

[135] This was a conservative assumption. There was a great deal of evidence from defendants' due diligence reviews that key documents were missing from loan files at the time they were being reviewed by defendants, and defendants just waived them in anyway or allowed an originator to "locate" the missing documents. But, with the passage of time, it is difficult to know how many documents were never part of the file and how many have simply been lost.

[136] Notably, some of the Dashboard Reports' recalculations identified a more serious deviation from guidelines than Hunter had found.

When the Court's review was complete, the Court was able to confirm, as reported in the beginning of this section of the Opinion, Hunter's findings of material credit risk due to deviations from originators' guidelines for approximately 50% of the loans in the SLGs. For 44 of these loans, the material defects confirmed by the Court were violations of Minimum Standards. Of these 44, Hunter relied exclusively on his Minimum Standards in the case of just 13. For the rest, Hunter used the Minimum Standards to supplement an originator's located guidelines. Hunter's findings of a material failure to comply with Minimum Standards were entirely appropriate in each of these instances, and defendants' Dashboard Reports identified no compensating factors that could have permitted a reasonable originator to find the borrower credit-worthy.

Similarly, defendants' complaints about owner-occupancy defects proved to be largely irrelevant. Hunter's owner-occupancy defect finding was a decisive factor for only two of the loans supporting the Court's findings. While valid owner-occupancy defects were present in other loans, those findings by Hunter were just one of several serious problems with the loan that contributed to its risk. The breakdown by SLG of all owner-occupancy defects as found by the Court was as follows:

SECURITIZATION	SAMPLE SIZE	NUMBER WITH OWNER-OCCUPANCY DEFECT	PERCENTAGE WITH OWNER-OCCUPANCY DEFECTS
NAA 2005-AR6	131	0	0.00%
NHELI 2006-FM1	100	3	3.00%
NHELI 2006-FM2	100	3	3.00%
NHELI 2006-HE3	99	1	1.01%
NHELI 2007-1	98	0	0.00%
NHELI 2007-2	98	1	1.02%
NHELI 2007-3	97	3	3.09%
TOTAL	723	11	1.52%

Moreover, in over 63% of these loans with owner-occupancy defects, the borrower was refinancing an existing loan for what she represented was her primary residence; the issue of the borrower's "intent" was simply not in play.

The contention by defendants during summation that the Court should not examine their Dashboard Reports to ascertain the extent to which their generalized, thematic attacks on Hunter's work had any impact on Hunter's evaluation of credit risk of a particular loan is not surprising.[137] That examination showed that those attacks actually had little impact on Hunter's work.

* * *

Whether one accepts Hunter's conclusion that 66% of the Sample loans had underwriting defects that materially affected credit risk, or the Court's more conservative, confirmatory review that indicated that at least 45% per SLG did, the only possible conclusion is this: The Certificates sold to the GSEs were supported by loans for which the underwriting process had failed. Guidelines were systematically disregarded. These loans could not be accurately described as having been "originated generally in accordance" with originators' guidelines.

VIII. Credit Ratings

FHFA also alleges misrepresentations regarding the credit ratings of the Certificates. FHFA has shown falsity on this claim as well.

[137] Defendants had submitted the Dashboard Reports electronically to the Court with their other trial exhibits on February 20. Defense counsel used Forester's findings extensively in their cross-examination of Hunter. On March 23, following the completion of Hunter's testimony, the Court requested a set of the Dashboard Reports in hard copy and advised the parties that it would be reviewing them individually. Defendants delivered them on March 25. On April 2, the parties delivered a hard drive containing the loan files and guidelines for the 482 loans organized in a more accessible fashion. By the time of their April 9 summation, at which defendants apparently objected to the Court's review of the Dashboard Reports, that review was close to complete. Any objection by defendants was therefore not only without merit but untimely.

According to FHFA, the AAA or equivalent credit ratings assigned by the rating agencies were inflated and did not in fact apply to each Securitization's collateral, since defendants provided the rating agencies incorrect data regarding the loan population. As this Court has previously remarked, FHFA's claim "is not that the ratings themselves were false. [Instead,] FHFA challenges representations in the Offering Materials that the reported credit rating related to the actual loan collateral for the securitization." *FHFA v. Merrill Lynch & Co.*, 903 F. Supp. 2d 274, 276 n.2 (S.D.N.Y. 2012).

As noted above, Nomura provided rating agencies with pre-closing loan tapes created from Nomura's LMS database, which reported data for each loan, including characteristics such as FICO score, DTI ratio, LTV/CLTV ratio, loan purpose, property type, interest rate, owner-occupancy status, documentation program, and presence of mortgage insurance. The ratings and loss estimates generated by the rating agencies' models were extremely sensitive to the data on these loan tapes; if incorrect data were used—data reflecting more favorable loan characteristics—these models would require less credit support than should have been required of a securitization. Defendants had an economic incentive to maximize the size of the AAA rated tranche in any particular offering. Consequently, the observed AAA subordination levels were near the AAA/AA margin.[138]

[138] Defendants' expert Riddiough acknowledged that the subordination of the AAA certificates was only 1.3% to 5.1% that of the AA certificates.

FHFA's allegation regarding credit ratings is largely derivative of its claims with respect to LTV ratios and guideline compliance. *FHFA v. Ally Fin. Inc.*, No. 11cv7010 (DLC), 2012 WL 6616061, at *1 n.2 (S.D.N.Y. Dec. 19, 2012). As a result, the Court's findings above with respect to those categories of misrepresentations greatly impact its findings here. The number of misreported LTV ratios per SLG ranged from 18% to 36%. Many of these misrepresented LTV ratios moved the ratio into a range between 80% and 100% or even above 100%. Similarly, the Court's findings of a rate of 45% or higher material underwriting defects in each SLG cast serious doubt on the accuracy of the loan tape data provided to the rating agencies regarding such critical data points as the DTI ratio, among other things.

Moreover, the Deloitte AUP reviews put defendants on notice that around 10% of the loans in each sample that Deloitte reviewed had discrepant loan tape data or were missing documentation necessary for the review. Hunter also performed a pre-closing loan tape review, comparing the information in the loan file against the information contained in the pre-closing loan tapes. He found that of 723 total loans reviewed, 321 (or 44%) had pre-closing loan tape defects and substantially increased credit risk. The breakdown per SLG ranged from 36% to 52%.

With this much inaccuracy in the loan tapes, FHFA has easily shown that the Prospectus Supplements misrepresented that the reported credit ratings related to the actual loan collateral for the Securitizations. As discussed next, those misrepresentations were material.

IX. Materiality

The representations in the Prospectus Supplements regarding both the LTV ratios for the loans within an SLG and the extent to which those loans were originated in compliance with underwriting guidelines, were each false and materially so. The Supplements contained utterly misleading descriptions of the quality and nature of the loans supporting the GSEs' Certificates. The LTV ratios for 18% or more of the loans within the relevant SLG were misrepresented in each of the seven Prospectus Supplements. The compliance with underwriting guidelines for 45% or more of the loans within the relevant SLG was misrepresented in each of the seven Prospectus Supplements. Because, as explained above, the data on the loan tapes reporting LTV and DTI ratios, among other data points, was significantly misstated, the credit rating agencies received materially false information that had a direct impact on their assignment of credit ratings to each of the Certificates, causing the Prospectus Supplements to make material misrepresentations about credit ratings as well. But while FHFA succeeded in showing that each of these three sets of misrepresentations was material, it has not shown that the misrepresentations regarding owner occupancy were material.

The standard for assessing materiality in connection with these claims can be found in the Offering Documents. All seven Prospectus Supplements provided that "[t]he characteristics of the loans included in a trust fund will not vary by more than *five percent* (by total principal balance as of the

Cut-off Date) from the characteristics of the loans that are described in the prospectus supplement."[139] (Emphasis added.) In other words, the Offering Documents themselves contemplate that if 5% or more of the collateral was other than as represented, this would be viewed as important by investors. As confirmed by defendants' materiality expert, this was a common threshold in PLS Offering Materials during the period between 2005 and 2007.

There is no real dispute that the 5% materiality threshold has been exceeded here. Defendants' own witnesses confirmed misstatements at or above the 5% threshold. Forester essentially conceded that Hunter's findings of material underwriting defects appeared appropriate for slightly more than 5% of the loans in the Sample, and, according to defendants' data, used by Mishol, 10% of all the loans in the SLGs that were actually tested through a full valuation review had a final LTV ratio of more than 100%.

Reasonable investors in the PLS market during the period 2005 to 2007 considered a broad range of information prior to purchase. But an essential component of any analysis was the characteristics of the collateral, as described by sponsors and underwriters in the Offering Documents. Among the

[139] Similarly, five of the Prospectus Supplements (all but NAA 2005-AR6 and NHELI 2006-FM1) provide that "[i]f, as of the Closing Date, any material pool characteristic differs by *5%* or more from the description in this prospectus supplement, revised disclosure will be provided either in a supplement or in a Current Report on Form 8-K." (Emphasis added.)

key characteristics were LTV ratios and compliance with underwriting guidelines.[140]

A. LTV Ratios

It is not disputed that LTV ratios were critical to PLS investors in evaluating the risk profile of a loan. In fact, as Nomura's LaRocca explained, information like LTV ratios was included in the Offering Documents because investors and rating agencies requested that specific information from Nomura. The most important LTV thresholds were the 80% and 100% thresholds. Nomura witnesses testified that Nomura would not buy or securitize loans with LTV ratios greater than 100%; they understood that RMBS investors during the 2005 to 2007 period found such loans unacceptable. Similarly, loans with an 80% or higher LTV ratio presented a greater risk of loss than loans with lower LTV ratios; reflecting that increased risk, borrowers were required to obtain mortgage insurance. Here, the Offering Documents not only misstated LTV ratios, they made dramatic misrepresentations regarding the number of loans with ratios above 80% and above 100%.

Investors were not the only parties relying on LTV disclosures. The credit rating agencies used these same statistics to assess credit risk and determine the minimum levels of required subordination for AAA ratings.

[140] Other important characteristics were owner-occupancy status, documentation type, loan product type (*i.e.*, adjustable-rate or fixed rate), the geographic dispersion of the loans, the borrowers' FICO scores, originator identity, and lien position.

Schwert's regression analysis confirmed the significance of LTV data to the structural subordination of RMBS. Schwert's model demonstrated the intuitive proposition that if the underlying collateral is riskier, one needs to provide more protection to structure a AAA rated security.[141] Had the LTV characteristics been accurately reported to the credit rating agencies, the Certificates would have needed greater credit enhancement and subordination to be issued, if at all, with a AAA rating.

B. Compliance with Underwriting Guidelines

As defendants' witnesses also acknowledged, whether loans were actually underwritten in compliance with guidelines was extremely significant to investors. Compliance with underwriting guidelines ensures, among other things, an accurate calculation of the borrower's DTI ratio, which is a critical data point in the evaluation of a loan's risk profile. As defendants' expert Vandell admitted, the very purpose of loan origination guidelines is to control the risk of default in an appropriate fashion. Forester, for his part, conceded that there is a higher likelihood of default for loans that do not meet guidelines unless sufficient and appropriate compensating factors are present.

Not surprisingly, rating agencies require representations about guideline compliance to ensure that the loans supporting a securitization are legitimate and qualified. According to credit rating company witnesses, the representation that the loans

[141] Schwert's analysis understates the problem as it could not account for, among other things, LTV ratios in excess of 100%.

were originated in accordance with guidelines was and still is standard in the industry.

C. Credit Ratings

In deciding whether to purchase a PLS, the credit rating of a certificate is highly important to investors. Investment-grade securities such as those at issue here are predominantly held by investors that tend to be averse to the risk of portfolio losses. Indeed, many institutional investors have internal investment requirements that prohibit them from investing in securities that are not rated investment-grade. A Freddie Mac policy required that PLS be rated by at least two of four named rating agencies as AAA. Fannie Mae had a similar policy, providing that PLS must have a minimum rating of AAA by at least one of S&P or Moody's.

During summations, defendants noted that the relevant question on materiality is not whether particular attributes, such as LTV ratios, are material, but rather whether the difference between the actual disclosures about those attributes and what FHFA alleges should have been disclosed is material. In other words, the question is whether the "delta"—the difference between what was reported and what was true—would have been viewed by a reasonable investor as having significantly altered the total mix of information made available. In this case, there was overwhelming evidence of materiality when viewed as the delta between the representations and the facts established at trial.

X. Rise and Fall of the Home Mortgage Market and Its Effect on Losses in the GSEs' RMBS Portfolios

Defendants offered at trial a loss causation defense. They argued, in essence, that any losses experienced by the Certificates were caused by market factors and not by any misrepresentations in the Offering Documents.[142] During summations, defendants referred to "the overwhelming showing" that the losses on the Certificates were caused not by any alleged misstatements "but by macroeconomic factors, most importantly the decline in housing prices." Defendants went on to say that "[t]here is a mass of evidence from Freddie and Fannie themselves" supporting defendants' loss causation position. Defendants pointed, for example, to a Fannie Mae 10-K for 2011, which states that "[a] substantial portion of [Fannie's] fair value losses and write-downs related to our investments in private-label mortgage-related securities backed by Alt-A and subprime mortgage loans [is] due to the decline in home prices and the weak economy." Notably, concluded defendants, no other factors were mentioned.

To support the defense, defendants offered evidence regarding the rise and decline in housing prices and other economic conditions at the beginning of this century, and it is to that chapter of American history that this Opinion now turns. The evidence at trial, including expert testimony, as well as common

[142] That the Prospectus Supplements themselves include warnings, discussed above, about "economic conditions" and "declines in the residential real estate market" is of limited probative value to the question of whether the cause of the losses at issue here can be disentangled from the misrepresentations.

sense drive a single conclusion. Shoddy origination practices that are at the heart of this lawsuit were part and parcel of the story of the housing bubble and the economic collapse that followed when that bubble burst. While that history is complex, and there were several contributing factors to the decline in housing prices and the recession, it is impossible to disentangle the origination practices that are at the heart of the misrepresentations at issue here from these events. Shoddily underwritten loans were more likely to default, which contributed to the collapse of the housing market, which in turn led to the default of even more shoddily underwritten loans. Thus, the origination and securitization of these defective loans not only contributed to the collapse of the housing market, the very macroeconomic factor that defendants say caused the losses, but once that collapse started, improperly underwritten loans were hit hardest and drove the collapse even further. The evidence at trial confirms the obvious: Badly written loans perform badly. In short, defendants could not propound a cause unrelated to the alleged misrepresentations.

A. Growth in the U.S. Housing Market: Late 1990s Through Early 2006

From the closing years of the twentieth century until early 2006 or so, there was extraordinary growth in the number of homebuyers and issued mortgages and in housing construction. These phenomena were intertwined with historically low interest rates, an increase in the use of adjustable-rate mortgages ("ARM") and other mortgage products, low unemployment, and government policies encouraging homeownership. With high employment rates and low interest rates, the pool of eligible borrowers increased, and they purchased homes.

During this same period, there was a relaxation of underwriting standards for residential mortgages. Among other things, lenders issued loans to borrowers with lower credit scores and without the down payment or documentation traditionally required. Reflecting these changes, the volume of subprime lending increased dramatically. During the period 2003 to 2005 alone, the number of subprime loans nearly doubled, from 1.1 million to 1.9 million. By 2005, subprime loans represented 20% of all new mortgage loans.

Because lending cannot exist without access to capital, the growth of the subprime mortgage market cannot be explained without recognizing the critical role that the securitization of these mortgage loans played in that process. The securitization of residential mortgage loans increased dramatically beginning in the mid-1990s. With every sale of a securitization, more money became available to securitizers, then to originators, and ultimately to borrowers. By 2003, 68% of new mortgage originations were securitized. This phenomenon was even more critical to the growth of the subprime mortgage market. In 2002, the volume of PLS securitizations had surpassed $400 billion for the first time, with less than half of this amount supported by prime mortgages. In 2001, roughly 50% of subprime mortgage loans had been securitized, but by 2005 and 2006, more than 80% of subprime mortgage loans were securitized.

The total dollar amount of outstanding PLS grew from just over $1 trillion in the first quarter of 2004 to almost $3 trillion in the second quarter of 2007. At its peak, PLS represented $2.8 trillion in outstanding RMBS.

Beginning in 2004, Freddie Mac and Fannie Mae significantly increased their own purchases of PLS. From 2003 through 2007, the two GSEs purchased more than $593 billion of subprime and Alt-A PLS. The total volume of subprime PLS during these years was close to $1.7 trillion.

The increased demand for homes led to a boom in the construction of new houses. And, during these years, housing prices soared. From January 2000 to May 2006, average home prices rose by 125%.

B. The Bubble Bursts

But these trends did not continue: The housing bubble burst. Beginning in mid-2004, the Federal Reserve began steadily increasing the targeted federal funds rate and over time mortgage interest rates rose. By mid-2006, many potential buyers could no longer afford homes. And, at least in some areas of the country, housing construction outstripped demand. By early 2006, the increase in housing prices stalled. After peaking in April 2006, housing prices began a decline and ultimately fell sharply. From April 2007 through May 2009, house prices in the United States fell by nearly 33%.

No one can forget the recession that followed and lasted one-and-a-half years, from December 2007 to June 2009, making it the longest recession since the Great Depression. GDP contracted by approximately 4.3%. Unemployment rose from 4.4% in May 2007 to

10% in the fourth quarter of 2009. Some of the headline-making events during this period were the run on Bear Stearns, which led to a government-organized rescue attempt in March 2008, and the collapse of Lehman Brothers on September 15, 2008.

These historic events, however, had roots in the contraction of the housing market, and in particular in investors' loss of confidence in the credit quality of the mortgage loans that served as collateral for their investments. On May 4, 2007, UBS shut down its internal hedge fund Dillon Read after it suffered approximately $125 million in subprime-related losses. That same month, Moody's put 62 tranches of 21 U.S. subprime deals on review for a possible downgrade. On June 7, 2007, Bear Stearns Asset Management informed investors that it was suspending redemptions from a leveraged fund that had invested in collateralized debt obligations backed by subprime loans. In June, S&P and Moody's downgraded over 100 bonds backed by second-lien subprime mortgages. And the list of negative events related to subprime investments continued through the rest of 2007 and beyond.

In retrospect, of critical importance was the August 9, 2007 announcement by BNP Paribas that it had temporarily suspended redemptions for three of its investment funds that had invested in subprime RMBS. It explained that "[t]he complete evaporation of liquidity in certain market segments of the US securitization market has made it impossible to value certain assets fairly regardless of their quality or credit rating. The situation is such that it is no longer possible to value fairly the underlying US ABS assets."

BNP Press Release, Aug. 9, 2007, *available at* http://www.bnpparibas.com/en/news/press-release/bnp-paribas-investment-partners-temporaly-suspends-calculation-net-asset-value-fo. Following this announcement, money market participants became reluctant to lend to each other and short-term rates increased on instruments that had previously been considered safe.

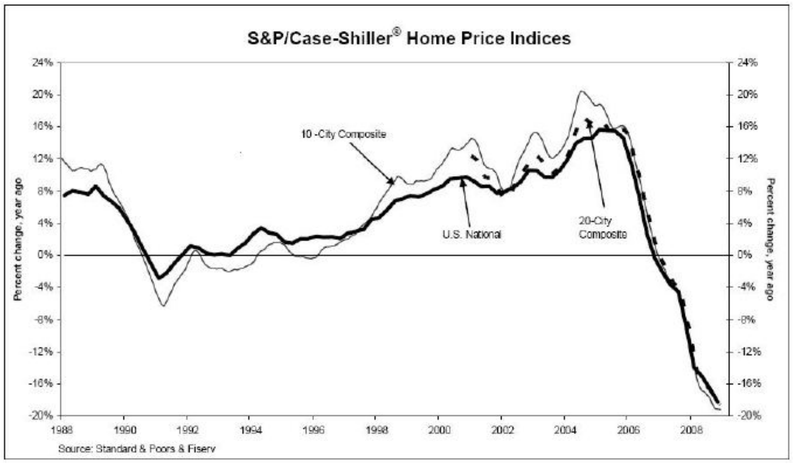
C. Causes of Contraction in Housing Market

The factors contributing to the contraction of the housing market and the decline in house prices were numerous and mutually reinforcing: Higher prices and higher interest rates led to a softening of demand for homes; falling demand, coupled with oversupply, put downward pressure on house prices; and falling prices led to negative equity, which together with newly tightened underwriting standards limited the ability of homeowners to refinance existing loans. As the economy soured and unemployment soared, defaults and foreclosures increased; with the increase in defaults, investor demand for securitized mortgages collapsed.

Shoddy underwriting practices (as opposed to relaxed underwriting standards) like those at issue here contributed to both the spectacular expansion of the subprime mortgage and securitization markets and their contraction. The ability of originators to quickly sell and shift the risk of subprime loans off their books reduced their incentive to carefully screen borrowers. They approved loans that did not comply with stated underwriting guidelines and they misrepresented the quality of those loans to purchasers. Appraised values were overstated, owner occupancy was misreported, credit risk was hidden, and second liens were undisclosed. In short, these shoddy practices contributed to the housing price boom.

And, of course, those who had purchased homes during the boom years were most at risk of finding their homes "underwater" when the housing bubble burst. Their mortgage balance was greater than the sharply declining value of their home. By the end of 2009, approximately 24% of all mortgaged residential properties in the U.S. had negative equity. Defaults on mortgage obligations became more rampant. This was particularly true for subprime mortgages, where serious delinquencies increased by more than five times from mid-2005 to late-2009. At the end of that period, about 30% of subprime mortgages were delinquent.

As the following chart illustrates, the decline in housing prices was steep.


S&P/Case-Shiller® Home Price Indices

Source: Standard & Poors & Fiserv

The financial crisis and recession exacerbated the housing crisis. With the increase in unemployment, the demand for housing fell and the incidence of delinquencies and defaults rose. The tightening of lending standards and the collapse of the PLS securitization market reduced the supply of credit for would-be borrowers.

Just as the shoddy and unscrupulous origination practices contributed to the housing boom, they contributed to the collapse in prices after the housing bubble burst. Originally understated LTV ratios necessarily increased the rate of defaults, as did the misrepresentations about credit status and owner occupancy. Not surprisingly, Barth found support in academic studies for his opinion that misrepresented PLS securitized loans had higher delinquency and default rates than other loans. With high delinquency and foreclosure rates, and the re-sale of foreclosed properties, more housing stock was placed on the market and housing prices became even further depressed.

Many of these problems and processes were interconnected and the cross-currents among them were numerous. They fed upon each other to create a housing boom, and they interacted to create and exacerbate the economic decline that followed that boom. The origination and securitization of shoddy mortgages—mortgages that did not meet their originators' guidelines—were among the drivers of both phenomena. As recognized by defendants' expert Vandell, to whom the Opinion now turns, the bursting of the housing price bubble triggered a financial crisis and an ensuing recession, which, in turn, further exacerbated the housing crisis.

D. Vandell's Study of the Hunter Loans

To support their contention that it made not one whit of difference to the value of the Certificates if the Offering Documents misrepresented the quality of any or even all of the loans supporting the Certificates, given the drastic decline in housing prices and the deep recession, defendants offered benchmarking analyses. Three of those analyses were excluded prior to trial as unreliable under *Daubert* and Fed. R. Evid. 702. In none of the three analyses did defendants compare the performance of a set of loans with underwriting defects to a set without such defects. *Vandell Opinion*, 2015 WL 539489, at *6.

In place of the excluded analyses, the Court permitted defendants to substitute a different test. Vandell, using a multinomial cross-sectional logit model,[143] looked at 721 loans that were re-underwritten by Hunter, comparing the performance of those Hunter found to be materially defective with the performance of those for which Hunter made no such finding. After controlling for observable loan and borrower characteristics, changes in economic factors, and the security-level effect,[144] Vandell concluded that

[143] "Multinomial logit is an appropriate approach when the dependent variable consists of three or more . . . outcomes. Specifically, multinomial logit estimates the likelihood of a particular outcome, relative to another category that serves as a referent." Steven J. Balla et al., *Outside Communications and OIRA Review of Agency Regulations*, 63 Admin. L. Rev. 149, 173 (2011) (citation omitted).

[144] By "security level effect," or "Security Indicators," Vandell refers to the fact that he has controlled for the possibility that the loans in a particular securitization may have unobservable characteristics—such as neighborhood concentration or

the "probability of default or serious delinquency was not statistically significantly different at the five percent significance level for Hunter Defective Loans versus Hunter Non-Defective Loans for the Supporting Loan Groups of any of the At-Issue Certificates." Vandell concluded that "either Mr. Hunter's re-underwriting results are not reliable or his alleged underwriting defects did not affect the performance of the loans in the Supporting Loan Groups."

Another of defendants' experts, Riddiough, reviewed Vandell's analysis and opined that, after accounting for loss causation, FHFA's recovery would be equal to $0. In other words, defendants' expert evidence on loss causation presented the Court with yet another all-or-nothing proposition: Losses on the Certificates were or were not caused entirely by factors other than any material misrepresentations. Defendants made no attempt to tease out a portion of any losses.

There are at least three independent failures in Vandell's analysis. First, and much like the problem

origination during the same time period within a year—that could affect their performance. According to Schwert, Vandell's inclusion of "Security Indicators" in his multinomial cross-sectional logit model is inappropriate for two reasons. First, the probability that a borrower will default does not depend on the securitization into which her loan is placed. Second, the estimated coefficients on the Security Indicators may reflect the effects of underwriting defects, not factors unrelated to the alleged misrepresentations. In any event, Schwert concluded that including the Security Indicators did not actually matter, as the predicted probability of default, once corrected as described below, was higher in the model including the Indicators.

that saw his three other analyses excluded, Vandell claimed to be comparing defective loans against non-defective loans, but did not. He admitted at trial that he took no steps to ensure he actually had a "clean" set of loans for his comparison. Vandell was unaware of Hunter's testimony that the level of underwriting defects in the Sample was so severe that it was unlikely that any of the loans in the seven SLGs—including the ones for which Hunter had not identified defects—was actually free of defects. Additionally, Vandell included in his "non-defective" comparator set loans that Hunter had actually labeled defective (though not in a way that materially increased credit risk).

Second, Vandell misreported the results of his own model. The dependent variable in Vandell's multinomial logit model is equal to one of three possible loan states: current, default, or prepaid. Vandell's model consisted of two legs, one that measured the effect of independent variables on the likelihood of default relative to remaining current, and another that measured the effect of independent variables on the likelihood of prepayment relative to remaining current. Prepayments affect default rates because loans that are prepaid cannot default, but loans that are not prepaid can default. Therefore, loan defects could result in higher overall default rates by increasing the likelihood of default, decreasing the likelihood of prepayment, or both, relative to remaining current. This means that inferences about overall probability of default cannot be drawn from just one equation in what is truly a two-equation system.

Nevertheless, Vandell only reported the estimates of the effect of defects on the likelihood of default relative to remaining current; he omitted the estimates of the effect of defects on the likelihood of prepayment relative to remaining current. Schwert reran Vandell's model to take into account both legs. The corrected analysis showed that the probability of default is, on average, nearly 10% higher for the loans that Vandell labeled "Hunter defective loans" as compared to the loans that Vandell labeled the "Hunter non-defective loans," and that the difference in default rates is statistically significant.

Vandell sat in the courtroom and listened as Schwert explained this problem with Vandell's analysis. When it came time for him to take the stand, Vandell admitted that his direct testimony was misleading. Vandell reversed himself and said that the purpose of his model was not to show the "probability" of default. When confronted with his chart entitled, "Effect of Hunter Defect on *Probability* of Default and Serious Delinquency," (emphasis added) Vandell admitted that "[t]hat's what it says. That's not, however, what it means."

A third failure in Vandell's analysis is that he failed to consider the impact of subordination on the losses incurred by the GSEs' Certificates. If the true characteristics of the loans had been disclosed, the Certificates would have issued with AAA ratings, if at all, only if the subordination levels had been higher than they in fact were. This bears directly on any loss causation analysis, but was ignored by Vandell.

Indeed, Schwert's testimony that there is a significant relation between AAA subordination levels of securitizations and the reported characteristics of the underlying loan collateral, including LTV ratios, went effectively unrebutted. While defendants' expert Riddiough attempted to undermine the statistical significance of Schwert's conclusion, Riddiough used the wrong method to assess statistical significance.[145] Defendants further attempted to undermine Schwert's testimony on subordination by arguing that his model did not account for forms of credit enhancement aside from subordination, such as cross-collateralization and excess spread. Defendants, however, offered nothing to show how the existence of other forms of credit enhancement could resuscitate Vandell's loss causation analysis from Schwert's critiques. In fact, Riddiough admitted that he did not view it as his job to quantify the effect of any allegedly missing variable in Schwert's analyses. In sum, Vandell's analysis was completely eviscerated at trial.

[145] During cross-examination Riddiough was shown an article bearing his name and that of Risharng Chiang. The article contained analysis at odds with testimony Riddiough had given about the operation of the rating agency process. When confronted with the inconsistency, Riddiough said that the statement in the article represented his old thinking, which subsequently had changed. When asked if he had written the article, Riddiough's answer was, "I don't know—it's interesting that you bring this article up. . . . [T]his article appeared with this other person's name on it. And I've always been puzzled about this article appearing with this person's name. . . . I've always been puzzled by the appearance of this article or with this person's name on it who I don't know." Almost within the same breath, however, when asked if this was the first time he was seeing the article, he responded, "It's the first time I recall seeing the article with this person's name on it, yes, it is."

E. GSE Witnesses

Defendants attempted to buttress their loss-causation defense by calling to the stand three senior GSE executives: Niculescu, Mudd, and Cook. Their testimony confirmed the obvious: The decline in housing prices was correlated with losses in the GSEs' PLS portfolio. In Mudd's view, PLS values were affected by both macroeconomic factors such as employment rates, home prices, geography, and interest rates, as well as security-specific effects, such as the underlying structure, rating, or composition of individual securities. Mudd testified that "generally the movement of housing prices downward would have a negative impact on the general value of mortgage-related assets."

Mudd was shown and agreed with a September 18, 2009 memorandum of law that was filed on behalf of Fannie Mae as a defendant in the unrelated litigation, *In re Fannie Mae 2008 Securities Litigation*, No. 08cv7831 (PAC) (S.D.N.Y.), which is one of several cases further discussed below. The memorandum states:

> As investors were well aware, Fannie Mae is a government-sponsored entity ("GSE") whose congressional charter prohibits it from diversifying, requiring that it invest in, and only in, residential mortgages; thus, it would always be particularly vulnerable to a mortgage market collapse. As then-Treasury Secretary Paulson explained a year ago, Fannie Mae's financial collapse was the consequence of "the GSE structure, and . . . the ongoing housing correction. . . . GSE

> managements and their Boards are responsible for neither."

Cook testified to understanding that certain levels of losses in the underlying collateral could cause the subordination in PLS securitizations to be pierced and, if that happened, could cause Freddie to lose money. According to Cook, defaults in the underlying loans was one of the factors ultimately related to the risks of the PLS that Freddie purchased.

None of this testimony, or similar statements in documents admitted into evidence, such as motion papers filed by the GSEs and FHFA in other cases,[146] discussed below, is sufficient to carry defendants' burden, on the loss causation defense, of affirmatively proving that any of the amount recoverable represents other than the depreciation in the Certificates' value resulting from the material misrepresentations. That the GSEs themselves attributed their losses in part to macroeconomic factors such as the decline in housing prices does not answer the pertinent question given the interconnected events that fed the housing bubble and drove its collapse.

[146] In addition to putting into evidence legal briefs filed in other cases, defendants introduced numerous other GSE documents—such as Forms 10-Q and 10-K, annual reports to Congress, and internal memoranda—demonstrating that the GSEs at least partially attributed their losses to macroeconomic conditions such as house price declines. As discussed below, pointing to the fact that the GSEs themselves viewed the decline in housing prices as a cause of their losses does not move the ball on defendants' loss causation defense.

XI. Corporate Entities and Individual Defendants

As already described, there was no entity or person responsible within Nomura for ensuring the accuracy of the representations in the Offering Documents that are at issue here. Each of the Nomura corporate defendants played an integral role in a seamless securitization process. They shared offices in the same headquarters in Lower Manhattan and were bound together by interlocking ownership, directors, and officers. The Individual Defendants, all of whom were Nomura officers or directors (or both), held titles of significance at the corporate defendants and signed the Registration Statements through which the Certificates were sold, but none of them understood the aspects of the securitization process that created Nomura's legal exposure in this case or took responsibility for the false statements in the Prospectus Supplements displayed so graphically at trial.

A. The Nomura Family

Each of the five Nomura entity defendants—NHA, Nomura Securities, NCCI, NAAC, and NHELI—were involved in the assembly, structuring and/or sale of one or more of the seven Securitizations. All are Delaware corporations with their principal places of business in New York City. FHFA seeks to hold NHA and NCCI responsible as control persons; it seeks to hold the remaining Nomura corporate entities (as well as RBS) liable as primary violators of the securities laws.

1. NCCI

NCCI was the sponsor for all seven Securitizations, and housed Nomura's Diligence

Group, the Trading Desk, and Transaction Management Group.[147] As such it performed due diligence on and purchased the loans at issue and bundled those loans into the Securitizations, which it then sold to the depositor for each Securitization. It also prepared the Offering Documents for each of the Securitizations. Because it sold the securitized loans to the depositor, it could prevent the issuance of a securitization by declining to sell the loans.

NHA established NCCI, and from 2005 through October 2006 wholly owned it. After October 2006, NHA owned NCCI through a new subsidiary corporation, NAMF. NCCI's directors were appointed by NHA, and those directors in turn appointed its officers.

NCCI and Nomura Securities were closely intertwined. All of NCCI's officers were also officers or employees of Nomura Securities. NCCI and Nomura Securities shared directors, officers, and employees, many of whom were also directors and officers of both NAAC and NHELI. Individuals with positions in more than one Nomura entity had identical responsibilities at each entity, and when the Due Diligence and Transaction Management Groups shifted formally to NCCI in 2006, it was without interruption or change.

[147] Prior to 2006, the Due Diligence and Transaction Management Groups were formally part of Nomura Securities, and their employees were formally employed by Nomura Securities. It was understood, however, that they were acting on behalf of NCCI. When the groups shifted formally to NCCI in 2006, the groups, employees, and responsibilities remained exactly the same.

2. NAAC & NHELI

NAAC and NHELI are special-purpose vehicles established for the sole purpose of participating as depositors in the RMBS process; they had no business operations apart from issuing RMBS. As depositors, their role was to purchase the mortgage loans included in the Securitizations, then sell the corresponding Certificates to underwriters, including Nomura Securities. NAAC was the depositor for one of the Securitizations, NAA 2005-AR6. NHELI was the depositor for the other six Securitizations.

NHA indirectly wholly owned NAAC and NHELI, first through NACC and, after October 2006, through NAMF.[148] NAAC's directors were appointed by its owner—first NACC, then NAMF—and its officers were appointed by those directors. NHELI's directors were likewise appointed by NACC and NAMF, and its officers were appointed by those directors. From 2005 to 2007, NHELI and NAAC had the same slate of directors. Neither NAAC nor NHELI had any employees beyond those officers and directors.

3. Nomura Securities

Nomura Securities was the underwriter or co-underwriter of three of the Securitizations: NAA 2005-AR6, NHELI 2006-FM1, and NHELI 2006-FM2. As such, it purchased the Certificates for the three Securitizations from NAAC and NHELI and sold them to the GSEs. As an underwriter, it was responsible for the accuracy of the Offering Documents prepared by NCCI, and for distributing these to the GSEs.

[148] Neither NACC nor NAMF is a defendant in this action.

Nomura Securities was, from 2005 to 2007, a wholly owned subsidiary of NHA and an affiliate of NAAC and NHELI. Nomura Securities' directors were appointed by NHA, and those directors in turn appointed its officers.

4. NHA

NHA is a holding company that holds the stock of its subsidiaries and receives its revenue from those subsidiaries. All of the other corporate defendants were directly or indirectly wholly owned by NHA. NHA, in turn, is owned by Nomura Holdings International, which is not a defendant here.

NHA oversaw and set policy for its subsidiaries' activities in the RMBS industry. During the relevant period, NHA interfaced with Nomura Securities through NHA's Credit Department, Risk Management Group, and Risk Credit Committee ("RCC"). The Credit Department provided services to Nomura subsidiaries; it also set applicable credit policies and established procedures for approving originators to do business with Nomura. Among other things, the Credit Department participated—along with the RCC and Risk Management Group—in deciding when to initiate and when to discontinue business with originators.

NHA's Credit Department also set limits on the amount of RMBS and whole loans that Nomura Securities could hold at any given time, and it policed those limits. NHA decided whether it or Nomura Securities would hold residuals in issued securitizations. NHA's Risk Management Group monitored the extent of these holdings, modeled associated credit and default risk, and conducted periodic "stress tests."

NHA could also exercise influence, one step removed, over NAAC and NEHLI through its subsidiaries NACC and NAMF. NHA appointed the directors of these subsidiaries; the subsidiaries in turn appointed the directors of NAAC and NHELI. Those directors were charged with managing and directing the "business and affairs" of NAAC and NHELI. As noted, there was substantial overlap between the directors and officers of NHA, NAAC, and NHELI.

Either NHA or one of its direct subsidiaries selected the directors of every Nomura corporation involved in the Securitizations. Some directors did double duty: All but one of Nomura Securities' directors served also as directors of NHA, and two of NHA's directors were directors of NACC. In turn, two of NACC's directors were directors of NAAC and NHELI. There was similar overlap among officers, as discussed below with the Individual Defendants. NHA provided "back-office" support—legal services, accounting, tax, and human resources—to Nomura Securities and NCCI.

B. RBS

RBS is a Delaware corporation with its principal place of business in Stamford, Connecticut. RBS served as the lead or co-lead underwriter on four of the Securitizations. As such, it was responsible for the accuracy of the statements in the Offering Documents and actually sold four Certificates to Freddie Mac.

C. Individual Defendants

Five defendants are individuals associated with the Nomura entity defendants.[149] Focusing solely on the positions they held at the Nomura entity defendants during the 2005 to 2007 period, Findlay was an officer and director of NHA and Nomura Securities,[150] an officer of NCCI,[151] and a director of NAAC and NHELI. Graham was an employee of Nomura Securities and NCCI, and an officer of NAAC and NHELI. LaRocca was an employee of Nomura Securities, an employee and officer of NCCI,[152] and an officer of NHELI. Gorin was an officer of NHA, Nomura Securities, NCCI,[153] NAAC, and NHELI. And McCarthy was an outside director of NAAC and NHELI.

Findlay, Gorin, and McCarthy signed each of the Registration Statements and their amendments pursuant to which the Securitizations were issued.

[149] Reinforcing a picture of a single Nomura organization where separate corporate identities were of little significance, each of the Individual Defendants, with the possible exception of McCarthy, expressed confusion at times regarding their titles, the Nomura entities with which they were associated, and which of the Nomura entities performed tasks vital to the securitization process.

[150] Findlay was a director of NHA and Nomura Securities as of July 2006.

[151] Despite having stipulated to being an officer of NCCI during the relevant period, Findlay backtracked from this statement at trial.

[152] LaRocca was also a director of NCCI as of July 2006.

[153] Despite having stipulated to being an officer of NCCI during the relevant period, at trial Gorin backtracked from this statement.

LaRocca signed the Registration Statements and their amendments for each of the six NHELI Securitizations; Graham signed the Registration Statement and its amendment for the single NAAC Securitization.[154] Aside from the Individual Defendants, Shunichi Ito ("Ito") was the only other person to sign the Registration Statements.[155]

All five Individual Defendants testified at trial. The general picture was one of limited, if any, sense of accountability and responsibility. They claimed to rely on what they assumed were robust diligence processes to ensure the accuracy of the statements Nomura made, even if they did not understand, or, worse, misunderstood, the nature of those processes. Not one of them actually understood the limited role that due diligence played in Nomura's securitization process, and some of them actually had strong reason to know of the problems with the diligence process and of the red flags that even that problematic process raised.

Each Individual Defendant made a point of highlighting the aspects of Nomura's RMBS business for which he claimed to have no responsibility. None of them identified who was responsible for ensuring

[154] Defendants point out that none of the Individual Defendants signed the Prospectus Supplements. But the Prospectus Supplements were not signed by anyone. They were issued pursuant to the Registration Statements that the Individual Defendants signed. Moreover, the Registration Statements incorporate by reference the information contained in the Prospectus Supplements. In other words, the negative inference that defendants wish to raise does not follow.

[155] The amendments to the Registration Statements, in addition to being signed by Individual Defendants and Ito, were also signed by an "attorney-in-fact" for the depositors.

the accuracy of the contents of the Prospectus Supplements relevant to this lawsuit, and, as this group of Individual Defendants furnished the most likely candidates, the only logical conclusion is that no one held that responsibility.

1. Findlay

Findlay held critical roles in several of the Nomura entities responsible for the securitization of RMBS. He was responsible for setting up its due diligence practices when it entered the RMBS business. Because of his responsibility for managing risk at NHA, he was informed that Nomura's Securitizations were performing poorly, but took no steps to improve any of its processes. In short, if there was one Individual Defendant most responsible for the poor design and execution of Nomura's due diligence processes and the creation of misleading Offering Documents, it was Findlay.

Findlay joined NHA in October 2000 as CLO. At some point or another, Findlay has sat on the board of directors of NHA and at least seventeen other Nomura entities. He has served as an officer of a number of them as well. In 2012, he became President and CEO of NHA, while continuing to serve as CLO.

During the 2002 to 2012 period, Findlay was CLO of Nomura Securities as well.[156] As CLO of NHA and Nomura Securities, Findlay provided legal advice to Nomura's RMBS businesses. During the period 2005 to 2007, Findlay was also a member of the board of

[156] During cross-examination, Findlay testified that he became CLO of Nomura Securities in 2000. Whether Findlay took on this role in 2000 or 2002 is immaterial.

directors of both NAAC and NHELI. The boards of these two entities were each composed of Findlay, McCarthy, and Ito. The boards issued resolutions authorizing the receipt of loans from NCCI and the transfer of loans to the trust.[157]

Findlay testified to having reviewed the seven Prospectus Supplements before they were issued. It appears as though the extent of Findlay's review consisted of verifying that the documents had redlining on them, so that he could assure himself that others were in fact making changes to the documents. He did not verify the data reflected in the documents.

During the 2002 to 2004 period, as Nomura prepared to enter the RMBS business, Findlay participated in the establishment of NCCI's processes for pre-acquisition due diligence on mortgage loans. Findlay retained outside counsel and due diligence professionals to advise the company on how to structure the process.

Findlay testified that he believed (and still believes today) that Nomura had a robust due diligence process and that the Offering Documents were materially true, correct, and complete; he provided no reasonable basis for those beliefs. Instead, he had a profound misunderstanding about the processes in place at Nomura. Although Findlay was

[157] In an attempt to disclaim the responsibility of any single director, defendants note that if the members of the boards disagreed, the bylaws required a majority vote. Of course, both boards were comprised of three members, of which Findlay and McCarthy were two. In other words, it would have been impossible for NAAC or NHELI to act without at least one of the two of these Individual Defendants voting in favor.

involved in creating Nomura's due diligence processes, Findlay could not recollect that Nomura in fact had no written due diligence policies and procedures with respect to its RMBS business. In fact, Findlay has no present recollection of what the due diligence program focused on. He could not recall the identities of the members of the due diligence team, or whether Nomura used sampling in its pre-acquisition diligence. Similarly, Findlay testified that he would have thought that Nomura's due diligence team should have been able to draw reasonable extrapolations from the samples that they reviewed on a pre-purchase basis. He was not aware of the fact that Nomura's Diligence Group was unable to perform such an extrapolation. Findlay stated that he was surprised to learn during cross-examination that Kohout regarded the use of adverse sampling, as Nomura did it, to diminish the role of the Diligence Group to that of a noneffective entity. Findlay was not aware of the IngletBlair quality control review of Nomura's due diligence process in the summer of 2006, nor was he aware that Nomura's Diligence Group concluded that many of its originators were responsible for originating defective loans.

At one point, Findlay testified that he believed the due diligence team reviewed the Prospectus Supplements and checked the accuracy of the representations against the actual characteristics of the loans. Moments later, however, Findlay backtracked and said that the due diligence team was charged with preparing, not reviewing, the Prospectus Supplements. Both statements were incorrect. In short, Findlay had faith in a process that he could not recall and did not understand, despite his role in its creation.

There were at least two instances in late 2006 at which the poor quality of Nomura's securitizations was brought to Findlay's attention. From 2005 to 2007, Findlay sat on the RCC, the NHA committee designed to assist management by giving risk and credit advice, including with respect to aspects of the RMBS business, to NHA's subsidiaries, such as Nomura Securities and NCCI. In his capacity as a member of the RCC, on December 7, 2006, Findlay, along with other RCC members, was told that the originator, Ownit, had been forced to shut down "due to continued pressure from the softening of [the] subprime mortgage market." Findlay was told that Ownit's position was "[l]ike many other originators" in that it was suffering decreasing profits from a "cooling housing market" and "mounting EPD claims."[158] On December 13, 2006, Findlay attended another meeting at which the RCC discussed problems in Nomura's RMBS business, including a review of the actions that Nomura had taken in response to Ownit's closure.

In November 2006, Findlay received an email with the subject line, "Request from *Wall Street Journal*," and an attached report entitled "How Bad is 2006 Subprime Collateral?" The *Wall Street Journal* was inquiring about a report put out by UBS that ranked issuers and originators according to sixty-day-or-more delinquency percentages at deal seasoning of six months, with Nomura appearing third from the bottom out of twenty-eight. Even though Findlay was

[158] As described above, EPD refers to early payment default.

involved in coordinating Nomura's response to the forthcoming article, he testified that he did not read the UBS report. Nevertheless, when he forwarded it along to others (which is all that he did), he wrote that the report "basically presented that [Nomura] [was] third from the bottom of 28 issuers with problems[,] and that the key cause is poor underwriting." Findlay guesses that the only way he was able to report on its contents is that someone else told him about it.

Findlay forwarded the report to what he referred to as "risk legal." In his email doing so, he expressed that the approval of a Mr. Kashiwagi would be required before any response was sent to the *Wall Street Journal*. At trial, Findlay testified that he thinks Kashiwagi was the CEO.[159] According to Findlay, pursuant to an internal Nomura procedure, the CEO's approval was required before anyone could communicate with the press. Findlay's email also referred to a Mr. Takahashi, whom Findlay called a senior Japanese executive, Kashiwagi's boss.[160]

[159] It was not clear from Findlay's testimony of which Nomura entity he thought Kashiwagi was the CEO.

[160] Findlay's testimony—that he forwarded this important document, and envisioned it reaching his superiors to approve a response, without ever having read it himself—could give rise to at least two inferences, neither of which is particularly attractive. The testimony may be false—he may have actually read the report before sending it along to others. In that case, not only did he commit perjury, but he had good reason to know of the problems in Nomura's RMBS business, yet took no action to solve them. Or the testimony may be true, in which case Findlay was so detached from his professional responsibilities as to effectively render him a figurehead.

2. Graham

Graham was employed by Nomura Securities from April 2005 to October 2006 and by NCCI from October 2006 to October 2007. Shortly after joining Nomura in 2005, Graham became President and CEO of NAAC and, in the 2005 to 2007 time period, was also an officer of NHELI.

When hired by Nomura Securities, Graham's title was Managing Director, and he was the head of the Transaction Management Group. When Graham became employed by NCCI, his title and job responsibilities remained the same.[161] Graham reported to LaRocca. As Managing Director of the Transaction Management Group, the teams responsible for due diligence, loan acquisition, servicing, and securitization all reported to Graham. When he moved to NCCI, these groups continued to report to him, as did the team responsible for collateral analysis.[162]

Graham had direct responsibility for the content of the Prospectus Supplements. Graham's Transaction Management Group was responsible for preparing the transaction documents for the acquisition of loans that would be securitized and for preparing the Offering Documents that would be used to market the Securitization to investors. It would also assist in obtaining ratings for Securitizations. Graham, or

[161] Apparently the name of the group of which Graham was the head changed once he moved to NCCI, though it is not clear what the new name was.

[162] The general function of the collateral analysis team was to analyze collateral data at both the acquisition and securitization stages.

another member of his group, would review the Offering Documents, including the Prospectus Supplements, and make edits or comments about the language.

Graham understood that the disclosures in the Prospectus Supplements were compared to the data on the loan tapes. Graham did not know, however, whether anyone compared the loan file and the underwriting guidelines as part of the due diligence process. Graham knew that credit and compliance diligence was being conducted on only a sample of loans acquired in bulk acquisitions; as far as Graham knew, there was no one in Nomura's Diligence Group who had a background in statistics sufficient to determine if the sample size was adequate. And, although Graham initially testified that he believed Nomura's diligence practices exceeded industry standards, by February 2007 at the latest, Graham became aware that other industry participants were reportedly performing due diligence on all loan files in bulk deals, not just a sample.

In April 2007, Graham became aware that a fraud review on a NHELI transaction revealed that 43 of 263 loans that had passed Nomura's diligence processes were found to "have fraud." Graham could not recall Nomura taking any action to modify its diligence process in response to this finding.

3. LaRocca

LaRocca was employed by Nomura Securities from February 2001 to October 2006 and by NCCI from October 2006 to May 2008. He was also an officer of NCCI—he testified that he believed, but could not be sure, that he was a Vice President. As of July 2006, LaRocca was additionally a director of NCCI. During the 2005 to 2007 period, LaRocca was also the President and CEO of NHELI.1[163] Pursuant to NHELI's bylaws, the President and CEO "shall have general and active management of the business." It was in his capacity as President and CEO of NHELI that LaRocca signed Registration Statements pursuant to which six of the Securitizations were issued. LaRocca worked with outside counsel to prepare the legal documents for the Securitizations.

Before Graham joined Nomura in April 2005 and began reporting to LaRocca, LaRocca served as the head of the Transaction Management Group.[164] The Diligence Group reported to LaRocca, first directly and later through Graham. LaRocca was involved in setting diligence policy and was kept informed of Nomura's diligence results. As reflected in emails that he sent, LaRocca was aware that originators including Ownit, Fremont, ResMAE, People's Choice, and First NLC were "suspect" loan originators. In August 2006, LaRocca received the results of the audit conducted by IngletBlair. LaRocca could not recall any actions being taken in response to IngletBlair's findings. Despite his

[163] According to LaRocca, all of NHELI's officers were employees of either Nomura Securities or NHA, although, when asked which other Nomura entity employed the officers of NHELI, LaRocca had difficulty distinguishing who worked for NHA from who worked for Nomura Securities.

[164] It is not entirely clear from the record which precise group or groups LaRocca and Graham oversaw. Graham referred to himself as having been the head of the Transaction Management Group, while LaRocca testified that Graham was head of the Residential Transaction Management Group, which was a subgroup of the Transaction Management Group.

familiarity with problems in Nomura's RMBS business, LaRocca maintained at trial that he believed in the accuracy of the information contained in the Offering Documents.

During cross-examination, it was revealed that LaRocca misunderstood the role of Nomura's outside counsel, accountants, and the rating agencies in the securitization process and the extent to which he could rely on them for insuring the accuracy of information in the Offering Documents. For example, he identified the rating agencies as being among the "experts" who would review the Prospectus Supplements, giving him confidence in the accuracy of the representations therein. They did not conduct such a review. While the agencies inspected these documents to confirm that they were consistent with the representations Nomura had made to them, the agencies did not independently confirm the accuracy of the information disclosed in the documents.

4. Gorin

Unlike the first three Individual Defendants, each of whom had a level of responsibility for Nomura's due diligence program, neither of the final two Individual Defendants did. Each of the five Individual Defendants, however, had responsibility as an officer or director of NAAC and/or NHELI for the actions taken by the depositors.

In July 2004, Gorin was hired by Nomura Securities as a Controller. Ultimately, in addition to serving as Controller, Gorin also became Chief Financial Officer ("CFO") at Nomura Securities and

NHA.[165] From 2005 to 2007, Gorin was also one of seven officers of NAAC and one of eight officers of NHELI. While Gorin could not remember his precise title, he acknowledged that his electronic signature had been properly placed on the Registration Statements for the Securitizations in his capacity as CFO and Treasurer of NAAC and NHELI. Aside from offering his titles, Gorin did not describe the nature of the work he performed at Nomura.

Despite being a signatory, Gorin was unfamiliar with the contents of the Offering Documents, the type of security to which they related, and the role of NAAC and NHELI in the RMBS industry. Gorin did not review the Registration Statements and did not know what those documents were or even understand what an RMBS was.[166] This is startling given that the depositors, for which he served as CFO and Treasurer, had a singular function: to purchase home mortgage loans and place them in a trust. When asked if he had any belief about the accuracy of any representations in the Prospectus Supplements, his answer was no.

5. McCarthy

McCarthy became an independent director of NAAC and NHELI in January 2004 and still holds those positions today. Along with the other two members of the two boards—Findlay and Ito—McCarthy approved the issuance of certificates for securitizations, including those at issue in this case,

[165] Gorin also ultimately served as an officer of NCCI.

[166] When asked if he had an understanding of what a residential mortgage-backed security is, he answered, "[t]he only thing I can really say is that it's a residential mortgage-backed security."

that McCarthy understood would later be sold to investors. McCarthy's primary responsibility with respect to those transactions was to ensure that they did not impair NAAC's or NHELI's statuses as bankruptcy-remote entities, a status that guaranteed that nothing could be clawed back from RMBS investors in a bankruptcy proceeding.

From time to time, Juliet Buck ("Buck"), an attorney who McCarthy understood to have been employed by Nomura Securities and later by NHA, would contact McCarthy when something arose that needed his attention with respect to his role at NAAC and NHELI, such as signing a Registration Statement. McCarthy stated that he had no interaction with NCCI or Nomura Securities, other than to review Prospectus Supplements and other Offering Documents when Buck sent them to him.

In his role as a director of NAAC and NHELI, McCarthy signed Registration Statements and a resolution of the board of directors allowing each Securitization to go forward. McCarthy contends that given his review of the Offering Documents for the Securitizations, he had no reason to doubt that the documents were materially accurate. But during cross-examination, McCarthy admitted that his review was limited to ensuring that a given deal would not jeopardize the bankruptcy-remote status of the two depositors; he did not review the Prospectus Supplements to verify the accuracy of the representations. Furthermore, he had no knowledge of Nomura's diligence activities in connection with any RMBS issued by NAAC or NHELI.

DISCUSSION

Still remaining in this action are FHFA's claims under Sections 12(a)(2) and 15 of the Securities Act, and parallel provisions of Virginia's and D.C.'s Blue Sky laws. Following a description of the legal standards governing these claims, this Opinion will apply those standards to the facts found above.

I. Legal Standards

A. Law Surrounding RMBS

As has previously been explained in this case:

> The RMBS in this case were issued pursuant to "shelf registrations," which are pre-approved registration statements that allow new securities to be issued upon filing of a prospectus supplement. *See* 17 C.F.R. § 230.409, .415; [*UBS I*, 2012 WL 2400263, at *2].
>
> . . .
>
> Asset-backed securities are subject to an elaborate regulatory regime. *See* Regulation S-K, 17 C.F.R. § 229.10 *et seq*.; Regulation AB, 17 C.F.R. § 229.1100 *et seq*.; [*UBS I*, 2012 WL 2400263, at *2]. Of particular relevance here, Regulation AB requires detailed disclosures in asset-backed securities' prospectus supplements. Those disclosures include "any originator or group of affiliated originators, apart from the sponsor or its affiliates, that originated, or is expected to originate, 10% or more of the pool assets," and, "[t]o the extent material, a description of the originator's origination program" for "any originator . . .

> that originated, or is expected to originate, 20% or more of the pool assets." 17 C.F.R. § 229.1110. Also required is a "description of the . . . underwriting criteria used to originate or purchase the pool assets, including, to the extent known, any changes in such criteria and the extent to which such policies and criteria are or could be overridden." *Id.* § 229.1111(a)(3). In addition, it requires a prospectus to state the "cut-off date or similar date for establishing the composition of the asset pool." *Id.* § 229.1111(a)(5).

Hunter Opinion, --- F. Supp. 3d ---, 2015 WL 568788, at *7-8 & n.19.[167] Offering Documents for an RMBS Securitization are subject to the requirements of the Securities Act.

B. Background and Purpose of the Securities Act

The Securities Act of 1933 "emerged as part of the aftermath of the market crash in 1929." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976). After that unprecedented financial catastrophe and at the depth of the Great Depression it brought on, the Securities Act was passed to stop the sorts of abuses and omissions that had been instrumental in inflating the bubble that burst in 1929 -- "to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation." *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986) (quoting S. Rep. No. 73-47, at 1 (1933)). Congress's remedy was a slate of

[167] As mentioned above, NAA 2005-AR6 was issued before Regulation AB became effective on January 1, 2006.

unprecedented measures designed "to place adequate and true information before the investor." *Id.* (citation omitted).

Knowledge and care, Congress determined, were the surest path to a properly functioning market. The Securities Act aimed "to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud, and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." *Hochfelder*, 425 U.S. at 195; *see also Pinter v. Dahl*, 486 U.S. 622, 638 (1988) (Securities Act was intended "to protect investors by requiring publication of material information thought necessary to allow them to make informed investment decisions concerning public offerings of securities in interstate commerce"). It was, therefore, no accident that Congress chose to place a heavy burden on the parties with superior access to, and control over, information about securities: those who offered them.

The legislative history of Section 12(a)(2) in particular emphasizes that major market participants were not expected easily to evade the liability the Act imposed:

> For those whose moral responsibility to the public is particularly heavy, there is a correspondingly heavier legal liability—the persons signing the registration statement, the underwriters, the directors of the issuer, the accountants, engineers, appraisers, and other professionals preparing and giving authority to the prospectus—all these are

> liable to the buyer not only if they cannot prove they did not know of the flaw in the information offered the public but also if they cannot prove the use of due care. This throws upon originators of securities a duty of competence as well as innocence . . . .

Gustafson v. Alloyd Co., 513 U.S. 561, 581 (1995) (quoting H.R. Rep. No. 73-85, at 9 (1933)). Congress observed that this was a standard that "the history of recent spectacular failures overwhelmingly justifie[d]." H.R. Rep. No. 73-85, at 9. A heavy burden, Congress explained, was an indispensable means of maintaining the integrity of the market:

> The provisions throwing upon the defendant in suits under [Section 12] the burden of proof to exempt himself are indispensable to make the buyer's remedies under these sections practically effective. . . . Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance . . . . It is a responsibility that no honest banker and no honest business man should seek to avoid or fear. To impose a lesser responsibility would nullify the purposes of this legislation.

Id. at 9-10.

C. Securities Act Section 12(a)(2)

The private rights of action in the Securities Act were "designed to assure compliance with [its] disclosure provisions . . . by imposing a stringent standard of liability on the parties who play a direct role in a registered offering." *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 716 (2d Cir. 2011) (quoting *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983) (discussing Section 11 of the Securities Act)). Through Sections 11 and 12(a)(2), the Securities Act "provides the purchasers of registered securities with strict liability protection for material misstatements or omissions in registration statements filed with the SEC," *In re Lehman Bros. Mortg.-Backed Sec. Litig.*, 650 F.3d 167, 175 (2d Cir. 2011), as well as "misstatements or omissions in a prospectus," *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145, 156 (2d Cir. 2012).

By its terms, Section 12(a)(2) imposes liability on

> [a]ny person who offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

15 U.S.C. § 77*l*(a)(2). The elements of a claim under Section 12(a)(2) are:

> (1) the defendant is a statutory seller; (2) the sale was effectuated by means of a prospectus or oral communication; and (3) the prospectus or oral communication included an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.

In re Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 359 (2d Cir. 2010) (citation omitted). FHFA must make out its case by a preponderance of the evidence. *See Huddleston*, 459 U.S. at 390. "Neither scienter, reliance, nor loss causation is an element of . . . § 12(a)(2) claims . . . ." N*ECA-IBEW Health & Welfare Fund*, 693 F.3d at 156. It has already been determined that the sales of the seven Certificates at issue here were made "by means of" the Prospectus Supplements effectuating those sales. *See FHFA v. Nomura Holding Am., Inc.*, --- F.Supp.3d ---, 2014 WL 7229446, at *8 (S.D.N.Y. Dec. 18, 2014).

1. Statutory Seller

FHFA seeks to hold the two depositors—NAAC and NHELI—and the two underwriters—Nomura Securities and RBS—liable as statutory sellers.[168] "An individual is a statutory seller—and therefore a potential section 12(a)(2) defendant—if he: (1) passed title, or other interest in the security, to the buyer for value, or (2) successfully solicited the purchase of a

[168] FHFA brings no claim against an underwriter for NHELI 2007-3. This Securitization was underwritten by Lehman Brothers Inc.

security, motivated at least in part by a desire to serve his own financial interests or those of the securities' owner." *Morgan*, 592 F.3d at 359 (citation omitted).

This Court has already determined that a depositor can constitute a statutory seller:

> SEC Rule 159A . . . provides that "in a primary offering of securities," an issuer is a statutory seller for the purposes of Section 12(a)(2) "regardless of the underwriting method used to sell the issuer's securities." *See* 17 C.F.R. § 230.159A. Moreover, the Securities Act provides that "with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors . . . the term 'issuer' means the person or persons performing the acts and assuming the duties of *depositor*." 15 U.S.C. § 77b(a)(4). . . . Securities Act Rule 191 . . . provides that "[t]he depositor for the asset-backed securities acting solely in its capacity as depositor to the issuing entity is the 'issuer' for purposes of the asset-backed securities of that issuing entity." 17 C.F.R. § 230.191.

FHFA v. UBS Americas, Inc. ("*UBS II*"), 858 F. Supp. 2d 306, 333-34 (S.D.N.Y. 2012), *aff'd*, 712 F.3d 136 (2d Cir. 2013) (citation omitted).

As for underwriters, the Securities Act defines that term as

> any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such

> undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

15 U.S.C. § 77b(a)(11). The parties stipulated that it does not remain to be tried whether Nomura Securities sold the NAA 2005-AR6 Certificate to Fannie Mae, whether Nomura Securities sold the NHELI 2006-FM1 Certificate to Freddie Mac, and whether RBS sold the NHELI 2006-HE3, NHELI 2006-FM2, NHELI 2007-1, and NHELI 2007-2 Certificates to Freddie Mac. This answers the question whether these underwriters were statutory sellers here, as they passed title for value. It was Nomura Securities and RBS that solicited the GSEs' purchase of the Certificates by, among other things, providing them with collateral information and preliminary offering materials in the course of underwriting the public offerings through which each of the Certificates was sold.

2. Material Misrepresentation

With respect to the third element, "[i]n many cases—including this one—two issues are central to claims under section[] . . . 12(a)(2): (1) the existence of either a misstatement or an unlawful omission;[169] and (2) materiality." *Morgan*, 592 F.3d at 360. FHFA asserts that each Prospectus Supplement contained material misrepresentations concerning (1) compliance with underwriting guidelines, (2) LTV ratios, (3) owner occupancy, and (4) credit ratings.

[169] This Opinion uses the shorthand "falsity" to refer to misrepresentations, whether by misstatement or omission.

a. Falsity

"[W]hether a statement is misleading depends on the perspective of a reasonable investor: The inquiry (like the one into materiality) is objective." *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015) (citation omitted) (Section 11 claim).[170] The truth or falsity of facts or assertions in a Prospectus or Prospectus Supplement is assessed by "read[ing] it as a whole." *In re ProShares Trust Sec. Litig.*, 728 F.3d 96, 103 (2d Cir. 2013) (citation omitted) (Section 11). Courts "consider whether the disclosures and representations, taken together and in context, would . . . misle[a]d a reasonable investor about the nature of the securities." *Id.* (citation omitted). The

> veracity of a statement or omission is measured not by its literal truth, but by its ability to accurately inform rather than mislead prospective buyers. Statements of literal truth can become, through their context and manner of presentation, devices which mislead investors. Even a statement which is literally true, if susceptible to quite another interpretation by the reasonable investor, may properly be considered a material misrepresentation.

[170] "The test for whether a statement is materially misleading under Section 12(a)(2) is identical to that under Section 10(b) and Section 11: whether representations, viewed as a whole, would have misled a reasonable investor." *Rombach v. Chang*, 355 F.3d 164, 178 n.11 (2d Cir. 2004); *see also Litwin*, 634 F.3d at 717 n.10 ("[T]he test for materiality is the same when claims are brought pursuant to Sections 11 and 12(a)(2) of the Securities Act.").

Kleinman v. Elan Corp., plc, 706 F.3d 145, 153 (2d Cir. 2013) (citation omitted) (Section 10(b) claim). "The literal truth of an isolated statement is insufficient; the proper inquiry requires an examination of defendants' representations, taken together and in context. Thus, when an offering participant makes a disclosure about a particular topic, whether voluntary or required, the representation must be complete and accurate." *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245, 250-51 (2d Cir. 2014) (citation omitted).

Although Section 12(a)(2) forbids untrue statements of *fact*, false statements of opinion or belief are also actionable under Section 12(a)(2) in at least two ways. First, "every such statement explicitly affirms one fact: that the speaker actually holds the stated belief." *Omnicare*, 135 S. Ct. at 1326. For that reason, statements of opinion can be untrue statements of fact if the speaker does not actually hold the opinion—if, in other words, the statement falsely describes the speaker's state of mind. *Id.* The Second Circuit recognized this basis for holding statements of opinion actionable under Section 12(a)(2) in *Fait v. Regions Fin. Corp.*, where it explained that the plaintiff would need to show both that the statement was "objectively false" and "disbelieved." 655 F.3d 105, 110 (2d Cir. 2011). It was based on the Second Circuit's analysis in *Fait* that the Court, throughout this coordinated litigation, explained that, to satisfy the falsity element with respect to alleged misrepresentations of LTV ratios that use an appraised valuation, FHFA would be required to establish both that the original value derived from an appraisal, and thus the LTV ratio based on that appraisal, was inflated (or objectively false), and that the appraiser did not believe the appraised value to be accurate (in other words, that it was subjectively false).[171] *See UBS II*, 858 F. Supp. 2d at 326-27.

The Supreme Court issued the *Omnicare* opinion while trial was ongoing in this action.[172] As reflected above, Omnicare confirmed that a statement of opinion could be actionable if not sincerely held. But *Omnicare* clarified that there is another way in which a statement of belief or opinion can be actionable under Section 12(a)(2): through its omissions clause. *Omnicare*, 135 S. Ct. at 1333.

> [A] reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience. . . . Thus, if a [Prospectus Supplement] omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § [12(a)(2)]'s omissions clause creates liability.

[171] Less than two months before trial, the Court recapped the history of how falsity with respect to LTV ratios has been litigated in this case. *Kilpatrick Opinion*, 2015 WL 353929, at *1 n.2.

[172] The parties were given an opportunity to address in writing the impact of *Omnicare* on this case. None chose to make such a submission.

Id. at 1328-29.

> [W]hether an omission makes an expression of opinion misleading always depends on context. [Offering Documents] as a class are formal documents, filed with the SEC as a legal prerequisite for selling securities to the public. Investors do not, and are right not to, expect opinions contained in those statements to reflect baseless, off-the-cuff judgments, of the kind that an individual might communicate in daily life. At the same time, an investor reads each statement within such a document, whether of fact or of opinion, in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information. And the investor takes into account the customs and practices of the relevant industry. So an omission that renders misleading a statement of opinion when viewed in a vacuum may not do so once that statement is considered, as is appropriate, in a broader frame. The reasonable investor understands a statement of opinion in its full context, and § [12(a)(2)] creates liability only for the omission of material facts that cannot be squared with such a fair reading.

Id. at 1330.

b. Materiality

FHFA bore the burden of proving that any misrepresentations in the Offering Documents were material. “For a misstatement or omission to qualify as material, there must be a substantial likelihood that a complete and truthful disclosure would have been viewed by a reasonable investor as having significantly altered the total mix of information made available." *N.J. Carpenters Health Fund v. Royal Bank of Scotland Grp., PLC*, 709 F.3d 109, 126 (2d Cir. 2013) (citation omitted). "[T]he total mix of information relevant to the question of materiality can include publicly available information." *Id.* at 127. "The test for whether a statement is materially misleading under Section 12(a)(2) is . . . whether representations, viewed as a whole, would have misled a reasonable investor." *Rombach*, 355 F.3d at 178 n.11.

"Materiality is determined in light of the circumstances existing at the time the alleged misstatement occurred." *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 165 (2d Cir. 2000). "[A] material fact need not be outcome-determinative; that is, it need not be important enough that it would have caused the reasonable investor to change his vote. Rather, the information need only be important enough that it would have assumed actual significance in the deliberations of the reasonable [investor]." *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533 (2d Cir. 1991) (citation omitted). "Materiality is an inherently fact-specific finding that is satisfied when a plaintiff alleges a statement or omission that a reasonable investor would have considered significant in making investment decisions." *Litwin*, 634 F.3d at 716-17 (citation omitted). "[I]n the context of this case, materiality is an objective standard, determined with reference to a reasonable PLS trader—not a reasonable GSE, or a reasonable PLS trader with plaintiff's idiosyncratic regulatory restrictions and purchasing goals." *FHFA v. Nomura Holding Am., Inc.* ("*Single-Family Activities Opinion*"), No. 11cv6201 (DLC), 2015 WL 685153, at *6 (S.D.N.Y. Feb. 18, 2015) (citation omitted).

The SEC has explained that "[a]sset-backed securities and ABS issuers differ from corporate securities and operating companies. In offering ABS, there is generally no business or management to describe. Instead, information about the transaction structure and the characteristics and quality of the asset pool . . . is often what is most important to investors." Asset-Backed Sec., Securities Act Release No. 8518, 84 SEC Docket 1624 (Dec. 22, 2004).

"[A] court must consider both quantitative and qualitative factors in assessing an item's materiality, and that consideration should be undertaken in an integrative manner." *Litwin*, 634 F.3d at 717 (citation omitted). The Second Circuit

> ha[s] consistently rejected a formulaic approach to assessing the materiality of an alleged misrepresentation . . . [and has] cited with approval SEC Staff Accounting Bulletin No. 99, which provides . . . [that] the use of a percentage as a numerical threshold such as 5%, may provide the basis for a preliminary assumption of materiality, but a bright line percentage cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Among useful qualitative factors are (1) whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's

> operations or profitability, and (2) whether management expects that the misstatement will result in a significant market reaction.

Hutchison v. Deutsche Bank Sec. Inc., 647 F.3d 479, 485 (2d Cir. 2011) (citation omitted).

In this case, each of the Prospectus Supplements at issue states that no substantial changes to any SLG are expected after the Cut-off Date and sets a 5% change as the relevant threshold.[173] Five of the Prospectus Supplements also state that notice will be given if any material characteristic meaningfully changes, providing:

> If, as of the Closing Date, any material pool characteristic differs by 5% or more from the description in this prospectus supplement, revised disclosure will be provided either in a supplement or in a Current Report on Form 8-K.

The 5% figure comes directly from SEC guidance. Pursuant to Regulation AB, Item 6.05 to SEC Form 8-K requires disclosures "if any material pool characteristic of the actual asset pool at the time of issuance of the asset-backed securities differs by 5% or more . . . from the description of the asset pool in the prospectus." Asset-Backed Sec., Securities Act Release No. 8518, 84 SEC Docket 1624. And in 1999, long before Regulation AB was promulgated, SEC Staff

[173] Even the "outlier" Prospectus Supplement for NAA 2005-AR6 provides that "[t]he characteristics of the mortgage loans included in a trust fund will not vary by more than five percent (by total principal balance as of the Cut-off Date) from the characteristics of the mortgage loans that are described in the prospectus supplement."

Accounting Bulletin No. 99, cited by the Second Circuit in *Hutchison*, explained that "[o]ne rule of thumb . . . suggests that the misstatement or omission of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances." 64 Fed. Reg. 45150-01 (Aug. 12, 1999) (citation omitted).

Regulation AB further provides that material pool characteristics for RMBS include LTV ratios and occupancy status, and they similarly require detailed disclosures regarding deviations from underwriting guidelines. *See* 17 C.F.R. § 229.1111(a)(8), (b)(7)(iii)-(iv). As the Second Circuit has explained in a different context, that information is required to be disclosed under the securities laws does not render that information material per se, but it is evidence of materiality. *United States v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir. 1991).

3. Damages

Under Section 12(a)(2), once a *prima facie* case is made out, the plaintiff is entitled "to recover the consideration paid for [the] security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." 15 U.S.C. § 77l(a)(2). In other words, where a plaintiff still owns the security, its remedy is rescission. *Commercial Union Assur. Co., PLC v. Milken*, 17 F.3d 608, 615 (2d Cir. 1994) (construing identical language in predecessor Section 12(2)). Under the rescissory measure of damages, FHFA would be entitled to a return of the consideration paid for the Certificates, plus prejudgment interest, less any income received on the Certificates. *Id.* The amounts of the consideration paid and the income received on the Certificates are not in dispute. *See FHFA v. Nomura Holding Am., Inc.* ("*Riddiough Opinion*"), No. 11cv6201 (DLC), 2015 WL 640875, at *1 (S.D.N.Y. Feb. 16, 2015).

The parties dispute the rate of prejudgment interest that should apply. In a lawsuit to enforce a federal right, the rate of prejudgment interest rests in this Court's discretion, as guided by "(i) the need to fully compensate the wrongful party for actual damages suffered, (ii) considerations of fairness and the relative equities of the award, (iii) the remedial purpose of the statute involved, and/or (iv) such other general principles as are deemed relevant by the court." *Gierlinger v. Gleason*, 160 F.3d 858, 873 (2d Cir. 1998). The parties also dispute the date of tender, as discussed below.

II. Falsity

FHFA alleges that four sets of representations in each of the seven Prospectus Supplements were false. They are representations regarding the origination and underwriting of the loans within the SLGs backing the Certificates; LTV ratios and appraisals, including compliance with USPAP; occupancy status; and the credit ratings of the Certificates. FHFA has proven that all four sets of representations in each of the seven Prospectus Supplements were false.

A. Underwritten in Accordance with Guidelines

As described above, each of the Prospectus Supplements includes a representation that "[t]he Mortgage Loans . . . were originated generally in accordance" with originators' guidelines, or, in the case of NHELI 2006-FM1, the equivalent of this language in reference to the guidelines of the Securitization's sole originator. These representations were false.

At rates ranging from 45% to 59%, the loans within the SLGs had a substantially increased credit risk associated with a failure in the origination process. This number of loans, at a minimum, was not underwritten in compliance with their originators' guidelines and there were no compensating factors identified by the originator or the experts at trial to excuse that failure. This rate of issuance of defective loans reflects a wholesale abandonment by originators of their underwriting guidelines. FHFA showed that originators not only failed to originate loans generally in compliance with their own guidelines, but that they also more generally failed both to assess the ability of borrowers to meet their monthly mortgage obligations and to assure adequacy of the collateral for the mortgage, despite the representations in the Prospectus Supplements that originators had performed these most basic functions of origination.

The due diligence program run by Nomura, and, in the case of two of the Securitizations by RBS, were entirely inadequate to protect against false statements in the Offering Documents. But even with their many serious limitations, those programs provide striking confirmation of the deeply flawed nature of the originators' underwriting programs and the falsity of defendants' descriptions of the origination process. The serious limitations in defendants' due diligence programs were legion. Among other things, Nomura only conducted pre-acquisition due diligence, and did not do so in a manner that permitted it to extrapolate results to the SLGs backing any securitization. Nomura repeatedly made decisions when conducting due diligence to save money and satisfy sellers of mortgage loans. As a consequence, it failed to subject most loans it purchased to genuine credit or valuation due diligence, and waived in far too many loans that were evaluated and found seriously wanting. Nomura had no system for analyzing the impact of its pre-acquisition due diligence program on the loans it later selected, often from many different originators, for inclusion within an SLG and made no effort to conduct such an analysis.

Despite the amount of due diligence *not* done, there is significant evidence from its due diligence program that the loans Nomura purchased and securitized were not as described in their Prospectus Supplements. The database created for this litigation determined that less than 40% of the loans within the SLGs for the Certificates were subjected to credit due diligence, and 9% of the loans subject to diligence either had a final grade of EV3 or had been waived in by Nomura despite being assigned an EV3 grade by the due diligence vendor. Just over 40% of the loans within the SLGs for the Certificates were subjected to valuation due diligence, and of those that did receive valuation due diligence many showed evidence that the origination appraisals were unreliable. Both Nomura and RBS conducted after-the-fact fraud inquiries that pointed to the existence of fraud and serious deficiencies in originators' underwriting practices.

Today, defendants do not defend the underwriting practices of their originators. They did not seek at trial to show that the loans within the SLGs were actually underwritten in compliance with their originators' guidelines. At summation, defense counsel essentially argued that everyone understood back in 2005 to 2007 that the loans were lousy and had not been properly underwritten.

Given the exceedingly poor quality of the SLGs' loans, it is perhaps not surprising that defendants' expert Forester neither properly re-underwrote the loans nor met the FHFA re-underwriting findings head on. Instead, he unreasonably cabined his review of the findings of FHFA's expert. Even then, however, he admitted that, for roughly 5.5% of the loans, there was a "[p]otential significant defect" and that "it cannot be confirmed that a reasonable underwriter at the time of origination could have found that this loan satisfied the applicable guidelines." After examining each of Forester's specific responses to Hunter's findings, the Court confirmed that FHFA had indeed succeeded in proving the wholesale abandonment of underwriting guidelines by originators.

In opposing a finding of falsity, defendants largely rely on their proposed reading of the Prospectus Supplement language. Each of their arguments is addressed in turn.

1. General Adherence to Process

Defendants argue that the Supplements' representations regarding compliance with underwriting guidelines refer to originators' underwriting processes and describe only general but not perfect adherence to those processes. Defendants emphasize that underwriting is a matter of judgment and the Supplements spoke of exceptions to and deviations from underwriting guidelines.

Defendants are correct that many of the originators' guidelines allowed underwriters to make exceptions to guidelines if the exception could be justified by compensating factors and was documented. They are also correct that underwriting entails the exercise of judgment, at least within the parameters permitted by an originator's guidelines. But Hunter's review of the Sample loans entailed just that nuanced view of the underwriting process. He accepted any indication in a loan file that an underwriter had exercised such judgment, conducted his own search for compensating factors, and considered each of the instances in which Forester identified another possible compensating factor to excuse a lack of compliance with guidelines. This Court's review of the Dashboard Reports was similarly alert to any compensating factors or grounds for exceptions identified by Forester and his teams. At the end of the day, the defect rates recited above cannot be explained away through the play-in-the-joints of the underwriting process.

2. Whose Guidelines?

Defendants contend that no analysis may be done of the extent to which the loans within an SLG were underwritten in compliance with originators' guidelines for five of the seven Securitizations since, in making representations about compliance with underwriting guidelines, the Supplements were referring only to loans from those originators that contributed over 20% of the loans to the SLG and whose guidelines were described in some detail in the Supplements. This argument has already been rejected once, and it is rejected again. *Hunter Opinion*, --- F. Supp. 3d ---, 2015 WL 568788, at *11-13.

If this were a genuine argument, one would have expected it to be raised at the outset of this litigation. But it was not. Not by Nomura or RBS, and not by any other defendant in these sixteen coordinated actions. Instead, all the parties in this coordinated litigation expended years of effort and vast sums of money to collect and analyze the loan files and underwriting guidelines for every Sample loan to assess the extent to which each loan had been originated in compliance with its originators' guidelines. Thus, defendants are judicially estopped from making this argument, which was raised on November 25, 2014**.** *Id.* at *12-13.[174] But the argument is also without merit.

As described above, Regulation AB required, "[t]o the extent material, a description of the originator's origination program" for "any originator . . . that originated, or is expected to originate, 20% or more of the pool assets." 17 C.F.R**.** § 229.1110(b)(2). This latter regulation governed six of the seven Supplements, and each of them did contain a detailed description of one or more originators' guidelines. A single originator, Fremont, contributed the loans to NHELI 2006-FM1 and NHELI 2006-FM2, and defendants concede that

[174] As before, defendants point to Forester's Expert Report of August 14, 2014, in which he notes that Hunter did not test for compliance with the language of the "standards." While it may have inspired defendants' November 25 legal position, Forester's half-page observation—presented as fact, not argument—did not "raise the issue."

the statement about compliance with an originator's guidelines may be accurately measured for those two Securitizations. With respect to every other originator in the other five Securitizations, however, defendants contend that the Supplements refer only to general adherence to the underwriting process as it is described in broad strokes in the Supplements, and do not represent that the loans of the smaller contributing originators were underwritten in compliance with their originators' guidelines.

The Court rejected this argument in an opinion of February 11, which is reproduced in pertinent part below.

> The representations in the Prospectus Supplements regarding compliance with underwriting "criteria" and "standards" refer explicitly to a process that occurred prior to the securitization of the loans. . . . The Supplements give an overview of that origination process. They describe the presentation of information by a borrower "to the original lender" and determinations "made by the original lender" about the borrower's ability to make the required loan payments, among other things. They refer as well to the appraisal obtained by the Originator.
>
> As significantly, the only standards and criteria to which the Supplements could be referring are those that were in the hands of the original lenders. After all, the Originators would not even have had access to any language contained in the Supplements since

> the Originators would not have known into which, if any, Securitization the loan might be placed and the Supplement for the Securitization could not have been available to the Originator at the time of loan origination.
>
> Finally, the general descriptive language about standards and criteria was included in the Supplements to comply with regulatory requirements, *see* 17 C.F.R. § 229.1111(a)(3), but could hardly have been expected by anyone to give, by itself, comfort to investors that the loans in the SLGs had passed scrutiny. The language in the Supplements regarding the criteria is simply too vague to provide a complete description of the origination process. It omits the specific benchmarks and criteria that are part of the customary underwriting process at origination. In essence, these passages are a statement by the defendants that they have reviewed the Originators' processes and guidelines and confirmed that the loans within the Securitization were all originated in compliance with their Originators' standards and processes, and that those standards and processes all contained the central elements summarized in the Supplement.

Hunter Opinion, --- F. Supp. 3d ---, 2015 WL 568788, at *11-12.

Responding to the Court's reasoning that the Supplements' general description of the origination process is too vague to be complete, defendants now argue it would be "much more vague to disclose merely that loans complied generally with the unknown guidelines of unknown originators." There is no reason to think so. The disclosure is a summary prepared by Nomura of the common characteristics of the origination process employed by various originators. It provides assurance that Nomura investigated the guidelines and practices of all originators, whether named or not, and it vouches for the fact that each of the loans was originated generally in compliance with those originators' guidelines. If Nomura had not made such an investigation, it could not honestly represent that the underlying loans "were originated" (even "generally") in accordance with any criteria. Read in the context of the entire Prospectus Supplement, it also vouches for the reliability of the data contained in the Collateral Tables, which was acquired by originators during their underwriting of a loan.

3. The Meaning of "Generally"

Defendants make much of the fact that the representations in the Supplements only attest to "general" compliance—that loans were "originated generally in accordance" with the relevant guidelines. But the word "generally" must be understood in its context. As this Court has explained,

> Defendants ignore the fact that the Offering Documents represented that "*[a]ll* of the mortgage loans were originated . . . generally in accordance with [applicable] underwriting guidelines." (Emphasis added.) That *all* of the loans "generally" met guidelines indicated that certain immaterial exceptions might

> exist, not that a material number of the loans might substantially deviate from the guidelines, without compensating factors.

Due Diligence Opinion, --- F. Supp. 3d ---, 2014 WL 7232443, at *39.

This plain and contextually appropriate reading of the term "generally" finds confirmation elsewhere. At the time these Supplements were issued, there was also a market for "scratch-and-dent" loans. The Offering Documents for the securitizations of such loans explained that a percentage of loans had not been originated in accordance with their originators' guidelines. This kind of direct disclosure of defective underwriting was required if defendants wished to sell defective loans.

Second, the use of the word "generally" can't bear the weight defendants wish it to bear in this case. It could not and did not convey that roughly half the loans had substantially increased credit risk because they were not originated in compliance with their originators' guidelines, even after one accounts for exceptions to guidelines justified by compensating factors. Defendants' other argument—that the word "generally" makes a statement that plainly reads as an assertion of fact an "opinion"—does not alter its plain meaning, especially given that, as discussed below, Nomura indicated its opinions and beliefs explicitly when it chose to state them.[175] The

[175] Even if the word "generally" did transform statements of fact into opinions—and it did not—what is said below in response to defendants' other opinion-based arguments applies to reject this one as well.

representation that loans were originated generally in accordance with guidelines is a "classic statement of fact." *FHFA v. SG Americas, Inc.*, No. 11cv6203 (DLC), 2012 WL 5931878, at *2 (S.D.N.Y. Nov. 27, 2012).

4. Context

In summation, defense counsel argued that when the Prospectus Supplements are read "holistically" and "in context," their representations about the extent to which loans were originated in compliance with originators' underwriting guidelines were "true and not misleading." They are wrong.

Defense counsel pointed to two disclosures in the Supplements in particular. Most of the Supplements warned that the underwriting standards for the loans were "generally less stringent than the underwriting standards established by Fannie Mae or Freddie Mac;"[176] and in the case of the two Fremont Securitizations and NHELI 2007-3, they warned that "a substantial portion" of the mortgage loans may represent exceptions to guidelines due to the existence of compensating factors. Counsel also referred to evidence that subprime and Alt-A mortgages were underwritten to relaxed standards during the period 2005 to 2007.

None of these disclosures nor the existence of relaxed underwriting standards for subprime loans constitute notice, however, that originators of subprime loans had failed to adhere to their underwriting guidelines. They refer to something else.

[176] This language or its equivalent appeared in six Supplements.

The subprime market was booming in 2005 to 2006 because originators of subprime loans had adopted relaxed standards that allowed borrowers with low credit ratings and few assets to obtain mortgages. As the Supplements say, these standards were less rigorous than those adopted by the GSEs, but they were standards nonetheless. And some of the features of those new, relaxed standards were quantified and disclosed. For instance, the Collateral Tables listed the number of loans whose borrowers had certain FICO scores and the number of full documentation, partial documentation, or no documentation loans.

But the Supplements also assured investors that all of the loans within the SLGs were underwritten generally in compliance with their originators' standards. They did not suggest that originators had ignored their own standards. Similarly, while Supplements included notice that exceptions to the standards may have been made for some loans, or even many loans, they explained that exceptions were given only in the presence of compensating factors and after scrutiny of the individual loan. And to provide protection to investors purchasing Certificates backed by these less credit-worthy loans, securitizers structured their offerings with credit enhancement features to provide AAA securities to risk-adverse investors. In sum, notice that loans were now being extended to borrowers who had a less-than-perfect credit history through the adoption of relaxed underwriting guidelines was not notice that originators would ignore even those guidelines.

5. ResMAE Bankruptcy Advisory

Defendants stress that one of the Securitizations provided a pointed warning to investors. The Prospectus Supplement for the last Securitization at issue, NHELI 2007-3, states that ResMAE had "filed for bankruptcy protection under the United States Bankruptcy Code," and therefore

> *may* have experienced personnel changes that adversely affected its ability to originate mortgage loans in accordance with its customary standards . . . [or] experienced reduced management oversight or controls with respect to its underwriting standards. Accordingly, the rate of delinquencies and defaults on these Mortgage Loans *may* be higher than would otherwise be the case.

(Emphasis added.) ResMAE contributed 77% of the loans to the SLG at issue here.

Later in the Supplement, during the discussion of underwriting standards, there is the typical declaration that the mortgage loans in the SLGs were "generally originated in accordance" with originators' underwriting criteria. There is also a four-and-a-half-page description of the underwriting guidelines "used by ResMAE." It included representations like the following: "The underwriting staff fully reviews each loan to determine whether ResMAE's guidelines for income, assets, employment and collateral are met"; "All of the mortgage loans were underwritten by ResMAE's underwriters having the appropriate signature authority"; and "ResMAE's underwriters verify the income of each applicant under the Full

Documentation and Limited Documentation programs."

Hunter found that 66.67% of the loans for this Securitization's SLG had substantially increased credit risk associated with a failure to adhere to underwriting guidelines. The Court found that, conservatively, this was true for 45% of the loans**.** These percentages are too large to find that they were adequately disclosed by the warning that ResMAE "may" have been affected in its origination of loans by its bankruptcy, particularly when that warning is read in context.

6. Representation of "Belief"

In summation, defendants advanced an argument previously dismissed by the Court but newly grounded in the Supreme Court's recent *Omnicare* decision. 135 S. Ct. 1318. Because two Supplements state that Fremont's guidelines were "believed" by the depositor to have been applied "with some variation, by Fremont," defendants contend that FHFA must prove for those two Securitizations that that statement was not only objectively false but also subjectively false.[177]

The language on which defendants focus is in the second of the following two sentences. The first paragraph in the Supplement section addressed to Fremont underwriting standards reads as follows:

> All of the mortgage loans were originated or acquired by Fremont, generally in accordance with the underwriting criteria described in this section. The following is a summary of

[177] The two Fremont-backed Securitizations are NHELI 2006-FM1 and NHELI 2006-FM2.

> the underwriting guidelines believed by the Depositor to have been applied, with some variation, by Fremont. This summary does not purport to be a complete description of the underwriting guidelines of Fremont.

Following this paragraph, there are over four pages describing Fremont's underwriting criteria.

Read in context, the use of the word "believed" does not transform defendants' representation regarding Fremont's compliance with its underwriting guidelines into a statement of opinion. The first sentence is a straightforward statement of fact. The reference to defendants' belief in the second sentence is little more than a statement of assurance by defendants that they are correctly summarizing Fremont's guidelines— "little more than a reference to the depositor's exercise of its due diligence function and a further endorsement of the quality of the offering." *SG Americas*, 2012 WL 5931878, at *2. These "statements of belief about a matter of objective fact . . . [do] not impose upon the plaintiff the duty to [prove] that the defendants did not hold their expressed belief." *Id.* at *3.

In any event, Nomura may be held liable under the Securities Act and *Omnicare* for the statement in the second sentence without any showing regarding its scienter. 135 S. Ct. 1318. Nomura's statements of belief implied that defendants knew "facts sufficient to justify" forming the opinion they expressed. *Id.* at 1330 (citation omitted). The record is replete with evidence that it "lacked the basis for making those statements that a reasonable investor would expect." *Id.* at 1333. Indeed, defendants were aware of information contradicting the representations in the Supplements: RBS, for example, became aware of a "big spike" in repurchasing activity for Fremont loans, suggesting Fremont was originating a substantial number of defective loans, well before NHELI 2006-FM2 was issued.[178] Soon afterward, RBS would refer to Fremont as "FraudMont."

7. Due Diligence Confirmation

Finally, defendants contend that the results of Nomura's preacquisition due diligence review are more consistent with Forester's conclusion that only 5.5% of the Sample loans had "[p]otential serious defect[s]," than with Hunter's far larger number. They are wrong.

Defendants are apparently referring to their expert's calculation that, of the loans within the SLGs that had been subjected to pre-acquisition credit and compliance due diligence, 6.6% were rated EV3. But, as explained above, Nomura's due diligence program was seriously flawed. Among other things, it failed to scrutinize most loans, and results from any review it did perform cannot be fairly extrapolated to an SLG population. In addition to finding credit defects, other due diligence found serious valuation defects. Thus, this single-digit percentage of credit defects cannot independently confirm the accuracy of Forester's numbers. The Nomura due diligence program was not

[178] As explained above, approximately 63% of the loans in each relevant Fremont SLG received no actual valuation due diligence; of those that did receive due diligence, 49% and 36% of the AVM values outside of tolerance had no follow-up BPOs conducted, and ultimately 8 and 34 loans, respectively, were securitized despite having final LTV ratios of over 100%.

designed to, and did not, ensure that the Prospectus Supplements accurately described the extent to which an SLG's loans were underwritten in accordance with originators' guidelines.

B. LTV Ratios and Appraisals

Each Prospectus Supplement included Collateral Tables reporting the average LTV ratios and percentage of LTV ratios in certain ranges for each SLG. To show that the appraisals—and thus the LTV ratios—were false, FHFA was required to show both objective and subjective falsity. FHFA did so.

For at least 184 of the loans, FHFA established both that the appraisal value was false and the appraisers rendering those appraisal opinions did not believe that the values they reported were the true values of the properties. The proportion of such loans per SLG ranged from 18% to 36%. This had important consequences for the accuracy of the LTV ratio Collateral Tables. For example, the Prospectus Supplements all represented that there were no loans in the SLGs with LTV ratios of over 100; the actual figures ranged from 9.3% to 20.5%. Every LTV ratio Collateral Table contained statistics that were false.

FHFA has proved that LTV ratios were false in the sense of containing opinion statements about property values that were both objectively wrong and subjectively disbelieved. In addition, the record supports a finding of falsity based on the omission doctrine described in *Omnicare*, 135 S. Ct. 1318. USPAP requires an appraiser to conduct an investigation and to create a record of that investigation in support of the opinion of value reflected in the appraisal. Each Supplement assured investors that "all appraisals" of the mortgaged properties supporting the loans "conform to [USPAP]." Kilpatrick's CAM demonstrated that this, too, was false; because the CAM was firmly grounded in USPAP requirements, a failing grade on the CAM also indicated a failure to conform to USPAP. Accordingly, whether analyzed as a false statement of belief or as an actionable omission, FHFA has carried its burden of showing that the representations concerning LTV ratios were false.

In defending against this claim, defendants did not choose to conduct any study of the original appraisals, either through an appraisal review or otherwise, to confirm their accuracy. Instead, defendants principally relied on their multi-faceted attacks on Kilpatrick's methodology. Those have been addressed above. In addition, they offered two other kinds of evidence that they contend undermine Kilpatrick's conclusion. They called appraisers who performed two of the 184 non-credible appraisals to testify at trial. For the reasons explained above, their testimony failed to suggest that their appraisal values were either reliable or reflected honestly held beliefs, and failed to undermine Kilpatrick's work or the variety of evidence that confirmed his conclusions. Finally, defendants point to the valuation due diligence that they performed and the text of each Prospectus. It is to those arguments that this Opinion now turns.

1. BPO Statistics

Defendants contend that only 162 loans, or roughly 1% out of the 15,806 loans in the SLGs, were found during their due diligence review "to be outside the BPO tolerance thresholds." They assert that this is strong evidence that original appraisals were "well-supported" value estimates.

There are several problems with defendants' calculation. First, they did not subject 15,806 loans to due diligence. As explained above, roughly 57% of the loans in the SLGs had no real valuation due diligence performed. Therefore, it is not appropriate to claim that only 162 out of over 15,000 loans were out of tolerance. Nor does the figure 162 reflect the total universe of out-of-tolerance appraisals discovered during Nomura's due diligence review. Many loans that received an out-of-tolerance AVM value were never sent for a BPO review. When the LTV ratios are recalculated for those loans with out-of-tolerance AVM and BPO numbers, taken together, the story is a very different one than that suggested by defendants. Taking the AVM values and BPO values obtained by Nomura from its vendors, and using those values to recalculate LTV ratios, substantially more than 162 loans—242—in the SLGs had LTV ratios of over 100%. Nor does the number 162 take into account the 962 loans in the SLGs whose AVM values were outside tolerance thresholds yet had no BPO done at all. And, of course, because of the way Nomura conducted its due diligence, there is no reliable way to extrapolate any of the results from its due diligence program to the entire SLG population. As explained above, the results obtained in Nomura's due diligence program strongly confirm Kilpatrick's conclusions.

2. Text of the Offering Documents

Defendants appeared to argue in an opening statement that FHFA cannot use any evidence, except perhaps an admission of fraud from the original appraiser, to prove that the reported LTV ratios were false. For this argument, they rely of the following formulation in the Prospectuses. Each Prospectus explained that, for purposes of the Prospectus and Prospectus Supplement, "[t]he 'Value' of a Mortgaged Property . . . is generally the lesser of (a) the *appraised value determined in an appraisal obtained by the originator at origination of that loan* and (b) the sales price for that property." (Emphasis added.) Defendants argue that this language forecloses any independent assessment of the appraisals underlying the loans—and therefore, by implication, that the LTV ratios reported in the Supplements cannot be false. Not so.

Section 12(a)(2) imposes strict liability for statements that are materially false. The relevant question is whether the appraisals, and the LTV ratios upon which they were built, were false or not; the fact that FHFA identified with precision which appraisal values it used to construct the LTV ratios cannot and does not inoculate defendants from liability for reproducing false information in the Prospectus Supplements.

C. Owner Occupancy Collateral Tables

FHFA has also claimed that defendants made false statements about the number of mortgage loans issued to borrowers for properties they were occupying. The Collateral Tables for each Prospectus Supplement listed the percentage of loans within an SLG for owner-occupied properties, as well as for second homes and investment properties. These statistics were provided as of the Cut-off Date for the

Supplement. *Owner-Occupancy Opinion*, 2015 WL 394072, at *3-4.

Conservatively, FHFA has shown that the owner-occupancy figures were false in each Supplement. The false statements affected from 1% to 3% of the loans within each SLG.[179] Any challenges that defendants have made to this finding have already been addressed.

D. Credit Ratings

Finally, FHFA alleges the falsity of "representations in the Offering Materials that the reported credit rating related to the actual loan collateral for the securitization." *Merrill Lynch*, 903 F. Supp. 2d at 276 n.2.[180] Each Supplement represented that "[t]he ratings of each class of Offered Certificates will depend primarily on an assessment by the rating agencies of the related Mortgage Loans . . . and the subordination afforded by certain classes of certificates." Each Supplement also represented that credit agencies had rated the Certificates sold to the GSEs as AAA or its equivalent.

It is undisputed that in assigning ratings to the Certificates, the credit rating agencies relied on the data contained in the loan tapes that Nomura provided to them. Those loan tapes contained data stored on Nomura's LMS system. Putting aside transcription errors and the addition of servicing

[179] Using the Cut-off Date, Hunter calculated that the percentages ranged from 1.59% to 6.59%.

[180] Defendants' trial memorandum of law discusses at length a legal standard for assessing the falsity of credit ratings that was rejected in *Merrill Lynch*, 903 F. Supp. 2d at 276 n.6.

information, the LMS data was the data provided by the loans' originators, including FICO scores, DTI ratios, LTV ratios, and owner-occupancy status. FHFA has shown that that data did not accurately reflect those characteristics of the loans within the SLGs.

Given the enormity of the misdescriptions shown, defendants' representation that the ratings "will depend primarily on an assessment . . . of the related Mortgage Loans" is false. The rating agencies could not, and did not, assign ratings to the mortgage loans Nomura was securitizing because the data provided by Nomura did not accurately describe those loans.

E. Excluded Evidence

On April 1, while trial was ongoing, defendants submitted, purportedly pursuant to Fed. R. Evid. 103, what is styled an "Offer of Proof with Respect to Excluded Evidence." The document purports "to place in the record documents and testimony with respect to [certain] categories of evidence . . . that were excluded by rulings of the Court before and during trial, in the event that the substance of this excluded evidence was not clear from the context of the rulings." Four categories of evidence are listed, two of which defendants argue were probative of the truth of their representations in the Prospectus Supplements: Nomura's retention of residual interests in the seven Securitizations and evidence of the GSEs' own due diligence practices.[181] This evidence was properly

[181] The other two categories, which are discussed below, are Housing Goals and GSE selection of loans in the Securitizations, and testimony from Niculescu and Cook.

excluded pursuant to Fed. R. Evid. 401 and 403 as having little to no bearing on the issue of falsity, and because its limited probative value was substantially outweighed by its tendency to confuse and mislead, to waste the Court's and the parties' resources, and to create unfair prejudice.

1. Retention of Residuals

Defendants sought to introduce evidence that Nomura retained a residual interest in the lowest subordinate tranche of each Securitization and that it lost money as a result. This evidence, they contended, attests to Nomura's stake in the Securitizations, its confidence in its due diligence process, and its motivation to perform adequate due diligence.

Having granted summary judgment against defendants on their affirmative defense of due diligence, *see Due Diligence Opinion*, --- F. Supp. 3d ---, 2014 WL 7232443, at *40, the Court excluded evidence of Nomura's motivation to create an adequate due diligence program.[182] The only issue at trial to which Nomura's due diligence remained relevant was the issue of falsity. Nomura and FHFA argued that the due diligence that Nomura performed, and the results it obtained from performing that due diligence, made it more or less likely that the information contained in the Prospectus Supplements was accurate and complete. As a result, evidence of the due diligence that Nomura and RBS performed was

[182] The Court reserved the right to reopen the trial record for admission of this evidence and further argument by counsel in the event that the Court were willing to impose the most punitive interest rate sought by FHFA.

received at trial. Nomura's motivations in creating and running its due diligence program are of such minimal relevance to the issue of falsity, however, that its admission was substantially outweighed by the concerns expressed in Rule 403 and it was excluded.[183]

2. GSEs' Single-Family Due Diligence

Defendants also sought to offer evidence of Fannie Mae and Freddie Mac's due diligence processes performed in the part of their businesses in which they purchased whole loans. As expressed in Nomura's Offer of Proof, defendants sought to present evidence of the GSEs' due diligence and the findings from that program, including the exceptions they made to deviations from originators' underwriting guidelines, the GSEs' disclosures in their own securitizations, and the GSEs' communications with and evaluations of originators. With this evidence, defendants say, they would have shown that the GSEs employed due diligence processes similar to those employed by Nomura, that the GSEs regularly "waived in" loans graded 3 by their due diligence vendors, and that the GSEs' disclosures in their Offering Documents for securitizations were similar to those made by Nomura.

For many reasons, this evidence was largely excluded at trial. *See FHFA v. Nomura Holding Am., Inc.* ("*Single-Family Due Diligence Opinion*"), No. 11cv6201 (DLC), 2014 WL 7234593, at *4 (S.D.N.Y. Dec. 18, 2014); *Single-Family Activities Opinion*, 2015

[183] In any event, the Court previously held that Nomura's residual interest, a "temporary position in a highly risky investment," could say little to nothing about the quality of their due diligence. *See Due Diligence Opinion*, --- F. Supp. 3d ---, 2014 WL 7232443, at *33.

WL 685153, at *4. It is useful to repeat at least a few of the reasons for excluding that evidence here.

Defendants were never able to explain adequately why this evidence of what the GSEs did or did not do in their own businesses was relevant to the issues being tried. If a due diligence defense remained to be tried, and defendants believed that evidence of an industry standard in performing due diligence would be helpful to them, then the obvious comparators and standard setters would be the other defendants in this coordinated litigation who sold far larger quantities of PLS than did Nomura. But defendants' expert took the position that there was no industry standard for conducting due diligence, undercutting any reason to offer any other institution's practices. *See Due Diligence Opinion*, --- F. Supp. 3d --- 2014 WL 7232443, at *39.

Second, for many reasons, evidence of the GSEs' due diligence practices and their disclosures in their own Offering Documents would have been highly prejudicial, wasteful, and misleading. The GSEs bought different loans, under different standards, and securitized different loans through an instrument with different risks and guarantees. *See Single-Family Due Diligence Opinion*, 2014 WL 7234593, at *3-5. Nor is the fact that the GSEs used identical due diligence vendors relevant. As Nomura stressed at trial, since each client had the opportunity to create its own set of review standards or overlays (although Nomura declined the requests to create credit overlays), conclusions drawn based on a comparison of waiver rates alone would be misleading.[184] Similarly, that the GSEs bought different loans from some of the same originators does not provide any insight into whether defendants' Prospectus Supplements accurately described Nomura's loans.

III. Materiality

In evaluating materiality, each Prospectus Supplement is to be read "as a whole," "holistically and in [its] entirety." *ProShares Trust Sec. Litig.*, 728 F.3d at 103, 105. As noted, numerous factors support setting the quantitative materiality threshold in this case at 5%. Those factors include statements in Second Circuit opinions, SEC regulations, and the Offering Documents themselves. In addition, as noted, when RBS asked for a complete list of the originators of the loans in a Securitization, and for statistics including LTV ratio, FICO score, and DTI ratio, Nomura refused to identify originators contributing fewer than 5% of the loans. This is further confirmation that those in the industry viewed it as important if 5% or more of the collateral was misrepresented across such metrics.

As for qualitative factors, there was overwhelming, and essentially undisputed, evidence that the features that would be viewed by the reasonable PLS investor as significantly altering the total mix of information available included collateral characteristics such as LTV ratios, compliance with underwriting guidelines, owner-occupancy status, and

[184] In any event, the Court received, over FHFA's objection, the entirety of Clayton's summary report of the waiver rates of its clients, including many banks and the GSEs.

the credit ratings of the Certificates.[185] LTV ratios gave assurance about the adequacy of the collateral. Compliance with underwriting guidelines gave assurance about the credit risk associated with the loans and the reliability of the statistics reported in the Collateral Tables. Owner-occupancy status was intimately tied to the selection of underwriting standards, the evaluation of a borrower's commitment to the loan, and the overall risk associated with the Securitization. Credit ratings evaluated many different quantitative measures of risk and the management of risk through the structure of the Securitization.

Combining these quantitative and qualitative analyses, FHFA showed that the separate misrepresentations within each of the seven Prospectus Supplements on LTV ratios, compliance with underwriting guidelines, and credit ratings were all material in and of themselves. FHFA failed to prove that the materiality threshold was met with respect to the Prospectus Supplements' reporting of owner-occupancy statistics when those representations are taken alone. Only when combined with one of the other misrepresentations do the owner-occupancy statistics add to the showing of materiality.

Little needs to be said in favor of the Court's finding of materiality with respect to the misrepresentation of LTV ratios aside from directing the reader to the chart presented above that demonstrates the differences between what was

[185] In summation, defense counsel admitted that under the right circumstances each of the relevant subject matters could be material to an investor.

reported in the Prospectus Supplements regarding LTV ratios (the columns marked "Original") and what was true (the columns marked "Extrapolated"). At least 18% of the loans per SLG had origination appraisals that were non-credible and inflated by over 15%; for five of the SLGs, the percentages ranged from 28% to 36%. These non-credible, inflated appraisals had a dramatic impact on the reporting of LTV ratios in the Collateral Tables, moving 37% of the ratios in the Securitizations over 80%, instead of the 21% reported. And, examining solely those LTV ratios that moved over 100%, none of the Supplements reported that any loans fell in that range, while the actual LTV ratios above 100% fell somewhere between 9.3% and 20.5% for each SLG.

Similarly, little needs to be said in favor of the Court's finding of materiality with respect to guidelines compliance. As explained, at least 45% of the loans per SLG had underwriting defects that materially increased credit risk.

With respect to credit ratings, each Prospectus Supplement represented that the Certificate would not issue without AAA (or equivalent) ratings from S&P or Moody's. The Prospectus Supplements misrepresented that the reported credit rating related to the actual loan collateral for the Securitization. Through the loan tapes, defendants provided the rating agencies with faulty descriptions of the loan populations of each SLG, and those misrepresentations affected the ratings given by the agencies to these securities, causing them to be inflated and not to reflect the quality of the underlying collateral. Worse LTV ratios and failures to comply with underwriting guidelines would have increased the level of subordination required to achieve AAA ratings. In other words, had defendants provided the rating agencies with correct loan-level information, the Certificates would have lacked the level of subordination necessary to be rated as AAA (or its equivalent).

As for owner occupancy, FHFA succeeded in showing that it is a critical factor in assessing the credit risk of a loan, but, as noted in the table presented earlier, at most 3.09% of the loans in a given SLG displayed owner-occupancy defects. And Hunter's owner-occupancy defect finding was a decisive factor for only two of the loans supporting the Court's findings of material underwriting defects. In short, FHFA failed to meet the materiality threshold with respect to misrepresentations of owner-occupancy statistics when analyzed in isolation from the other misrepresentations.

Defendants offer essentially six attacks against the conclusion of materiality here. They complain that, to prove materiality, FHFA relied on experts, and did not call as a fact witness any PLS investor or someone from the GSEs. There is no reliance element in FHFA's claims, however; materiality is an objective test. What the GSEs themselves viewed as significant is relevant only to the extent that it sheds light on what reasonable investors in the PLS market generally viewed as significant.[186] Moreover,

[186] It is telling that defendants took depositions of GSE traders who purchased the Securitizations, yet offered no evidence from those depositions to suggest that LTV ratios, compliance with

defendants offer no compelling reason why expert testimony is inappropriate on this score. But, most significantly, the materiality of these four characteristics was not fundamentally in dispute. Confirmation that these are critical components to anyone's evaluation of a PLS certificate came from every corner of the record, including from defendants' business records, their fact witnesses, and their experts.

Defendants argue that reasonable PLS investors understood that collateral characteristics in Prospectus Supplements could not be read in isolation. But the Court's finding of materiality with respect to LTV ratios, guideline compliance, and credit ratings are not based on isolated readings. Rather, they are based on the totality of the information available to reasonable investors during the period 2005 to 2007, the value placed on those characteristics by such investors, and the magnitude of misrepresentations with respect to those characteristics.

Defendants also maintain that investors knew that appraisals reflected the subjective judgments of individual appraisers and might vary by 10-15% from values produced by AVMs. The appraisals that the Court found false, however, varied by more than 15% from the GAVM estimate, and were separately and individually found to be non-credible after an intensive review. Investors of course understood appraisals to be statements of opinion, but that does not mean investors expected or would tolerate

underwriting guidelines, owner-occupancy status, or credit ratings were not material in making their investment decisions.

statements of opinion that were wildly inflated, not supported by a USPAP-compliant investigation, and not sincerely held by those who rendered them.

Another point made by defendants is that investors recognized that underwriting determinations were inherently subjective and subject to exceptions. Even assuming this is true as a general proposition, it does not undermine the finding of materiality here, where a minimum of 45% of the loans per SLG had underwriting defects that materially increased credit risk. Defects on this scale cannot be explained away by mere reference to "subjectivity" or "exceptions." At this point they reflect a wholesale abandonment of underwriting guidelines.

Defendants further contend that LTV ratios, compliance with underwriting guidelines, and owner occupancy were but three collateral characteristics among others that investors considered, such as documentation type, loan product type, asset type, geography, FICO score, originator identity, and first or second lien statistics. But many of these factors are intertwined with the substantive content of the underwriting guidelines, further reinforcing the materiality of misrepresentations concerning compliance with those guidelines. The misrepresentations at issue here were also central to the assignment of credit ratings, underscoring the significance of Nomura's failure to provide accurate information to credit rating agencies. In any event, "a material fact . . . need not be important enough that it would have caused the reasonable investor to change his vote. Rather, the information need only be important enough that it would have assumed actual significance in the deliberations of the reasonable [investor].” *Folger Adam*, 938 F.2d at 1533 (citation omitted).

Finally, with respect to credit ratings, defendants contend that typical RMBS investors during the relevant time period were large institutions that conducted sophisticated pre-acquisition analyses and that used the credit ratings, at most, to confirm the validity of their own models. The record does not support this assertion. Testimony from defendants’ own witnesses confirmed the high importance of credit ratings, and the GSEs’ own written policies restricted their purchasing decisions based on the credit rating of a security.

IV. Control Person Liability

A. Section 15

FHFA alleges control person liability on the parts of NHA, NCCI, and each Individual Defendant, for controlling one or more of Nomura Securities, NAAC, and NHELI, the primary violators. Pursuant to Section 15 of the Securities Act:

> *Every person who*, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, *controls* any person liable under section . . . [12] of this title, *shall also be liable* jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, *unless the controlling person had no knowledge of or*

> *reasonable ground to believe in the existence of the facts* by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o(a) (emphasis added). In other words, Section 15 imposes joint and several "control person" liability. *See Lehman*, 650 F.3d at 185.

"To establish § 15 liability, a plaintiff must show a primary violation of § 1[2] and control of the primary violator by defendants." *Id.* (citation omitted). Given the statutory language and the Supreme Court's acknowledgment, when considering Section 15 in conjunction with its affirmative defense, that the claim imposes a negligence standard only, *Hochfelder*, 425 U.S. at 208-09 & n.27, Section 15 is not read to include a "culpable participation" requirement. *See In re WorldCom, Inc. Sec. Litig.*, No. 02cv3288 (DLC), 2005 WL 638268, at *16 n.20 (March 21, 2005); *see also In re MF Global Holdings Ltd. Sec. Litig.*, 982 F. Supp. 2d 277, 308-09 (S.D.N.Y. 2013).[187] If both a primary violation and control are shown, the "unless clause" of Section 15, emphasized above, provides defendants an affirmative defense.

The content of both the "control" element and the affirmative defense are informed by the structure of the larger regulatory framework in which Section 15 sits. As noted above, the Securities Act, of which Section 15 is a part, was passed to provide investors with accurate, honest information, by imposing

[187] The Second Circuit has explicitly reserved judgment on whether a *prima facie* Section 15 claim, like its Section 20 counterpart for Exchange Act claims, requires a showing of "culpable participation" by the alleged control person. *Lehman*, 650 F.3d at 186.

liability on major market participants— "the persons signing the registration statement, the underwriters, the directors of the issuer, the accountants, engineers, appraisers, and other professionals preparing and giving authority to the prospectus"—for misrepresentations. *Gustafson*, 513 U.S. at 581 (citation omitted). As noted above, the federal securities laws were "designed to assure compliance with disclosure provisions . . . by imposing a stringent standard of liability on the parties who play a direct role in a registered offering," thus placing responsibility on directors and officers for public disclosures. *Litwin*, 634 F.3d at 716 (quoting *Huddleston*, 459 U.S. at 381-82).

1. Control

> [T]he "controlling person" provisions were enacted to expand, rather than restrict, the scope of liability under the securities laws. Control was defined in a broad fashion to reach prospective wrongdoers, rather than to permit the escape of those who would otherwise be responsible for the acts of their employees.

SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 812-13 (2d Cir. 1975) (citation omitted).

Congress did not define the terms "control," "controlled," or "controlling person," that appear in Section 15 of the Securities Act and in the companion Section 20 of the Exchange Act. The legislative history of these statutes makes it clear that Congress deliberately left the concept of control undefined:

> [W]hen reference is made to "control," the term is intended to include actual control as

> well as what has been called legally enforceable control. It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.

H.R. Rep. No. 73-1383, at 26 (1934) (citation omitted).

While Congress did not define "control" under the Securities Act or the Exchange Act, the SEC offered a definition in the rules that it promulgated under those statutes. According to SEC regulations, "[t]he term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405 (Securities Act); *id.* § 240.12b-2 (Exchange Act).

The Second Circuit has adopted the SEC's definition and has held that "control" under Section 15 is "the power to direct or cause the direction of the management and policies of the primary violators, whether through the ownership of voting securities, by contract, or otherwise." *Lehman*, 650 F.3d at 185 (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996), an Exchange Act case, which itself cited 17 C.F.R. § 240.12b-2).

Numerous considerations bear on whether a defendant exercised "control" for purposes of Section 15, and the inquiry is necessarily context and fact dependent (as is the inquiry into Section 15's affirmative defense). *See Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000) (Exchange Act Section 20(a)). A review of relevant caselaw and other authority on Section 15 control person liability reveals certain principles that guide the analysis. Those principles include the nature of the controlled entity, the status of the alleged controlling entity, and the actions taken by the controlling entity on behalf of the controlled entity. These principles must be viewed in the broader context of the purposes of the securities laws, discussed above.

a. Nature of the Controlled Entity

The nature of the controlled entity matters, because if it turns out that the controlled entity was incapable of taking, or unlikely to take, actions on its own, it becomes more likely that others, who controlled the entity, took actions on its behalf. As the Second Circuit has explained, "Section 15 had its genesis in the concern that directors would attempt to evade liability under the registration provisions by utilizing 'dummy' directors to act in their stead." *Mgmt. Dynamics*, 515 F.2d at 812 (citing S. Rep. No. 73-47, at 5; H.R. Rep. No. 73-152, at 27 (1933) (Conf. Rep.)). The Circuit has not held that a finding of a "dummy director" or "shell corporation," standing alone, demonstrates that some other entity or individual is exercising control, but the Circuit has suggested that such a finding is relevant to the inquiry.

In *Lehman*, the plaintiffs argued that they had adequately alleged control simply by stating that one of the defendants was a dummy corporation with the sole purpose of securitizing transactions. 650 F.3d at 187. Were dummy or shell status completely irrelevant to the control person inquiry, the Second Circuit would likely have said as much. Instead, the Circuit noted that the complaint did not, in fact, allege that the corporation was a dummy, and did not, in fact, plead facts suggesting that the corporation "was a shell company created to avoid liability for securities law violations." *Id.* at 187-88. By negative implication, had facts supporting a shell or dummy finding been adequately pled (and ultimately proved), that would have borne on the control person analysis.

b. Status of Controlling Entity

The status of the putative controlling entity is also relevant. Certain types of entities, or entities that stand in certain relationships to the controlled entity, are especially likely to exert the hallmarks of control. For example, Section 15 itself provides that being a "stock owner[]" is probative. 15 U.S.C. § 77o(a). Being a parent corporation over a subsidiary, and having common officers, directors, personnel, and office space or other shared resources, are also relevant indicia of control. *See, e.g., Waterford Inv. Servs., Inc. v. Bosco*, 682 F.3d 348, 356 (4th Cir. 2012) (noting relevance of these factors to inquiry of control under FINRA Rule 12100(r), which court analogized to control person inquiry under federal securities law); *In re Mut. Funds*

Inv. Litig., 566 F.3d 111, 131 (4th Cir. 2009) r*ev'd on other grounds sub nom. Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (Exchange Act) (noting that allegation of common director goes to control person status).

The status of the putative controlling entity is important not only if that entity is a business, but also if it is a natural person, such as a director, officer, or employee of a company found to be primarily liable. Officer or director status alone does not constitute control, but it is relevant to the inquiry. *Howard*, 228 F.3d at 1065 ("[A]lthough the directors' status as such was insufficient for a finding of control, their day-to-day oversight of company operations and involvement in the financial statements at issue" were relevant considerations.).

In this regard, the number and nature of positions held are pertinent. *See, e.g., Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1108 (10th Cir. 2003), *as amended on denial of reh'g* (Aug. 29, 2003) (Exchange Act). Thus, the distinction between inside and outside directors can be important to the control person analysis, since an inside director has at least two positions from which to exercise control. The potential for the distinction between inside and outside directors to be relevant for purposes of control person liability mirrors the importance played by that distinction elsewhere in the regulatory scheme. *See, e.g.*, 15 U.S.C. § 78u-4(f)(2), (10)(C)(ii).

c. Actions Taken on Behalf of Controlled Entity

Again, the SEC's definition of control, adopted by the Second Circuit, focuses on power over "the management and policies" of the controlled person. *Lehman*, 650 F.3d at 185; 17 C.F.R. § 230.405. Because the status of the putative controlling person, standing alone, may not suffice, it is useful to look as well at the actions that that person took or had the duty to take on behalf of the controlled entity. For instance, in a different RMBS case where, like here, control person liability was alleged against the sponsors of the securities, the district court found that control had been sufficiently pled:

> [T]he complaint explains how the sponsors exercised that control:
>
> The sponsors acquired and selected the loans that would be securitized and determined the terms under which those loans were sold to the depositors and then to the trusts. The sponsors also determined and approved the structure of the securitizations and the manner in which the depositors and the trusts sold the related Certificates, and controlled the disclosures made in connection with the related securitizations.
>
> These allegations state sufficient indicia of the exercise of control . . . .

Capital Ventures Int'l v. J.P. Morgan Mortg. Acquisition Corp., No. 12cv10085 (RWZ), 2013 WL 535320, at *9-10 (D. Mass. Feb. 13, 2013) (citation omitted) (materially similar Massachusetts state statute).

Of particular importance when the putative controlling person is a natural person is whether he or she acted on the controlled entity's behalf by rendering his or her signature on documents issued by the entity.

See Howard, 228 F.3d at 1065-66 ("[One's] participation in the day-to-day management of [the controlled entity] and his review and signature of the financial statements" was relevant to control inquiry.). Demonstrating the holistic nature of the control person inquiry, in which one's status and the actions that one takes cannot be viewed in isolation, one's director or officer status and one's responsibility for signing financial disclosures can be linked, further reinforcing the degree of responsibility that one has for the financial actions of the firm.

As this Court has previously queried with respect to signatures required by the securities laws,

> [A]s a practical matter, just what is a signature on an SEC filed document meant to represent if it does not represent a degree of responsibility for the material contained in that document? The very fact that a director is required to sign . . . documents charges the director with power over the documents and represents to the corporation, its shareholders, and the public that the corporation's director has performed her role with sufficient diligence that she is willing and able to stand behind the information contained in those documents. As the SEC explained when it announced [an expanded signature] requirement in 1980:
>
> With an expanded signature requirement, the Commission anticipates that directors will be encouraged to devote the needed attention to reviewing the Form 10-K and to seek the involvement of other professionals to

> the degree necessary to give themselves sufficient comfort. In the Commission's view, this added measure of discipline is vital to the disclosure objectives of the federal securities laws, and outweighs the potential impact, if any, of the signature on legal liability.

In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 420 (S.D.N.Y. 2003) (quoting Integration of Sec. Act Disclosure Sys., Securities Act Release No. AS-279, 20 SEC Docket 1308 (Sept. 25, 1980)).

Signature requirements were expanded yet again when Congress enacted the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 and 18 U.S.C.), "[t]o safeguard investors in public companies and restore trust in the financial markets." *Lawson v. FMR LLC*, 134 S. Ct. 1158, 1161 (2014) (citation omitted); *see also In re Herald*, 730 F.3d 112, 117 (2d Cir. 2013) (noting that Congress passed Sarbanes-Oxley "to increase transparency and stability in the securities markets." (citation omitted)). "The Sarbanes-Oxley Act is a major piece of legislation . . . designed to improve the quality of and transparency in financial reporting . . . . [It] requires CEOs and CFOs to certify their companies' financial reports . . . ." *Cohen v. Viray*, 622 F.3d 188, 195 (2d Cir. 2010) (citation omitted).

Specifically, Section 302 of Sarbanes-Oxley, requires principal executive and financial officers to certify each annual and quarterly report. *See* 15 U.S.C. § 7241(a).

> [P]ursuant to section 302 . . . [a] signing officer must certify that he has reviewed the

> report, that based on his knowledge the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, and that the report and any information included within the report fairly present in all material respects the financial condition and results of operations of the issuer. Moreover, the officer must certify that he is responsible for establishing and maintaining internal controls, and that he has evaluated the effectiveness of the issuer's internal controls within the past ninety days and has presented in the report his conclusions about the effectiveness of the corporation's internal controls based on his evaluation as of that date.

Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 1003 (9th Cir. 2009), *as amended* (Feb. 10, 2009) (citation omitted). "It [is] reasonable to expect that corporate officers stand behind the company's public disclosure and be subject to sanction should they violate that certification." H.R. Rep. No. 107-414, at 51 (2002).

The importance that attaches to certifications of quarterly and annual financial reports similarly applies to the certification of Registration Statements and their amendments. After all, Section 11 of the Securities Act imposes liability on "every person who signed the registration statement," if the Registration Statement contains a materially misleading statement or omission. 15 U.S.C. § 77k(a). This broad imposition of liability underscores the significance that inheres in placing one's name on a document filed with the SEC for the purpose of providing information to investors or would-be investors. As the Second Circuit has explained:

> The Securities Act of 1933 had two major purposes, to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof. These aims were to be achieved by a general antifraud provision and by a registration provision. Section 11 deals with civil liability for untrue or misleading statements or omissions in the registration statement; its stringent penalties are to insure full and accurate disclosure through registration.

Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967) (citation omitted).

2. Defense

As expressed in the language of Section 15 reproduced above, the provision includes an affirmative defense if the defendant can show that "the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 15 U.S.C. § 77o(a). NHA, NCCI, and the Individual Defendants assert this affirmative defense.

The statutory language of this defense echoes Section 11's defense of reliance on expertised portions of a Registration Statement, which, like the Section 15 defense, turns on whether a defendant has "reasonable ground to believe" that statements are true. Because "it is a normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning," *Taniguchi v. Kan Pac. Saipan, Ltd.*, 132 S. Ct. 1997, 2004-05 (2012) (citation omitted), the meaning of "reasonableness" under Section 15 can be informed by Section 11's mandate that "the standard of reasonableness shall be that required of a prudent man in the management of his own property," 15 U.S.C. § 77k(c).

A prudent man does not assume a totally passive, willfully blind role in the management of his own property. Thus, although the "unless" clause of Section 15—"unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts"—could be read to condone a see-no-evil, hear-no-evil approach, that clause must be read in the broader context of the federal securities laws, which promote the opposite values: supervision, due diligence, and accountability. Indeed, the Tenth Circuit has explicitly rejected the see-no-evil, hear-no-evil approach. As that court explained in *S.F.-Okla. Petroleum Exploration Corp. v. Carstan Oil Co.*:

> The defendant had the burden to demonstrate the exception to Section [15] — a lack of knowledge. . . . This he attempted to do by taking the position that he was a figurehead; that . . . he did not participate in any way; and that he had made no effort to learn what the corporation was doing. When reliance is placed on his testimony it demonstrates that he must have made a

> conscious effort not to know. This established that he had not performed his duties as a director. He had the opportunity to know as there is no hint whatever that this is a case where a director or officer made an effort to find out and was unable to find the facts or was prevented from doing so.

765 F.2d 962, 964-65 (10th Cir. 1985).

Similarly, the Seventh Circuit, in ruling that "control does not depend on the *qualifications* of the control people . . . [but i]nstead . . . refers to their *authority*," noted that "[i]f the rule were otherwise, corporate officers and directors could escape control liability by remaining as ignorant as possible—surely not the result that Congress intended." *Donohoe v. Consol. Operating & Prod. Corp.*, 982 F.2d 1130, 1138 (7th Cir. 1992) (emphasis added).

This Opinion likewise rejects the see-no-evil, hear-no-evil approach. The determination of whether someone lacks a reasonable ground to believe in the existence of the facts creating liability must be context- and fact-dependent. Some of the same factors that bear on the control inquiry bear on this inquiry as well, including most notably the status of the controlling person and the actions the controlling person took, or had the responsibility to take, on behalf of the controlled person. The very same considerations that cause one's status as a corporate director or officer charged with signing Offering Documents to support a finding of control, may undermine a finding of a lack of a reasonable ground to believe in the existence of certain underlying facts when those facts relate to the accuracy of statements in Offering Documents. In short, while the statute offers a defense to one who lacks reasonable grounds to believe in the existence of the underlying facts, if discharging one's responsibilities as a signatory of public documents would furnish such grounds, one will be hard pressed to make out the defense. After all, as described above, the securities laws and the surrounding regulatory framework impute a certain degree of knowledge and responsibility to those who certify an offering's information to the public.

B. Application

Before evaluating the statuses and actions taken by the purported controlling entities—NHA, NCCI, and the Individual Defendants—it is useful to note something about the nature of two of the controlled entities, NAAC and NHELI. These two special purpose vehicles were, in effect, shells, with no employees or assets aside from what they held for purposes of Nomura's RMBS business. Their sole function was to serve as depositors for securitizations, including the seven at issue.

1. NHA

NHA controlled—that is to say, enjoyed the power to direct or cause the direction of the management and policies of—all three primary violators: Nomura Securities, NAAC, and NHELI. NHA's ownership of Nomura Securities, NAAC, and NHELI;[188] its ability

[188] Against a finding of control, defendants point out that NHA's ownership of NAAC and NHELI was indirect, through NACC and later NAMF. By negative implication, defendants concede that NHA's direct ownership of Nomura Securities, which they do not deny, is highly relevant to finding that NHA controlled Nomura Securities. Moreover, as noted, NHA's indirect whole ownership

to appoint their directors; and the overlap of their directors have all been discussed above.

NAAC's and NHELI's directors chose the officers, who were responsible for the management and operation of the companies. Two officers of both NAAC and NHELI, Buck and Sam Herbstman, also served as officers of NHA. And Findlay was an officer and director of NHA and a director of NAAC and NHELI.

Moreover, NHA created NAAC and NHELI for the purpose of issuing RMBS Certificates. Because NHA could decide which loans NCCI could purchase and could deny NCCI permission to buy any loans, NHA had the ability to control and even halt NAAC's and NHELI's issuance of securitizations. Indeed, all the varied ways in which NHA oversaw, set policy for, and provided support to the other Nomura entities are detailed above and need not be reproduced here.

2. NCCI

Similarly, NCCI controlled all three primary violators. The overlap of officers, directors, and personnel has been noted: Notably, the CEOs of NAAC and NHELI, Graham and LaRocca, were also officers of NCCI.[189] These NCCI officers signed the Registration Statements and were responsible for putting together the Offering Materials and for otherwise papering the transactions, including by preparing the Prospectus Supplements.

of NAAC and NHELI is not the only factor demonstrating NHA's control over those entities.

[189] And, in the case of LaRocca, a director as well.

NCCI also controlled the three primary violators by directing their RMBS business activities. NCCI's disclosed position as sponsor manifested a responsibility for the content of the Prospectus Supplements. NCCI was responsible for conducting diligence on the loans before purchase, decided which loans to purchase and securitize, and held the loans on its books before depositing them with NAAC or NHELI. In other words, NCCI could prevent the primary violators from issuing RMBS by refusing to purchase loans for securitization, or, having bought loans, refusing to deposit them.

3. Individual Defendants

Multiple factors also lead to the conclusion that the Individual Defendants controlled the primary violators in some combination or another.[190] All five Individual Defendants were officers and/or directors of the some combination of the primary violators: Nomura Securities, NAAC, and NHELI. Those statuses are coupled with other evidence of control, including signatures on Registration Statements, shelf amendments, and director and officer resolutions.

The Individual Defendants seek to disclaim their responsibility for the accuracy of the statements made in the Prospectus Supplements issued pursuant to those Registration Statements, because they did not sign the Prospectus Supplements. But there is no one

[190] As discussed below, under the D.C. Blue Sky law, Findlay's, Graham's, Gorin's, and McCarthy's statuses as officers or directors of NAAC or Nomura Securities suffice to establish the requisite control.

better positioned to be held accountable as a control person. With the exception of the third director of the depositors (Ito), the five Individual Defendants are the only signatories of the Registration Statements. If anyone is responsible for the accuracy of the statements made in the Prospectus Supplements issued pursuant to them, it is these five individuals. While the absence of their signatures from the Prospectus Supplements means that they will not be held strictly liable as primary violators, the presence of their signatures on the Registration Statements is highly pertinent to the inquiry of control person liability.

Beyond signatures, Findlay, who helped set up Nomura's RMBS due diligence processes, was responsible for approving the Securitizations. The Transaction Management Group, with which Graham and LaRocca were both engaged, was actively involved in various aspects of Nomura's RMBS business, from loan acquisition to securitization to review of the Prospectus Supplements and other Offering Documents. Gorin was responsible for maintaining the financial accounts of various Nomura entities, including NAAC and NHELI.[191] And McCarthy, along with Findlay and Ito, approved the issuance of the

[191] Defendants say that, because NAAC and NHELI had no employees or day-to-day operations, there was no management or policy that Gorin could have directed. This argument is unavailing. That the depositors had no employees or day-to-day operations—*i.e.*, that they were "shells"—makes it more, not less, likely that they were controlled by the officers at their helms, especially those in charge of their financials.

seven Certificates and reviewed the Offering Documents, including the Prospectus Supplements.

4. Unsuccessful Affirmative Defense

No defendant has carried the burden of proving, under Section 15, that he had no knowledge of, or reasonable ground to believe in, the existence of the facts by reason of which the primary violators are liable. Assuming defendants had no subjective knowledge of the material misrepresentations in the Offering Documents, they did not prove that they had no reasonable ground to believe that there were such misrepresentations.

NHA did not prove that it lacked a reasonable ground to believe in the existence of the material misrepresentations, both because Findlay designed Nomura's diligence process on NHA's behalf, and because, through the various channels described above, NHA continuously monitored the problems and risks in Nomura's RMBS business. Due to the flaws in the design of Nomura's diligence process and the red flags that even that flawed process raised, NHA failed to show that it had no reasonable grounds to believe that the Prospectus Supplements contained the misrepresentations at issue here. Similarly, NCCI did not prove that it lacked a reasonable ground to believe in the existence of the material misrepresentations, largely because, as sponsor, NCCI was intimately connected to every aspect of the securitization process, including the diligence.

The Individual Defendants similarly failed to make out the affirmative defense for control persons. Based on their roles and knowledge as described in earlier sections of this Opinion, Findlay, Graham, and

LaRocca each failed to prove the lack of a reasonable ground to believe in the existence of the material misrepresentations, because it was revealed that they did, in fact, have reasonable grounds to know the nature of the work being done during the diligence process, the red flags it raised, and the flawed loans that were being securitized.

Gorin and McCarthy are not entitled to the affirmative defense, but, unlike Findlay, Graham, and LaRocca, not because of demonstrated familiarity with the faults of Nomura's diligence or the red flags it revealed. Quite the opposite. Gorin and McCarthy were familiar with next to nothing about Nomura's RMBS business; they took no steps to educate themselves about what was going on and did nothing to assure themselves of the truth of the statements in the Offering Documents. Any information they did have about the business of which they were a part was limited, inaccurate, or both. Their see-no-evil, hear-no-evil approach cannot be countenanced.

In fact, not just Gorin and McCarthy, but all the Individual Defendants, on some level, professed ignorance about the way in which Nomura's system was supposed to work, and in particular, about whose responsibility it was to ensure that the Prospectus Supplements made accurate representations. Their ignorance is unsurprising, as it appears that no one held that responsibility. But this cannot furnish the basis for the defense. If no one is in charge, those who should be do not get a pass. For instance, none of the Individual Defendants has presented an affirmative defense by showing that he had a reasonable basis to believe both that another qualified, trustworthy, and responsible person or entity was charged with ensuring the accuracy of those portions of the Prospectus Supplements that are at issue here, and that that person or entity had fulfilled that duty.

The Individual Defendants' approach to defending against the charges in this action is not entirely surprising. They effectively had two options, given the interplay between the element of control and the affirmative defense. They could have effectively conceded control but attempted to construct a strong defense by demonstrating the ways in which they, or those on whom they were entitled to rely, were actively engaged in ensuring the quality of Nomura's RMBS business and the accuracy of its Offering Documents—how, despite having discharged their director and officer responsibilities with care, they simply had no reasonable grounds to believe that the Offering Documents contained material misrepresentations. They did not take this tack. Instead, they attempted to fight Section 15 liability by downplaying their involvement in the business, and maintained that, because they were so absent, they had no grounds to believe in the existence of any underlying facts about the business, including the potential for material misrepresentations in the Offering Documents. But, as described, they cannot seek the protection of the affirmative defense if simply doing their job—in the way expected of a prudent man conducting his own affairs—would have provided the reasonable grounds to believe in the existence of the relevant facts.

The point is encapsulated in Findlay's claim that he did not read the UBS report before passing it along to others, with the expectation that a response would require authorization from his superiors. Either Findlay in this instance, and the other Individual Defendants more generally, were aware of information such as the UBS report, in which case they were affirmatively provided the reasonable grounds to believe that Nomura's Offering Documents contained material misrepresentations. Or Findlay actually did not read the report, as he testified, and the other Individual Defendants actually made no efforts to educate themselves about the processes in which they placed their trust.

But as officers and directors of the two depositors, whose business was exclusively devoted to the securitization of RMBS, and as the individuals invested with signatory authority over the Registration Statements for the Securitizations, they were obligated to act prudently in connection with each of the Prospectus Supplements filed by the depositors. They abdicated these roles and shirked this knowledge and responsibility by failing to satisfy themselves, outside of what each viewed as his narrowly circumscribed role, that the NAAC and NHELI Offering Documents were truthful and complied with the requirements of the law. Without any basis and without taking any steps to assure themselves, they blindly trusted that the rest of the Nomura RMBS business was operating effectively. Having, in effect, done nothing, they cannot claim the protection of the affirmative defense to control person liability.

V. Damages

Section 12 provides a fixed formula for damages: The plaintiff is entitled "to recover the consideration paid for [the] security with interest thereon, less the amount of any income received thereon, *upon the tender* of such security, or for damages if he no longer owns the security." 15 U.S.C. § 77*l*(a)(2) (emphasis added). The GSEs retain the Certificates they purchased from defendants, and thus their recovery is measured by the statutory formula. In the case of an RMBS, investors' original investment is repaid in regular increments. Accordingly, each month, the GSE was to be paid a return of principal on its Certificate and a coupon reflecting an interest payment.

To calculate damages, FHFA's expert deducted principal payments received by each GSE on a month-to-month basis to arrive at the amount of prejudgment interest due on the consideration paid. The proceeds balance at the time of judgment plus the accumulated prejudgment interest make up the statute's "consideration paid" with "interest thereon." Finally, to arrive at a damages figure, the expert added all of the coupon interest payments received by the GSEs and subtracted that amount from the sum of the consideration paid and prejudgment interest. The parties do not dispute the amount of "income received" on the seven Certificates, nor is there substantial disagreement about the amount of "consideration paid." Prior to trial, defendants' request for a further reduction of damages based on a calculation of interest on interest was rejected. *Riddiough Opinion*, 2015 WL 640875, at *2-3.

The parties dispute two remaining issues regarding damages: the date of "tender," and the proper interest rate. The date of tender is the date of judgment, when the GSEs will tender their Certificates to defendants. Prejudgment interest will be calculated at the Certificates' coupon rate.

A. Date of Tender

With its February 20, 2015 submission of the pretrial order and the direct testimony of its damages expert, FHFA argued for the first time that it constructively tendered its securities as of September 2, 2011, the date of the initial complaint, and that because under Section 12 consideration paid is recovered "upon the tender of such security," it is entitled to receive the recovery dictated by the statute's formula as of that date and to retain all payments received since that date. With this interpretation of the recovery formula, FHFA would be entitled to retain over $178 million in principal and interest payments received since this lawsuit was filed.[192] It is not.

FHFA found support for its creative argument in caselaw recognizing the doctrine of "constructive tender." But that doctrine has been applied not to fix a date from which to calculate damages, but to clarify how a plaintiff might satisfy the prerequisite of "tender" some courts have required of Section 12 claimants. *See Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1034-35 (2d Cir. 1979). In that context, the

[192] Depending on the interest rate selected to calculate the recovery due to FHFA here, the effect of selecting FHFA's tender date could be an increase in damages of over $160 million.

constructive tender doctrine refers to the implicit *offer* to tender rather than the actual tender of securities. For instance, in *Wigand*, the Court of Appeals observed that

> "[a]s a final condition to liability under section 12[(a)](2), the Act requires "tender" of the securities, if they are still held by the plaintiff. The language of that section gives no hint as to the time, place or manner of such tender. . . . Obviously rescission can only take place if the plaintiff gives back the stock he has received, and therefore a [complaint's] demand for rescission contains an *implicit offer* to tender, sufficient to satisfy the statute."

Id. (emphasis added); *see also Morin v. Trupin*, 747 F. Supp. 1051, 1063 (S.D.N.Y. 1990) ("A requisite element of a Section 12[(a)](2) claim is the plaintiffs' tender of the securities they purchased. . . . A complaint that does not plead at least an offer of tender is insufficient and subject to dismissal."); *Anisfeld v. Cantor Fitzgerald & Co.*, 631 F. Supp. 1461, 1464 (S.D.N.Y. 1986) ("An essential condition of liability under Section 12[(a)](2) of the Securities Act is that the plaintiff tender the securities he purchased, . . . and an offer in the complaint to tender the securities is sufficient to satisfy the condition.").

In any event, it would be wholly inconsistent with Section 12's rescissionary aim to impose a date past which a plaintiff would be permitted to keep some kind of recovery bonus. In return for receiving the award dictated by the statute, the statutory formula requires FHFA to return the principal and interest payments it has received during the time that it has possessed the Certificates. While it is true, as FHFA argues, that "Congress shifted the risk of an intervening decline in the value of the security to defendants," *Loftsgaarden*, 478 U.S. at 659, that risk does not include the risk that FHFA will receive a windfall in its recovery. That risk is the risk that defendants bear from any decline in the value of the Certificates since their sale to the GSEs. In allowing a rescissionary remedy, Section 12(a)(2) restores the parties to their positions as of the time the contract was made. *See Post-Filing Payments Opinion*, --- F. Supp. 3d ---, 2014 WL 7232590, at *10.

B. Interest Rate

The parties also dispute the appropriate interest rate to impose. They have advocated for a series of different rates, but both agree that one of those rates may be the coupon rate. FHFA has advocated for the IRS underpayment interest rate, although it also submitted damages estimates assuming the Certificates' coupon rate as well as a flat 3% interest rate. For their part, defendants advocated for the "risk-free" federal postjudgment rate, but concede that if a rate higher than the federal postjudgment rate is imposed, "the only appropriate one would be the coupon rate." The impact of these various interest rate formulations is as follows:[193]

Risk-Free Rate	Coupon Rate	3% Rate	IRS Penalty Rate
$562,825,709	$624,406,948	$693,635,028	$1,001,704,235

[193] Risk-free rate is calculated as of March 31, 2015.

The most appropriate rate for Section 12(a)(2) damages is the coupon rate. That rate vindicates the GSEs' original expectations when purchasing the Certificates. The interests of "full[] compensation," "fairness," and remediation each militate in favor of the coupon rate. *See Gierlinger*, 160 F.3d at 873.

FHFA asserts that the appropriate rate is the IRS underpayment interest rate for large corporate underpayments, which is defined as the federal short-term interest rate plus 5%. 26 U.S.C. § 6621(c)(1). The IRS underpayment interest rate is typically applied when defendants have engaged in fraud or other conscious wrongdoing. The prototypical case is an SEC enforcement action. *See, e.g., First Jersey Sec.*, 101 F.3d at 1476. This is a strict liability Securities Act case; it does not allege that defendants engaged in fraud.

Similarly inappropriate is the "risk-free" federal postjudgment interest rate proposed by defendants. The federal postjudgment rate is defined by statute as "the 1-year constant maturity Treasury yield." 28 U.S.C. § 1961(a). While, as defendants point out, interest in some circumstances "should be measured by interest on short-term, risk-free obligations," an award of interest is first and foremost "intended to make the injured party whole." *N.Y. Marine & Gen. Ins. Co. v. Tradeline (L.L.C.)*, 266 F.3d 112, 131 (2d Cir. 2001). In this case**,** fully compensating FHFA for its reasonable expectations for recovery on AAA rated Certificates is necessary to achieve that end.

VI. Loss Causation

Pursuant to Section 12 of the Securities Act, as amended by the Private Securities Litigation Reform

Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, defendants have pursued the statutory affirmative defense of negative loss causation. The statute provides:

> [I]f the person who offered or sold [the] security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents *other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted*, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

15 U.S.C. § 77*l*(b) (emphasis added). In other words, the statute permits a defendant to reduce or eliminate altogether the obligation to pay damages for its violation of Section 12(a)(2). Section 12 places the burden on defendants to prove that something other than the subject of the misrepresentations or omissions was responsible for any decrease in value of the Certificates.

"Loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff . . . [and] is related to the tort law concept of proximate cause." *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157 (2d Cir. 2007) (citation omitted) (Section 10(b) claim).[194] "A misrepresentation is the proximate cause of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations." *In re Omnicom Grp., Inc. Sec. Litig.*, 597 F.3d 501, 513 (2d Cir. 2010) (citation omitted) (Section 10(b) claim). "The zone of risk is determined by the purposes of the securities laws, i.e., to make sure that buyers of securities get what they think they are getting." *Id.* (citation omitted). Therefore, to prevail on its Section 12 defense a defendant must carry its burden of showing that the loss in the value of the securities at issue was proximately caused by events unrelated to the subject of the alleged misrepresentations. *GSE Loss Causation Opinion*, 2015 WL 685159, at *2.

Section 12's loss causation defense

> fulfills the rescissory purpose of the statute, which repudiates the transaction and seeks to place the parties in the status quo. If the securities being tendered by FHFA are less valuable than the securities the GSEs received at the time of the purchase agreements for reasons unrelated to defendants' alleged misconduct, then the return of the GSEs' consideration will be

[194] "[T]he negative causation defense in Section 12 and the loss causation element in Section 10(b) are mirror images of one another. Because of their complementarity, the loss causation analysis conducted under Section 10 is informative of the analysis under Section 12." *FHFA v. Nomura Holding Am., Inc.* ("*GSE Loss Causation Opinion*"), No. 11cv6201 (DLC), 2015 WL 685159, at *2 (S.D.N.Y. Feb. 18, 2015) (citation omitted).

> similarly offset. When a defendant receives a plaintiff's securities in exchange for the return of the plaintiff's consideration paid, *offset by any unrelated* depreciation in value, the parties are placed in the status quo ante. This is fully in keeping with Section 12(a)(2)'s longstanding offset of the purchase price by the amount of any income received thereon.

FHFA v. Nomura Holding Am., Inc. ("*Ryan Opinion*"), No. 11cv6201 (DLC), 2015 WL 629336, at *2 (S.D.N.Y. Feb. 13, 2015) (citation omitted).

Defendants contend that the entirety of any loss here is due to macroeconomic factors, all stemming from the collapse of housing prices, beginning in 2007. Recently, in a context in which the plaintiff bore the burden of affirmatively establishing loss causation, the Second Circuit remarked that, "[c]ertainly, when a plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the [misrepresentation] is lessened." *Fin. Guar. Ins. Co. v. Putnam Advisory Co., LLC*, --- F.3d ---, 2015 WL 1654120, at *8 n.2 (2d Cir. Apr. 15, 2015).

But, in a telling observation that resonates with the record created here, the Circuit went on to "observe that there may be circumstances under which a marketwide economic collapse is itself caused by the conduct alleged to have caused a plaintiff's loss, although the link between any particular defendant's alleged misconduct and the downturn may be difficult to establish." *Id*. Again, this statement was made in a context in which an element of the plaintiff's claim would require the plaintiff to affirmatively establish that link. Here, by contrast, defendants bear the burden of proving that something other than that which was concealed by the misrepresentations in the Prospectus Supplements caused the loss in value of the Certificates.

In making its observation about the linkage between a defendant's misconduct and a market-wide phenomenon, the Court of Appeals cited the Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (2011), better known as the Financial Crisis Inquiry Report ("Report"), published by the U.S. Financial Crisis Inquiry Commission.[195] The Report notes links between the shoddy origination practices concealed by the misrepresentations in the Prospectus Supplements and the market-wide factors on which defendants blame the losses.[196] According to the Report:

> As defaults and losses on the insured mortgages have been increasing, the [private mortgage insurance ("PMI")] companies have seen a spike in claims. As of October 2010, the seven largest PMI companies, which share 98% of the market, had rejected about 25% of the claims (or $6 billion of $24 billion) brought

[195] *Available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf (last visited May 11, 2015).

[196] No party introduced the Report as an exhibit, and the Court did not consult it in making any of the findings of fact in this action. Directed by the Second Circuit's *Putnam Advisory* decision to the Report, however, the Court views it as confirmatory of the record created at trial.

> to them, because of v*iolations of origination guidelines, improper employment and income reporting, and issues with property valuation.*

Report at 225 (emphasis added).

Defendants have failed to carry their burden of proving their affirmative defense of negative loss causation. Notably, they have not quantified the loss that they say is due to macroeconomic factors. They seek to offset the entirety of any judgment awarded to FHFA and offer no means to set off only a portion of any award. As already described, shoddy origination practices contributed to the housing bubble, and were among the factors that contributed to the economic collapse that followed when that bubble burst. Defendants do not dispute this. They do not deny that there is a link between the securitization frenzy associated with those shoddy practices and the very macroeconomic factors that they say caused the losses to the Certificates. This lack of contest, standing alone, dooms defendants' loss causation defense, which, again, requires them to affirmatively prove that something other than the alleged defects caused the losses.

Rather than fighting the existence of the link, defendants present a series of other arguments, each of which is addressed here. They argue that four decisions from the Second Circuit Court of Appeals support their defense; the recession was not within the zone of risk of the misrepresentations and omissions in the Offering Documents; these seven Securitizations played a miniscule role in the creation of the housing bubble; the Government played a role in the creation of the bubble; FHFA has already admitted in court filings and elsewhere that the collapse of housing prices led to the decline in securities' prices; and excluded evidence would have supported the defense.

A. Second Circuit Caselaw

Defendants cite four decisions by the Court of Appeals for the Second Circuit in support of the argument that market-wide phenomena, such as the housing and financial crises, "can be" intervening causes sufficient to break the proximate causal chain.[197] In the appropriate case, that is of course so. But none of the cases carries the weight defendants wish. In all four cases, the plaintiffs bore the burden of proving loss causation, so an inability to disentangle the cause of losses inured to the defendants' benefit. In the instant case, by contrast, where the burden of proving negative loss causation falls on defendants, the exact same inability to disentangle works to defendants' disadvantage. Moreover, in none of these four cases did the plaintiff allege that the defendant's own practices had fueled the market-wide phenomena associated with the loss.

In *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), in the context of an Exchange Act Section 10(b) claim, where loss causation is an element of the plaintiff's *prima facie* case, the complaint failed to plead loss causation because it included "no allegation that the market reacted negatively to a corrective disclosure" by the defendants. *Id.* at 175. In *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 188-89 (2d Cir. 2001), there was no argument made about

[197] This argument was presented in defendants' March 9 brief.

market-wide factors and thus there was no need for either side to disentangle losses caused by the alleged misconduct from losses caused by larger market trends. In *Powers v. British Vita, P.L.C.*, 57 F.3d 176, 180 (2d Cir. 1995), a civil RICO action, the court affirmed in part the dismissal of the complaint for failure to allege loss causation. In that case, the plaintiff conceded that the stock price fell for reasons other than the defendants' conduct. *Id.* at 189.

Finally, in *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 765 (2d Cir. 1994), a bank that made loans through mortgage brokers brought a civil RICO claim against one such broker, alleging that the broker misrepresented the value of properties pledged as collateral to induce the bank to make loans. Affirming dismissal of the RICO complaint for failure to plead loss causation, the court reasoned:

> [T]he substantial period [of five years] between the alleged fraud and [the plaintiff]'s loss, coupled with the concurrence of that loss with the *real estate market crash*, is additional support for the conclusion that the fraud was not a substantial cause of [the plaintiff]'s injury. Despite [the plaintiff]'s allegation that the net operating income for most of the collateral properties was insufficient to service the principal and interest payments due on the loans, few of the properties went into default until mid-1990, when the *real estate market collapsed*. . . . [The plaintiff's] claims fail because it has not adequately plead facts which, if proven, would show that its loss was caused by the

> alleged misstatements as opposed to intervening events.

Id. at 772 (emphasis added). The court went on to qualify its ruling by warning that it "d[id] not mean to suggest that in all cases a fraud plaintiff will be unable to plead proximate cause when the claim follows a market collapse." *Id.* Again, unlike the instant case, there is no indication that the plaintiff in *First Nationwide Bank* attempted to connect the real estate market crash of the '90s to widespread misconduct of the kind in which its defendant was alleged to have engaged.

B. Zone of Risk

In their March 9 filing, defendants argue that the housing market and economic recession that they say led to the losses in value of the Certificates were not within the "zone of risk" concealed by the misrepresentations, and thus represent a break in the causal chain, giving rise to a loss causation defense. This argument conceives of "zone of risk" under the loss causation doctrine too narrowly. Narrowly construed, what caused the losses on the Certificates was default and delinquency by borrowers on the mortgages backing the relevant SLGs. The relevant question, of course, is what caused these instances of default and delinquency. It is in response to this question that the interrelatedness of the underlying undisclosed collateral defects and the macroeconomic factors urged by defendants comes into stark relief.

C. The Seven Securitizations Were Comparatively Small

Defendants argue that their role in the market generally, and with respect to these deals individually, was too small to have contributed in a serious way to the liquidity that fueled the housing bubble. These seven deals, valued at roughly $2.45 billion, represented less than 0.1% of the roughly $3 trillion in PLS issued in the period 2005 to 2007.

Such an approach will not be credited. On defendants' view, each PLS depositor, sponsor, or underwriter in the RMBS market may well have contributed to the housing market collapse and the financial recession through their practices, but, because no single depositor, sponsor, or underwriter can be proved solely or largely responsible, all of them can use those macroeconomic declines to their advantage in a loss causation defense. Unsurprisingly, defendants have not pointed to any legal support for this position. The affirmative defense of loss causation requires a defendant to prove that the loss in the value of the security was proximately caused by events unrelated to the phenomena underlying the alleged misrepresentations. The fact that defendants, along with many others, took part in those phenomena, is not a defense. Unable to show this fundamental unrelatedness, appeals to the *size* of one's own contribution to a larger cause are unavailing.

Defendants bemoan the fact that FHFA's expert Barth would not quantify the precise extent to which the loans at issue in the seven Securitizations contributed to the oversupply of credit in the housing market. But this turns the burden on its head. For FHFA's purposes of rebutting a showing of loss causation, it is enough to call into question whether defendants have succeeded in putting forth a cause of loss independent of the material misrepresentations.

Affirmative quantification would be required on defendants' part, to prove the amount, if any, of the losses attributable to such independent factors. Notably, and indicative of defendants' shortfall in this case, their expert Vandell admitted that he had not undertaken any effort to evaluate how much additional credit went to borrowers as a result of the origination of defective loans, or to apportion the loss to the value of the Certificates to different causes.

D. The Government's Contribution to the Bubble and Recession

Defendants argue that Government regulations and policies, such as those pursued by the GSEs, also contributed to the macroeconomic factors that defendants say caused the losses. The implication, presumably, is that FHFA as a governmental agency and the Government Sponsored Entities on whose behalf it acts should not seek to recover for losses that may have been caused in part by the Government. As has been recounted tirelessly in this litigation, the identity of the plaintiff is wholly irrelevant to the legal issues that were tried here. Defendants were not restricted from offering evidence of the growth of liquidity in the housing market. But what is at stake is the amount of growth overall; not the particular amounts attributable to any one actor. For present purposes, the question is whether defendants persuasively proved that something other than that which was misrepresented in the Offering Documents caused the alleged losses. Defendants did not.

E. Admissions by the FHFA and the GSEs

Defendants used trial testimony from three witnesses who worked at the GSEs, GSE statements made in SEC filings and elsewhere, and court filings on behalf of the GSEs in support their loss causation defense. According to defendants, since the GSEs and FHFA have admitted repeatedly that the collapse in housing prices caused the GSEs to incur losses, they have essentially conceded the loss causation defense offered at this trial.

In particular, defendants contend that the statements by GSE agents in prior lawsuits definitively establish FHFA's position on the issue of losses sustained by these seven Certificates. In other words, defendants argue that, under the doctrine of judicial estoppel, FHFA may not make a different argument to rebut defendants' loss causation defense here.

Judicial estoppel is intended "to protect the integrity of the judicial process by prohibiting parties from deliberately changing positions according to the exigencies of the moment." *Adelphia Recovery Trust v. Goldman, Sachs & Co.* ("*Goldman*"), 748 F.3d 110, 116 (2d Cir. 2014) (citation omitted). "Typically, judicial estoppel will apply if: 1) a party's later position is clearly inconsistent with its earlier position; 2) the party's former position has been adopted in some way by the court in the earlier proceeding; and 3) the party asserting the two positions would derive an unfair advantage against the party seeking estoppel." *In re Adelphia Recovery Trust*, 634 F.3d 678, 695-96 (2d Cir. 2011) (citation omitted). Application of the judicial estoppel doctrine "depends heavily on the specific factual context before the court," and "relief is granted only when the risk of inconsistent results with its impact on judicial integrity is certain." *Goldman*, 748

F.3d at 116. "This latter requirement means that judicial estoppel may only apply where the earlier tribunal accepted the accuracy of the litigant's statements." *In re Adelphia*, 634 F.3d at 696. The Second Circuit has described estoppel as appropriate where the statements at issue are in "irreconcilable direct conflict." *Rodal v. Anesthesia Grp. of Onondaga, P.C.*, 369 F.3d 113, 119 (2d Cir. 2004).

The testimony offered by trial witnesses employed by the GSEs and the GSEs' own documents and filings have been described earlier in the Opinion. None of that evidence contradicts the position taken by FHFA here in its analysis of defendants' loss causation defense. Similarly, statements made in the four prior lawsuits on which defendants rely do not judicially estop FHFA from asserting at this trial that the industry-wide practices in which defendants engaged, and the subject matter of the misrepresentations and omissions in the Offering Documents, contributed to any loss in value of the Certificates.

In the four prior lawsuits on which defendants rely, the GSEs were defending against allegations that their stock prices—a reflection of the GSEs' performance overall (including both their PLS and Single-Family businesses)—had fallen because of the GSEs' own misrepresentations or mismanagement. In mounting their defense, the GSEs sensibly pointed to a systemic economic collapse to argue that the plaintiffs had failed to adequately plead loss causation (as was their burden).

First, in *Ohio Pub. Emps. Ret. Sys. v. Fed. Home Loan Mortg. Corp.*, No. 08cv160 (BYP) (N.D. Ohio), the plaintiff alleged that Freddie Mac and its officers misrepresented the amount of subprime loans that the GSE purchased. 2014 WL 5516374, at *2. In moving to dismiss, Freddie Mac argued that the plaintiffs could not show loss causation because, among other reasons, they "ignor[ed] the single worst financial crisis since the Great Depression" and thus "fail[ed] to allege any facts to exclude the most obvious explanation for Freddie Mac's stock decline—the impact of a dramatic, unprecedented financial markets collapse." Freddie Mac's motion was granted on loss causation grounds—not because the plaintiff failed to account for the market collapse, but because under controlling Sixth Circuit precedent it failed to plead that Freddie Mac made a corrective disclosure or revealed a truth behind any alleged misrepresentation. *Id*. at *9.

Second, in *In re Fed. Home Loan Mortg. Corp. Derivative Litig.*, No. 08cv773 (LMB) (E.D. Va.), prior to initiating derivative suits, the plaintiffs made demands on Freddie Mac's board, which appointed a special litigation committee to investigate. The case was stayed after the court found that the plaintiffs lacked standing, *see* 643 F. Supp. 2d 790, 799 (E.D. Va. 2009), *aff'd sub nom. La. Mun. Police Emps. Ret. Sys. v. FHFA*, 434 F. App'x 188 (4th Cir. 2011), but during the pendency of the stay the committee's investigation continued. The report that resulted, filed as an exhibit in the case, stated that "[m]uch of the Company's losses was a result of the nationwide decline in house prices, which was not foreseen by Company management."

Third, in *Kuriakose v. Fed. Home Loan Mortg. Corp.*, No. 08cv7281 (JFK) (S.D.N.Y.), the plaintiff brought a securities fraud action against Freddie Mac and its officers, asserting that they had materially misrepresented Freddie Mac's exposure to non-prime mortgage products, the sufficiency of its capital, and the strength of its due diligence and quality control mechanisms. 2011 WL 1158028, at *4 (S.D.N.Y. Mar. 30, 2011). In moving to dismiss, Freddie Mac pointed to macroeconomic factors and argued that "[f]ailing to predict the timing and magnitude of a historically unprecedented drop in housing prices and the recent financial crisis is not fraud." The district court dismissed all claims. In dismissing the claims concerning its exposure to loss and capitalization, the court found that the complaint failed to plead a false or misleading statement, or to present facts giving rise to a strong inference of scienter. *Id.* at *11-13. In dismissing the plaintiffs' allegations that Freddie Mac misrepresented the strength of its underwriting standards and internal controls, the court found that the plaintiffs failed to plead that any disclosure of concealed information by Freddie Mac concerning its internal controls supported a theory of loss causation. *Id.* at *13. It further found that, given that "the price of Freddie Mac's stock was clearly linked to the 'marketwide phenomenon' of the housing price collapse, there [was] a decreased probability that Plaintiffs' losses were caused by fraud." *Id.* In summarily affirming the subsequent dismissal of a second amended complaint, the Second Circuit explained that the plaintiff had failed to allege any decline in the price of the GSE's stock that was related to a corrective disclosure regarding the alleged misrepresentations. *Cent. States, Se. & Sw. Areas*

Pension Fund v. Fed. Home Loan Mortg. Corp., 543 F. App'x 72, 74 (2d Cir. 2013).

Finally, in *In re Fannie Mae 2008 Sec. Litig.*, No. 08cv7831 (PAC) (S.D.N.Y.) (about which, as noted earlier, Mudd was questioned during this trial), in moving to dismiss, Fannie Mae argued that the plaintiffs could not show loss causation because "in the historically tumultuous market of late 2007 through 2008, there were a multitude of factors affecting the price of Fannie Mae's securities—most of which were global and market-wide factors not specifically relating to Fannie Mae." The court dismissed all but the plaintiffs' claims related to risk management and internal controls for failure to adequately plead material misrepresentation. In relation to the remaining claims, it held that, "[a]lthough it may be likely that a significant portion, if not all, of Plaintiffs' losses were actually the result of the housing market downturn and not these alleged misstatements," the plaintiffs had still pled a theory of loss causation adequate to survive a motion to dismiss. 742 F. Supp. 2d 382, 414 (S.D.N.Y. 2010).

Here, FHFA is not judicially estopped from presenting its evidence and arguments against defendants' loss causation defense. In this case, FHFA seeks to hold specific parties responsible, under strict liability securities law, for their roles in making misrepresentations in Offering Documents for seven specific Certificates. Arguing that a systemic collapse in housing prices caused a decline in the GSEs' stock price does not conflict with, let alone foreclose, FHFA's claims here or its opposition to defendants' affirmative defense.

There is no dispute that there is a strong correlation between the collapse of housing prices and losses incurred by the GSEs, whose entire existence is devoted to the housing market. The question presented by the loss causation defense in this case, however, when asserted in connection with FHFA's Securities Act claims, is a different one. The question is whether defendants have shown that the macroeconomic events that contributed to a loss in value of the Certificates were unrelated to defective loans whose quality was misrepresented in the Offering Documents. The various statements by the GSEs and FHFA (in prior lawsuits, public filings, and elsewhere) to which defendants point do not assist them in answering that question.

The losses the GSEs suffered on these seven Certificates certainly coincided with a catastrophic market event. The misrepresentations FHFA has shown were made in defendants' Offering Documents have not been persuasively separated from that event. An event cannot be "intervening" if defendants' misrepresentations, and the underlying facts they concealed, were part and parcel of it.

F. Excluded Evidence

As noted above, two of the categories of evidence listed in defendants' April 1 Offer of Proof are testimony from Niculescu and Cook, and evidence concerning Housing Goals and the GSEs' selection of loans in the Securitizations. Defendants contend that this evidence would have been probative with respect to the loss causation defense.

1. Testimony from Neculescu and Cook

FHFA moved *in limine* to preclude defendants from using GSE employee witnesses to provide their opinions regarding the issue of loss causation. In response, as the Offer of Proof recounts, the Court outlined before trial the evidentiary showing that a party would need to make for the admission of lay opinion testimony. *See GSE Loss Causation Opinion*, 2015 WL 685159, at *4; Order of March 4, 2015, ECF Doc. No. 1358. And at the final pretrial conference, the Court explained that what was critical to the receipt of lay opinion testimony was a showing that the employee had a responsibility for developing an opinion regarding the cause of any loss, and not whether the employee was the person who did the research necessary to inform that opinion.

The Offer of Proof lists the subjects concerning loss causation on which defendants were unsuccessful in questioning Niculescu and Cook because the Court sustained FHFA's objections.[198] But, in many instances, an objection was sustained because defendants failed to lay an adequate foundation for the testimony; in other instances, the objection that was sustained was as to form only. The few objections sustained on the basis of relevance were done so in keeping with the Court's prior rulings, for instance, because the question did not relate to losses to the PLS side of the GSEs' businesses. In sum, nothing in

[198] Defendants claim that such testimony would have been relevant not only to loss causation, but also to materiality. The previous discussion of materiality, particularly the emphasis on its objective standard, which does not account for the GSEs' idiosyncrasies, forestalls this claim.

defendants' Offer of Proof indicates that disallowed testimony was admissible and would have aided defendants' loss causation defense.

2. Housing Goals and GSE Selection of Loans in Securitizations

On December 18, 2014, the Court excluded evidence pertaining to the Housing Goals put in place for the GSEs by federal statute and regulations promulgated by the Department of Housing and Urban Development. *Housing Goals Opinion*, at *3-4 (S.D.N.Y. Dec. 18, 2014). The Court rejected defendants' contention that Housing Goals are important to the loss causation defense, explaining:

> The question is not whether the GSEs purchased Certificates backed by particularly risky subprime or Alt-A mortgages. Rather, the question is whether defendants' alleged misrepresentations concerning those loans in their Offering Documents caused losses beyond losses that would have occurred had the loans been as represented—however risky. If defendants represented risky loans accurately, or if the Certificates suffered some or all of their loss in value due to factors other than the purported misrepresentations, then defendants will not be liable for those losses.

Id. at *3.[199]

[199] The Court also rejected defendants' argument that Housing Goals are relevant to materiality, an argument that rested on defendants' view that materiality should be assessed from the perspective of a GSE with broad public missions to support

Defendants' Offer of Proof maintains that absent this ruling, they would have offered evidence that the GSEs' losses were caused by their desire to invest in PLS to meet the agencies' Housing Goals.[200] But the GSEs' motives in making a particular type of investment and the but-for cause of their loss are not at issue here. Indeed, the Offer of Proof does not explain how any of the excluded Housing Goals evidence is relevant. In addition to being irrelevant to the claims and defenses, receipt of such evidence would run afoul of Fed. R. Evid. 403. *Housing Goals Opinion*, 2014 WL 7229361, at *3. Accordingly, nothing in defendants' Offer of Proof causes the Court to doubt the soundness of the December 18 decision to exclude such evidence as irrelevant to the loss causation defense.

For all of the reasons given above, defendants ultimately failed to disentangle, as was their burden on the affirmative defense, what they say caused the losses from the very subjects of the material misrepresentations at issue. Defendants set for themselves the challenging task of proving the counterintuitive proposition that more shoddy origination did not produce worse performing loans. It is unsurprising that they failed to carry that burden.

liquidity and affordability in the market. *Housing Goals Opinion*, 2014 WL 7229361, at *3. For similar reason, on March 10, 2015, the Court excluded evidence concerning the GSEs' selection of loans in the seven Securitizations.

[200] The Offer of Proof states that, but for the contested rulings, defendants would have examined FHFA expert Barth about the contribution of the GSEs to the housing bubble. But defendants were permitted to examine Barth about that topic and did so.

VII. Blue Sky Laws

With respect to four of the seven Securitizations, FHFA has brought suit under the Blue Sky laws of Virginia and the District of Columbia, Va. Code Ann. § 13.1-522(A)(ii); D.C. Code § 31-5606.05(a)(1)(B), (c).[201] FHFA brings claims under the Virginia Blue Sky law against RBS in its capacity as underwriter on the NHELI 2006-FM2, NHELI 2007-1, and NHELI 2007-2 Securitizations. FHFA brings a claim under the D.C. Blue Sky law against NAAC as depositor and Nomura Securities as underwriter on the NAA 2005-AR6 Securitization, and a control person claim against NHA, NCCI as sponsor, and Findlay, Gorin, Graham, and McCarthy.

A. Legal Standards

The Virginia and D.C. Blue Sky laws were modeled on the Uniform Securities Act of 1956, which was in turn modeled on the Securities Act of 1933. *FHFA v. HSBC N. Am. Holdings Inc.*, 988 F. Supp. 2d 363, 370 (S.D.N.Y. 2013). Therefore, it is not surprising that the two Blue Sky laws have similar language, and that courts look to federal law to interpret the similar terms.

The Virginia Blue Sky law provides, in pertinent part, that

> [a]ny person who . . . sells a security by means of an untrue statement of a material fact or

[201] FHFA does not assert Virginia Blue Sky claims with respect to NHELI 2006-FM1 and 2006-HE3, which are time-barred, *see FHFA v. HSBC N. Am. Holdings Inc.*, No. 11cv6189 (DLC), 2014 WL 4276420, at *1 (S.D.N.Y. Aug. 28, 2014), and NHELI 2007-3, whose statutory seller was Lehman Brothers, a nonparty.

> any omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him who may sue either at law or in equity to recover the consideration paid for such security, together with interest thereon at the annual rate of six percent, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of such security, or for the substantial equivalent in damages if he no longer owns the security.

Va. Code Ann. § 13.1-522(A)(ii). The Virginia Blue Sky law has been described as "substantially identical" to the Securities Act. *Dunn v. Borta*, 369 F.3d 421, 428 (4th Cir. 2004). For that reason, "Virginia courts will look to interpretations of the federal securities laws when called upon to construe the Virginia Securities Act." *Id.* at 428 n.17 (citation omitted); *Andrews v. Browne*, 662 S.E.2d 58, 62 (Va. 2008).

The D.C. Blue Sky law provides:

> A person shall be civilly liable to another person who buys a security if the person [o]ffers or sells a security by means of an untrue statement of a material fact or an omission to state a material fact necessary in

> order to make the statement made, in the light of the circumstances under which made, not misleading, the buyer does not know of the untruth or omission and the offeror or seller does not sustain the burden of proof that the offeror or seller did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.
>
> . . .
>
> [A] buyer may sue at law or in equity: To recover the consideration paid for the security, interest at the rate used in the Superior Court of the District of Columbia from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security and any income received on it . . . .

D.C. Code § 31-5606.05(a)(1)(B), (b)(1)(A). Like the Virginia Blue Sky law, the D.C. Blue Sky law is generally interpreted in accordance with Section 12(a)(2). *Hite v. Leeds Weld Equity Partners, IV, LP*, 429 F. Supp. 2d 110, 114 (D.D.C. 2006).

The relevant provisions of the Virginia and D.C. Blue Sky laws are essentially the same as those of Section 12(a)(2), and the same duty to prove falsity and materiality is imposed on FHFA. *Dunn*, 369 F.3d at 428, 433; *Hite*, 429 F. Supp. 2d at 114. Accordingly, here it will suffice to note the ways in which the legal standards applicable to the Blue Sky claims differ from those applicable to the Securities Act claims.

1. Damages

The Virginia and District of Columbia Blue Sky laws both adopt Section 12(a)(2)'s measure of damages. Va. Code Ann. § 13.1-522(A); D.C. Code § 31-5606.05(b)(1)(A). "The formulae differ only in the applicable interest rate." *Riddiough Opinion*, 2015 WL 640875, at *1. Additionally, while Section 12(a)(2) does not expressly provide for recovery of costs and reasonable attorneys' fees, the Blue Sky laws do. Va. Code Ann. § 13.1-522(A); D.C. Code § 31-5606.05(b)(1)(A).

Under the Virginia Blue Sky law, a six-percent interest rate is set by statute. Va. Code Ann. § 13.1-522(A) ("together with interest thereon at the annual rate of six percent"). Similarly, under the D.C. Blue Sky law, the interest rate is the "rate used in the Superior Court of the District of Columbia," D.C. Code § 31-5606.05(b)(1), which is also six percent, *id.* § 28-3302(a) ("The rate of interest in the District upon . . . things in action in the absence of expressed contract, is 6% per annum.").

2. Loss Causation

"[N]either Virginia's nor the District of Columbia's Blue Sky law provides a loss causation defense to the claims at issue." *Ryan Opinion*, 2015 WL 629336, at *2.

3. Control Person Liability

FHFA asserts control person liability not only under Section 15 of the Securities Act, but also under a largely analogous provision of the D.C. Blue Sky law[202]:

> A person who directly or indirectly controls a person liable under subsection (a) of this section; a person occupying a similar status or performing similar functions; an employee of the person liable who materially aids in the conduct giving rise to the liability; and a broker-dealer or agent who materially aids in the conduct shall be liable jointly and severally with, and to the same extent as the person liable, unless he[] or she is able to sustain the burden of proof that he or she did not know, and in exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There shall be contribution among the several persons so liable

D.C. Code § 31-5606.05(c). The notable difference is that the D.C. Blue Sky law renders liable (subject to a reasonable care affirmative defense) officers and directors of the person liable without regard to whether they possessed control.

4. Jurisdictional Elements

Under the Virginia and D.C. Blue Sky laws, FHFA bears the burden of demonstrating that the sales of the Certificates occurred in Virginia and D.C., respectively. Freddie Mac is headquartered in McLean, Virginia, and Fannie Mae is headquartered in Washington, D.C.

[202] FHFA does not assert a control person claim under the Virginia Blue Sky law.

The Uniform Securities Act, substantially adopted by both jurisdictions, by its own terms applies "to persons who sell or offer to sell when (1) an offer to sell is made in this state, or (2) an offer to buy is made and accepted in this state." Unif. Sec. Act (1956) § 414(a). The Uniform Act goes on to say that, "an offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer (1) originates from this state or (2) is directed by the offeror to this state and received at the place to which it is directed." *Id.* § 414(c). While the Virginia Blue Sky law does not contain this language, it "is intended to govern those who sell securities within the state [of Virginia] even though incorporated elsewhere and never entering into the state." *Lintz v. Carey Manor Ltd.*, 613 F. Supp. 543, 550 (W.D. Va. 1985).

The D.C. Blue Sky statute itself provides that it "shall apply to a person who sells, or offers to sell, when an offer to sell is made in the District or an offer to purchase is made and accepted in the District." D.C. Code § 31-5608.01(a). Again, like the Uniform Act, the D.C. statute provides that "an offer to sell or to purchase is made in the District, whether or not either person is present in the District, if the offer originates in the District, or is directed by the offeror to a destination in the District and received where it is directed." *Id.* § 31-5608.01(c).

B. Applying the Blue Sky Laws

Given the substantial similarity between both Blue Sky laws and the relevant provisions of Section 12, the proof of falsity and materiality described above with respect to Section 12 suffices to prove falsity and materiality under the Blue Sky laws. Defendants have not argued to the contrary.

Only the Securitization's direct seller, RBS, is liable under Virginia's Blue Sky law. Under the D.C. Blue Sky law, Nomura Securities and NAAC are liable as direct sellers. Under the D.C. Blue Sky law, Findlay, Graham, Gorin, and McCarthy are liable as control persons due to their positions as officers and directors of NAAC,[203] and NHA and NCCI are liable for the reasons stated above in connection with the discussion of Section 15. Moreover, that which has been said above with respect to the Section 15 affirmative defense applies with equal force to what they could have known with the exercise of reasonable care, thus precluding the affirmative defense under the D.C. Blue Sky law. Any signatory director or officer of NAAC exercising reasonable care under the law and in service of his office could have known of the existence of material misrepresentations in the Offering Documents.

FHFA is awarded damages under the Blue Sky laws in accordance with the damages calculation described above, with the exception that the interest rate applied is the statutorily prescribed 6% interest rate. As of March 31, 2015, those damages are $522,942,248. As double recovery is not permitted, to the extent it seeks Blue Sky damages on a Securitization, FHFA may not also recover on its Section 12 claims for that Securitization.

[203] And, for Findlay and Gorin, due to their positions at Nomura Securities as well.

1. Place of Sale

Defendants offer a single defense unique to the Blue Sky laws. They contend that FHFA did not carry its burden of proving that the sales or offers of sale were directed to persons within Virginia or the District of Columbia. After all, say defendants, that an employee was generally based at a particular location does not mean that the person was necessarily at that location at the time he or she received or sent an email.

When there is no contrary evidence, the location of one's workplace can adequately prove presence in that location while conducting business that would ordinarily take place there. There is sufficient evidence that the offers of sale were directed at and received by individuals who work in the GSEs' headquarters in Virginia and D.C. and that those offers were accepted there. The facts proven at trial thus suffice to establish the jurisdictional prerequisites for both Blue Sky laws.

a. Three Freddie Mac Transactions

Freddie Mac has its principal place of business in McLean, Virginia. This is where Freddie Mac's PLS traders worked between 2005 and 2007, including Hackney and Aneiro, who worked on the three Securitizations.

RBS and Nomura sent offering materials and collateral information regarding each of the three Securitizations to Freddie Mac employees using their Freddie Mac email addresses, to a designated Freddie

Mac email address for the receipt of documents,[204] or to the Freddie Mac business mail address in McLean. This included, for the NHELI 2006-FM2 Certificate, a term sheet, computer records reflecting approval of purchase, and an RBS confirmation of pre-trade details; for the NHELI 2007-1 Certificate, an email with details of the trade, and an RBS confirmation of pre-trade details; and for the NHELI 2007-2 Certificate, e-mails and a physical mailing confirming investment requirements, as well as an email confirming pre-trade details.

b. Fannie Mae Transaction

Fannie Mae has its principal place of business in Washington, D.C., which is where Fannie Mae's PLS traders worked when Fannie Mae purchased the NAA 2005-AR6 Certificate in 2005. Nomura sent offering materials and collateral information for this Securitization to Fannie Mae PLS traders at their work email addresses. Nomura Securities sent its confirmation for the Certificate's purchase to Fannie Mae's physical address in Washington, D.C.

Defendants have offered no affirmative evidence that the offers to sell were not made in and/or accepted in Virginia and D.C. RBS has pointed to the fact that one Freddie Mac trader communicated an agreement to purchase a Certificate from his Blackberry. The implication, apparently, is that the trader must have been using his Blackberry because he was not in the office on that day. It hardly follows from use of a Blackberry that the user is out of the office. Moreover,

[204] It appears to have been routine that "final deal documents" were sent to a departmental account, "abs_docs."

the Blackberry message was for a Certificate other than the three Freddie Mac Certificates on which FHFA is proceeding under the Blue Sky laws. Finally, defendants point to no evidence that any Freddie Mac traders lived anywhere other than the State of Virginia.

Defendants argued that an adverse inference should be drawn against FHFA because it did not bring the traders or other GSE witnesses to New York to testify to the traders' locations at the time they made the decisions to purchase the Certificates. No adverse inference is appropriate. There is sufficient evidence to find that both the offers to sell and the decisions to buy were made in the relevant jurisdiction, and evidence of either one would be sufficient.

2. The Dormant Commerce Clause

Defendants made a last-minute argument that applying the Blue Sky laws here would violate the Dormant Commerce Clause. The argument fails.

For over a century it has been established that state Blue Sky laws do not violate the Dormant Commerce Clause because they "only regulate[] transactions occurring within the regulating States." *Edgar v. MITE Corp.*, 457 U.S. 624, 641 (1982) (citing *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 557-58 (1917)). Indeed, Congress has recognized the validity of intrastate securities laws through a provision in the Securities Exchange Act "designed to save state blue-sky laws from pre-emption." *Edgar*, 457 U.S. at 641 (citation omitted).

Defendants acknowledge this line of precedent, but argue that it was overturned *sub silentio* by

Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010), and *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012), which they claim "set[] forth a new, federal definition of where a transaction occurs." *Morrison* and *Absolute Activist* are the "principal case authority in this Circuit governing the application of § 10(b) and Rule 10b-5 to claims involving *extraterritorial* conduct." *Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 209 (2d Cir. 2014) (emphasis added). The Blue Sky claims do not involve extraterritorial conduct, and a legal standard for cases that do involve such conduct will not be applied.

CONCLUSION

Judgment will issue on the following claims, against the following defendants, as to the following Securitizations:

Securitization	Section 12(a)(2)	Section 15	D.C. Code § 31-5606.05 (a)(1)(b)	D.C. Code § 31-5606.05 (c)	Va. Code Ann. § 13.1-522 (A)(ii)
NAA 2005-AR6	NAAC, Nomura Securities	NHA, NCCI, Individual Defendants	NAAC, Nomura Securities	NHA, NCCI, Findlay, Gorin, Graham, Mc Carthy	

NHELI 2006-FM1	NHELI, Nomura Securities	NHA, NCCI, Individual Defendants			
NHELI 2006-HE3	NHELI, RBS	NHA, NCCI, Individual Defendants			
NHELI 2006-FM2	NHELI, RBS	NHA, NCCI, Individual Defendants			RBS
NHELI 2007-1	NHELI, RBS	NHA, NCCI, Individual Defendants			RBS
NHELI 2007-2	NHELI, RBS	NHA, NCCI, Individual Defendants			RBS
NHELI 2007-3	NHELI	NHA, NCCI, Individual Defendants			

Eighty-two years ago, in the midst of the Great Depression, Congress passed the Securities Act in the hope that “full disclosure of material information,” *Hochfelder*, 425 U.S. at 195, in Offering Documents would “prevent further exploitation of the public by the sale of unsound . . . securities through misrepresentation.” *Loftsgaarden*, 478 U.S. at 659 (citation omitted). Now, in the aftermath of our great recession, FHFA seeks to vindicate those principles. For the reasons stated here, it is entitled to judgment.

An order will issue for FHFA to submit a proposed judgment with updated damages figures calculated under the formulae applied in this Opinion. A schedule will also be set for submissions concerning attorneys' fees.

SO ORDERED:

Dated: New York, New York
May 11, 2015

[handwritten: signature]
DENISE COTE
United States District Judge

Appendix F

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

U.S. Const. amend. VII

In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.

12 U.S.C. §4617

(a) Appointment of the Agency as conservator or receiver

(1) In general

Notwithstanding any other provision of Federal or State law, the Director may appoint the Agency as conservator or receiver for a regulated entity in the manner provided under paragraph (2) or (4). All references to the conservator or receiver under this section are references to the Agency acting as conservator or receiver.

(2) Discretionary appointment

The Agency may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity.

(3) Grounds for discretionary appointment of conservator or receiver

The grounds for appointing conservator or receiver for any regulated entity under paragraph (2) are as follows:

(A) Assets insufficient for obligations

The assets of the regulated entity are less than the obligations of the regulated entity to its creditors and others.

(B) Substantial dissipation

Substantial dissipation of assets or earnings due to—

(i) any violation of any provision of Federal or State law; or

(ii) any unsafe or unsound practice.

(C) Unsafe or unsound condition

An unsafe or unsound condition to transact business.

(D) Cease and desist orders

Any willful violation of a cease and desist order that has become final.

(E) Concealment

Any concealment of the books, papers, records, or assets of the regulated entity, or any refusal to submit the books, papers, records, or affairs of the regulated entity, for inspection to any examiner or to any lawful agent of the Director.

(F) Inability to meet obligations

The regulated entity is likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business.

(G) Losses

The regulated entity has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the regulated entity to become adequately capitalized (as defined in section 4614(a)(1) of this title).

(H) Violations of law

Any violation of any law or regulation, or any unsafe or unsound practice or condition that is likely to—

(i) cause insolvency or substantial dissipation of assets or earnings; or

(ii) weaken the condition of the regulated entity.

(I) Consent

The regulated entity, by resolution of its board of directors or its shareholders or members, consents to the appointment.

(J) Undercapitalization

The regulated entity is undercapitalized or significantly undercapitalized (as defined in section 4614(a)(3) of this title), and—

(i) has no reasonable prospect of becoming adequately capitalized;

(ii) fails to become adequately capitalized, as required by—

(I) section 4615(a)(1) of this title with respect to a regulated entity; or

(II) section 4616(a)(1) of this title with respect to a significantly undercapitalized regulated entity;

(iii) fails to submit a capital restoration plan acceptable to the Agency within the time prescribed under section 4622 of this title; or

(iv) materially fails to implement a capital restoration plan submitted and accepted under section 4622 of this title.

(K) Critical undercapitalization

The regulated entity is critically undercapitalized, as defined in section 4614(a)(4) of this title.

(L) Money laundering

The Attorney General notifies the Director in writing that the regulated entity has been found guilty of a criminal offense under section 1956 or 1957 of title 18 or section 5322 or 5324 of title 31.

(4) Mandatory receivership

(A) In general

The Director shall appoint the Agency as receiver for a regulated entity if the Director determines, in writing, that—

(i) the assets of the regulated entity are, and during the preceding 60 calendar days have been, less than the obligations of the regulated entity to its creditors and others; or

(ii) the regulated entity is not, and during the preceding 60 calendar days has not been, generally paying the debts of the regulated entity (other than debts that are the subject of a bona fide dispute) as such debts become due.

(B) Periodic determination required for critically undercapitalized regulated entity

If a regulated entity is critically undercapitalized, the Director shall make a determination, in writing, as to whether the regulated entity meets the criteria specified in clause (i) or (ii) of subparagraph (A)—

(i) not later than 30 calendar days after the regulated entity initially becomes critically undercapitalized; and

(ii) at least once during each succeeding 30-calendar day period.

(C) Determination not required if receivership already in place

Subparagraph (B) does not apply with respect to a regulated entity in any period during which the Agency serves as receiver for the regulated entity.

(D) Receivership terminates conservatorship

The appointment of the Agency as receiver of a regulated entity under this section shall immediately terminate any conservatorship established for the regulated entity under this chapter.

(5) Judicial review

(A) In general

If the Agency is appointed conservator or receiver under this section, the regulated entity may, within 30 days of such appointment, bring an action in the United States district court for the judicial district in which the home office of such regulated entity is located, or in the United States District Court for the District of Columbia, for an order requiring the Agency to remove itself as conservator or receiver.

(B) Review

Upon the filing of an action under subparagraph (A), the court shall, upon the merits, dismiss such action or direct the Agency to remove itself as such conservator or receiver.

(6) Directors not liable for acquiescing in appointment of conservator or receiver

The members of the board of directors of a regulated entity shall not be liable to the shareholders or creditors of the regulated entity for acquiescing in or consenting in good faith to the appointment of the Agency as conservator or receiver for that regulated entity.

(7) Agency not subject to any other Federal agency

When acting as conservator or receiver, the Agency shall not be subject to the direction or supervision of any other agency of the United States or any State in the exercise of the rights, powers, and privileges of the Agency.

(b) Powers and duties of the Agency as conservator or receiver

(1) Rulemaking authority of the agency

The Agency may prescribe such regulations as the Agency determines to be appropriate regarding the conduct of conservatorships or receiverships.

(2) General powers

(A) Successor to regulated entity

The Agency shall, as conservator or receiver, and by operation of law, immediately succeed to—

(i) all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity; and

(ii) title to the books, records, and assets of any other legal custodian of such regulated entity.

(B) Operate the regulated entity

The Agency may, as conservator or receiver—

(i) take over the assets of and operate the regulated entity with all the powers of the shareholders, the directors, and the officers of the regulated entity and conduct all business of the regulated entity;

(ii) collect all obligations and money due the regulated entity;

(iii) perform all functions of the regulated entity in the name of the regulated entity which are consistent with the appointment as conservator or receiver;

(iv) preserve and conserve the assets and property of the regulated entity; and

(v) provide by contract for assistance in fulfilling any function, activity, action, or duty of the Agency as conservator or receiver.

(C) Functions of officers, directors, and shareholders of a regulated entity

The Agency may, by regulation or order, provide for the exercise of any function by any stockholder, director, or officer of any regulated entity for which the Agency has been named conservator or receiver.

(D) Powers as conservator

The Agency may, as conservator, take such action as may be—

(i) necessary to put the regulated entity in a sound and solvent condition; and

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.

(E) Additional powers as receiver

In any case in which the Agency is acting as receiver, the Agency shall place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity in such manner as the Agency deems appropriate, including through the sale of assets, the transfer of assets to a limited-life regulated entity established under subsection (i), or the exercise of any other rights or privileges granted to the Agency under this paragraph.

(F) Organization of new enterprise

The Agency may, as receiver for an enterprise, organize a successor enterprise that will operate pursuant to subsection (i).

(G) Transfer or sale of assets and liabilities

The Agency may, as conservator or receiver, transfer or sell any asset or liability of the regulated entity in default, and may do so without any approval, assignment, or consent with respect to such transfer or sale.

(H) Payment of valid obligations

The Agency, as conservator or receiver, shall, to the extent of proceeds realized from the performance of contracts or sale of the assets of a regulated entity, pay all valid obligations of the regulated entity that are due and payable at the time of the appointment of the Agency as conservator or receiver, in accordance with the prescriptions and limitations of this section.

(I) Subpoena authority

(i) In general

(I) Agency authority

The Agency may, as conservator or receiver, and for purposes of carrying out any power, authority, or duty with respect to a regulated entity (including determining any claim against the regulated entity and determining and realizing upon any asset of any person in the course of collecting money due the regulated entity), exercise any power established under section 4588 of this title.

(II) Applicability of law

The provisions of section 4588 of this title shall apply with respect to the exercise of any power under this subparagraph, in the same manner as such provisions apply under that section.

(ii) Subpoena

A subpoena or subpoena duces tecum may be issued under clause (i) only by, or with the written approval of, the Director, or the designee of the Director.

(iii) Rule of construction

This subsection shall not be construed to limit any rights that the Agency, in any capacity, might otherwise have under section 4517 or 4639 of this title.

(J) Incidental powers

The Agency may, as conservator or receiver—

(i) exercise all powers and authorities specifically granted to conservators or receivers, respectively, under this section, and such incidental powers as shall be necessary to carry out such powers; and

(ii) take any action authorized by this section, which the Agency determines is in the best interests of the regulated entity or the Agency.

(K) Other provisions

(i) Shareholders and creditors of failed regulated entity

Notwithstanding any other provision of law, the appointment of the Agency as receiver for a regulated entity pursuant to paragraph (2) or (4) of subsection (a) and its succession, by operation of law, to the rights, titles, powers, and privileges described in subsection (b)(2)(A) shall terminate all rights and claims that the stockholders and creditors of the regulated entity may have against the assets or charter of the regulated entity or the Agency arising as a result of their status as stockholders or creditors, except for their right to payment, resolution, or other satisfaction of their claims, as permitted under subsections (b)(9), (c), and (e).

(ii) Assets of regulated entity

Notwithstanding any other provision of law, for purposes of this section, the charter of a regulated entity shall not be considered an asset of the regulated entity.

(3) Authority of receiver to determine claims

(A) In general

The Agency may, as receiver, determine claims in accordance with the requirements of this subsection and any regulations prescribed under paragraph (4).

(B) Notice requirements

The receiver, in any case involving the liquidation or winding up of the affairs of a closed regulated entity, shall—

(i) promptly publish a notice to the creditors of the regulated entity to present their claims, together with proof, to the receiver by a date specified in the notice which shall be not less than 90 days after the date of publication of such notice; and

(ii) republish such notice approximately 1 month and 2 months, respectively, after the date of publication under clause (i).

(C) Mailing required

The receiver shall mail a notice similar to the notice published under subparagraph (B)(i) at the time of such publication to any creditor shown on the books of the regulated entity—

(i) at the last address of the creditor appearing in such books; or

(ii) upon discovery of the name and address of a claimant not appearing on the books of the regulated entity, within 30 days after the discovery of such name and address.

(4) Rulemaking authority relating to determination of claims

Subject to subsection (c), the Director may prescribe regulations regarding the allowance or disallowance of claims by the receiver and providing for administrative determination of claims and review of such determination.

(5) Procedures for determination of claims

(A) Determination period

(i) In general

Before the end of the 180-day period beginning on the date on which any claim against a regulated entity is filed with the Agency as receiver, the Agency shall determine whether to allow or disallow the claim and shall notify the claimant of any determination with respect to such claim.

(ii) Extension of time

The period described in clause (i) may be extended by a written agreement between the claimant and the Agency.

(iii) Mailing of notice sufficient

The requirements of clause (i) shall be deemed to be satisfied if the notice of any determination with respect to any claim is mailed to the last address of the claimant which appears—

(I) on the books of the regulated entity;

(II) in the claim filed by the claimant; or

(III) in documents submitted in proof of the claim.

(iv) Contents of notice of disallowance

If any claim filed under clause (i) is disallowed, the notice to the claimant shall contain—

(I) a statement of each reason for the disallowance; and

(II) the procedures available for obtaining agency review of the determination to disallow the claim or judicial determination of the claim.

(B) Allowance of proven claim

The receiver shall allow any claim received on or before the date specified in the notice published under paragraph (3)(B)(i) by the receiver from any claimant which is proved to the satisfaction of the receiver.

(C) Disallowance of claims filed after filing period

Claims filed after the date specified in the notice published under paragraph (3)(B)(i), or the date specified under paragraph (3)(C), shall be disallowed and such disallowance shall be final.

(D) Authority to disallow claims

(i) In general

The receiver may disallow any portion of any claim by a creditor or claim of security, preference, or priority which is not proved to the satisfaction of the receiver.

(ii) Payments to less than fully secured creditors

In the case of a claim of a creditor against a regulated entity which is secured by any property or other asset of such regulated entity, the receiver—

(I) may treat the portion of such claim which exceeds an amount equal to the fair market value of such property or other asset as an unsecured claim against the regulated entity; and

(II) may not make any payment with respect to such unsecured portion of the claim, other than in connection with the disposition of all claims of unsecured creditors of the regulated entity.

(iii) Exceptions

No provision of this paragraph shall apply with respect to—

(I) any extension of credit from any Federal Reserve Bank, Federal Home Loan Bank, or the United States Treasury; or

(II) any security interest in the assets of the regulated entity securing any such extension of credit.

(E) No judicial review of determination pursuant to subparagraph (D)

No court may review the determination of the Agency under subparagraph (D) to disallow a claim.

(F) Legal effect of filing

(i) Statute of limitation tolled

For purposes of any applicable statute of limitations, the filing of a claim with the receiver shall constitute a commencement of an action.

(ii) No prejudice to other actions

Subject to paragraph (10), the filing of a

claim with the receiver shall not prejudice any right of the claimant to continue any action which was filed before the date of the appointment of the receiver, subject to the determination of claims by the receiver.

(6) Provision for judicial determination of claims

(A) In general

The claimant may file suit on a claim (or continue an action commenced before the appointment of the receiver) in the district or territorial court of the United States for the district within which the principal place of business of the regulated entity is located or the United States District Court for the District of Columbia (and such court shall have jurisdiction to hear such claim), before the end of the 60-day period beginning on the earlier of—

(i) the end of the period described in paragraph (5)(A)(i) with respect to any claim against a regulated entity for which the Agency is receiver; or

(ii) the date of any notice of disallowance of such claim pursuant to paragraph (5)(A)(i).

(B) Statute of limitations

A claim shall be deemed to be disallowed (other than any portion of such claim which was allowed by the receiver), and such disallowance shall be final, and the claimant shall have no further rights or remedies with respect to such claim, if the claimant fails, before the end of the 60-day period described under subparagraph (A), to file suit on such claim (or continue an action commenced before the appointment of the receiver).

(7) Review of claims

(A) Other review procedures

(i) In general

The Agency shall establish such alternative dispute resolution processes as may be appropriate for the resolution of claims filed under paragraph (5)(A)(i).

(ii) Criteria

In establishing alternative dispute resolution processes, the Agency shall strive for procedures which are expeditious, fair, independent, and low cost.

(iii) Voluntary binding or nonbinding procedures

The Agency may establish both binding and nonbinding processes under this subparagraph, which may be conducted by any government or private party. All parties, including the claimant and the Agency, must agree to the use of the process in a particular case.

(B) Consideration of incentives

The Agency shall seek to develop incentives for claimants to participate in the alternative dispute resolution process.

(8) Expedited determination of claims

(A) Establishment required

The Agency shall establish a procedure for expedited relief outside of the routine claims process established under paragraph (5) for claimants who—

(i) allege the existence of legally valid and enforceable or perfected security interests in assets of any regulated entity for which the Agency has been appointed receiver; and

(ii) allege that irreparable injury will occur if the routine claims procedure is followed.

(B) Determination period

Before the end of the 90-day period beginning on the date on which any claim is filed in accordance with the procedures established under subparagraph (A), the Director shall—

(i) determine—

(I) whether to allow or disallow such claim; or

(II) whether such claim should be determined pursuant to the procedures established under paragraph (5); and

(ii) notify the claimant of the determination, and if the claim is disallowed, provide a statement of each reason for the disallowance and the procedure for obtaining agency review or judicial determination.

(C) Period for filing or renewing suit

Any claimant who files a request for expedited relief shall be permitted to file a suit, or to continue a suit filed before the date of appointment of the receiver, seeking a determination of the rights of the claimant with respect to such security interest after the earlier of—

(i) the end of the 90-day period beginning on the date of the filing of a request for expedited relief; or

(ii) the date on which the Agency denies the claim.

(D) Statute of limitations

If an action described under subparagraph (C) is not filed, or the motion to renew a previously filed suit is not made, before the end of the 30-day period beginning on the date on which such action or motion may be filed under subparagraph (B), the claim shall be deemed to be disallowed as of the end of such period (other than any portion of such claim which was allowed by the receiver), such disallowance shall be final, and the claimant shall have no further rights or remedies with respect to such claim.

(E) Legal effect of filing

(i) Statute of limitation tolled

For purposes of any applicable statute of limitations, the filing of a claim with the receiver shall constitute a commencement of an action.

(ii) No prejudice to other actions

Subject to paragraph (10), the filing of a claim with the receiver shall not prejudice any right of the claimant to continue any action that was filed before the appointment of the receiver, subject to the determination of claims by the receiver.

(9) Payment of claims

(A) In general

The receiver may, in the discretion of the receiver, and to the extent that funds are available from the assets of the regulated entity, pay creditor claims, in such manner and amounts as are authorized under this section, which are—

(i) allowed by the receiver;

(ii) approved by the Agency pursuant to a final determination pursuant to paragraph (7) or (8); or

(iii) determined by the final judgment of any court of competent jurisdiction.

(B) Agreements against the interest of the Agency

No agreement that tends to diminish or defeat the interest of the Agency in any asset acquired by the Agency as receiver under this section shall be valid against the Agency unless such agreement is in writing and executed by an authorized officer or representative of the regulated entity.

(C) Payment of dividends on claims

The receiver may, in the sole discretion of the receiver, pay from the assets of the regulated entity dividends on proved claims at any time, and no liability shall attach to the Agency by reason of any such payment, for failure to pay dividends to a claimant whose claim is not proved at the time of any such payment.

(D) Rulemaking authority of the Director

The Director may prescribe such rules, including definitions of terms, as the Director deems appropriate to establish a single uniform interest rate for, or to make payments of post-insolvency interest to creditors holding proven claims against the receivership estates of the regulated entity, following satisfaction by the receiver of the principal amount of all creditor claims.

(10) Suspension of legal actions

(A) In general

After the appointment of a conservator or receiver for a regulated entity, the conservator or receiver may, in any judicial action or proceeding to which such regulated entity is or becomes a party, request a stay for a period not to exceed—

(i) 45 days, in the case of any conservator; and

(ii) 90 days, in the case of any receiver.

(B) Grant of stay by all courts required

Upon receipt of a request by the conservator or receiver under subparagraph (A) for a stay of any judicial action or proceeding in any court with jurisdiction of such action or proceeding, the court shall grant such stay as to all parties.

(11) Additional rights and duties

(A) Prior final adjudication

The Agency shall abide by any final unappealable judgment of any court of competent jurisdiction which was rendered before the appointment of the Agency as conservator or receiver.

(B) Rights and remedies of conservator or receiver

In the event of any appealable judgment, the Agency as conservator or receiver—

(i) shall have all of the rights and remedies available to the regulated entity (before the appointment of such conservator or receiver) and the Agency, including removal to Federal court and all appellate rights; and

(ii) shall not be required to post any bond in order to pursue such remedies.

(C) No attachment or execution

No attachment or execution may issue by any court upon assets in the possession of the receiver, or upon the charter, of a regulated entity for which the Agency has been appointed receiver.

(D) Limitation on judicial review

Except as otherwise provided in this subsection, no court shall have jurisdiction over—

(i) any claim or action for payment from, or any action seeking a determination of rights with respect to, the assets or charter of any regulated entity for which the Agency has been appointed receiver; or

(ii) any claim relating to any act or omission of such regulated entity or the Agency as receiver.

(E) Disposition of assets

In exercising any right, power, privilege, or authority as conservator or receiver in connection with any sale or disposition of assets of a regulated entity for which the Agency has been appointed conservator or receiver, the Agency shall conduct its operations in a manner which—

(i) maximizes the net present value return from the sale or disposition of such assets;

(ii) minimizes the amount of any loss realized in the resolution of cases; and

(iii) ensures adequate competition and fair and consistent treatment of offerors.

(12) Statute of limitations for actions brought by conservator or receiver

(A) In general

Notwithstanding any provision of any contract, the applicable statute of limitations with regard to any action brought by the Agency as conservator or receiver shall be—

(i) in the case of any contract claim, the longer of—

(I) the 6-year period beginning on the date on which the claim accrues; or

(II) the period applicable under State law; and

(ii) in the case of any tort claim, the longer of—

(I) the 3-year period beginning on the date on which the claim accrues; or

(II) the period applicable under State law.

(B) Determination of the date on which a claim accrues

For purposes of subparagraph (A), the date on which the statute of limitations begins to run on any claim described in such subparagraph shall be the later of—

(i) the date of the appointment of the Agency as conservator or receiver; or

(ii) the date on which the cause of action accrues.

(13) Revival of expired state causes of action

(A) In general

In the case of any tort claim described under clause (ii) for which the statute of limitations applicable under State law with respect to such claim has expired not more than 5 years before the appointment of the Agency as conservator or receiver, the Agency may bring an action as conservator or receiver on such claim without regard to the expiration of the statute of limitations applicable under State law.

(B) Claims described

A tort claim referred to under clause (i) is a claim arising from fraud, intentional misconduct resulting in unjust enrichment, or intentional misconduct resulting in substantial loss to the regulated entity.

(14) Accounting and recordkeeping requirements

(A) In general

The Agency as conservator or receiver shall, consistent with the accounting and reporting practices and procedures established by the Agency, maintain a full accounting of each conservatorship and receivership or other disposition of a regulated entity in default.

(B) Annual accounting or report

With respect to each conservatorship or receivership, the Agency shall make an annual accounting or report available to the Board, the Comptroller General of the United States, the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives.

(C) Availability of reports

Any report prepared under subparagraph (B) shall be made available by the Agency upon request to any shareholder of a regulated entity or any member of the public.

(D) Recordkeeping requirement

After the end of the 6-year period beginning on the date on which the conservatorship or receivership is terminated by the Director, the Agency may destroy any records of such regulated entity which the Agency, in the discretion of the Agency, determines to be unnecessary, unless directed not to do so by a court of competent jurisdiction or governmental agency, or prohibited by law.

(15) Fraudulent transfers

(A) In general

The Agency, as conservator or receiver, may avoid a transfer of any interest of an entity-affiliated party, or any person determined by the conservator or receiver to be a debtor of the regulated entity, in property, or any obligation incurred by such party or person, that was made within 5 years of the date on which the Agency was appointed conservator or receiver, if such party or person voluntarily or involuntarily made such transfer or incurred such liability with the intent to hinder, delay, or defraud the regulated entity, the Agency, the conservator, or receiver.

(B) Right of recovery

To the extent a transfer is avoided under subparagraph (A), the conservator or receiver may recover, for the benefit of the regulated entity, the property transferred, or, if a court so orders, the value of such property (at the time of such transfer) from—

(i) the initial transferee of such transfer or the entity-affiliated party or person for whose benefit such transfer was made; or

(ii) any immediate or mediate transferee of any such initial transferee.

(C) Rights of transferee or obligee

The conservator or receiver may not recover under subparagraph (B) from—

(i) any transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith; or

(ii) any immediate or mediate good faith transferee of such transferee.

(D) Rights under this paragraph

The rights under this paragraph of the conservator or receiver described under subparagraph (A) shall be superior to any rights of a trustee or any other party (other than any party which is a Federal agency) under title 11.

(16) Attachment of assets and other injunctive relief

Subject to paragraph (17), any court of competent jurisdiction may, at the request of the conservator or receiver, issue an order in accordance with rule 65 of the Federal Rules of Civil Procedure, including an order placing the assets of any person designated by the conservator or receiver under the control of the court, and appointing a trustee to hold such assets.

(17) Standards of proof

Rule 65 of the Federal Rules of Civil Procedureshall apply with respect to any proceeding under paragraph (16) without regard to the requirement of such rule that the applicant show that the injury, loss, or damage is irreparable and immediate.

(18) Treatment of claims arising from breach of contracts executed by the conservator or receiver

(A) In general

Notwithstanding any other provision of this subsection, any final and unappealable judgment for monetary damages entered against the conservator or receiver for the breach of an agreement executed or approved in writing by the conservator or receiver after the date of its appointment, shall be paid as an administrative expense of the conservator or receiver.

(B) No limitation of power

Nothing in this paragraph shall be construed to limit the power of the conservator or receiver to exercise any rights under contract or law, including to terminate, breach, cancel, or otherwise discontinue such agreement.

(19) General exceptions

(A) Limitations

The rights of the conservator or receiver appointed under this section shall be subject to the limitations on the powers of a receiver under sections 4402 through 4407 of this title.[1]

(B) Mortgages held in trust

(i) In general

Any mortgage, pool of mortgages, or interest in a pool of mortgages held in trust, custodial, or agency capacity by a regulated entity for the benefit of any person other than the regulated entity shall not be available to satisfy the claims of creditors generally, except that nothing in this clause shall be construed to expand or otherwise affect the authority of any regulated entity.

(ii) Holding of mortgages

Any mortgage, pool of mortgages, or interestin a pool of mortgages described in clause (i) shall be held by the conservator or receiver appointed under this section for the beneficial owners of such mortgage, pool of mortgages, or interest in accordance with the terms of the agreement creating such trust, custodial, or other agency arrangement.

(iii) Liability of conservator or receiver

The liability of the conservator or receiver appointed under this section for damages shall, in the case of any contingent or unliquidated claim relating to the mortgages held in trust, be estimated in accordance with the regulations of the Director.

(c) Priority of expenses and unsecured claims

(1) In general

[1] See References in Text note below.

Unsecured claims against a regulated entity, or the receiver therefor, that are proven to the satisfaction of the receiver shall have priority in the following order:

(A) Administrative expenses of the receiver.

(B) Any other general or senior liability of the regulated entity (which is not a liability described under subparagraph (C) or (D).[2]

(C) Any obligation subordinated to general creditors (which is not an obligation described under subparagraph (D)).

(D) Any obligation to shareholders or members arising as a result of their status as shareholder or members.

(2) Creditors similarly situated

All creditors that are similarly situated under paragraph (1) shall be treated in a similar manner, except that the receiver may take any action (including making payments) that does not comply with this subsection, if—

(A) the Director determines that such action is necessary to maximize the value of the assets of the regulated entity, to maximize the present value return from the sale or other disposition of the assets of the regulated entity, or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the regulated entity; and

[2] So in original. A second closing parenthesis probably should precede the period.

(B) all creditors that are similarly situated under paragraph (1) receive not less than the amount provided in subsection (e)(2).

(3) Definition

As used in this subsection, the term "administrative expenses of the receiver" includes—

(A) the actual, necessary costs and expenses incurred by the receiver in preserving the assets of a failed regulated entity or liquidating or otherwise resolving the affairs of a failed regulated entity; and

(B) any obligations that the receiver determines are necessary and appropriate to facilitate the smooth and orderly liquidation or other resolution of the regulated entity.

(d) Provisions relating to contracts entered into before appointment of conservator or receiver

(1) Authority to repudiate contracts

In addition to any other rights a conservator or receiver may have, the conservator or receiver for any regulated entity may disaffirm or repudiate any contract or lease—

(A) to which such regulated entity is a party;

(B) the performance of which the conservator or receiver, in its sole discretion, determines to be burdensome; and

(C) the disaffirmance or repudiation of which the conservator or receiver determines, in its sole discretion, will promote the orderly administration of the affairs of the regulated entity.

(2) Timing of repudiation

The conservator or receiver shall determine whether or not to exercise the rights of repudiation under this subsection within a reasonable period following such appointment.

(3) Claims for damages for repudiation

(A) In general

Except as otherwise provided under subparagraph (C) and paragraphs (4), (5), and (6), the liability of the conservator or receiverfor the disaffirmance or repudiation of any contract pursuant to paragraph (1) shall be—

(i) limited to actual direct compensatory damages; and

(ii) determined as of—

(I) the date of the appointment of the conservator or receiver; or

(II) in the case of any contract or agreement referred to in paragraph (8), the date of the disaffirmance or repudiation of such contract or agreement.

(B) No liability for other damages

For purposes of subparagraph (A), the term "actual direct compensatory damages" shall not include—

(i) punitive or exemplary damages;

(ii) damages for lost profits or opportunity; or

(iii) damages for pain and suffering.

(C) Measure of damages for repudiation of financial contracts

In the case of any qualified financial contract or agreement to which paragraph (8) applies, compensatory damages shall be—

(i) deemed to include normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims; and

(ii) paid in accordance with this subsection and subsection (e), except as otherwise specifically provided in this section.

(4) Leases under which the regulated entity is the lessee

(A) In general

If the conservator or receiver disaffirms or repudiates a lease under which the regulated entity was the lessee, the conservator or receiver shall not be liable for any damages (other than damages determined under subparagraph (B)) for the disaffirmance or repudiation of such lease.

(B) Payments of rent

Notwithstanding subparagraph (A), the lessor under a lease to which that subparagraph applies shall—

(i) be entitled to the contractual rent accruing before the later of the date on which—

(I) the notice of disaffirmance or repudiation is mailed; or

(II) the disaffirmance or repudiation becomes effective, unless the lessor is in default or breach of the terms of the lease;

(ii) have no claim for damages under any acceleration clause or other penalty provision in the lease; and

(iii) have a claim for any unpaid rent, subject to all appropriate offsets and defenses, due as of the date of the appointment, which shall be paid in accordance with this subsection and subsection (e).

(5) Leases under which the regulated entity is the lessor

(A) In general

If the conservator or receiver repudiates an unexpired written lease of real property of the regulated entity under which the regulated entity is the lessor and the lessee is not, as of the date of such repudiation, in default, the lessee under such lease may either—

(i) treat the lease as terminated by such repudiation; or

(ii) remain in possession of the leasehold interest for the balance of the term of the lease, unless the lessee defaults under the terms of the lease after the date of such repudiation.

(B) Provisions applicable to lessee remaining in possession

If any lessee under a lease described under subparagraph (A) remains in possession of a leasehold interest under clause (ii) of subparagraph (A)—

(i) the lessee—

(I) shall continue to pay the contractual rent pursuant to the terms of the lease after the date of the repudiation of such lease; and

(II) may offset against any rent payment which accrues after the date of the repudiation of the lease, and any damages which accrue after such date due to the nonperformance of any obligation of the regulated entity under the lease after such date; and

(ii) the conservator or receiver shall not be liable to the lessee for any damages arising after such date as a result of the repudiation, other than the amount of any offset allowed under clause (i)(II).

(6) Contracts for the sale of real property

(A) In general

If the conservator or receiver repudiates any contract for the sale of real property and the purchaser of such real property under such contract is in possession, and is not, as of the date of such repudiation, in default, such purchaser may either—

(i) treat the contract as terminated by such repudiation; or

(ii) remain in possession of such real property.

(B) Provisions applicable to purchaser remaining in possession

If any purchaser of real property under any contract described under subparagraph (A) remains in possession of such property under clause (ii) of subparagraph (A)—

(i) the purchaser—

(I) shall continue to make all payments due under the contract after the date of the repudiation of the contract; and

(II) may offset against any such payments any damages which accrue after such date due to the nonperformance (after such date) of any obligation of the regulated entity under the contract; and

(ii) the conservator or receiver shall—

(I) not be liable to the purchaser for any damages arising after such date as a result of the repudiation, other than the amount of any offset allowed under clause (i)(II);

(II) deliver title to the purchaser in accordance with the provisions of the contract; and

(III) have no obligation under the contract other than the performance required under subclause (II).

(C) Assignment and sale allowed

(i) In general

No provision of this paragraph shall be construed as limiting the right of the conservator or receiver to assign the contract described under subparagraph (A), and sell the property subject to the contract and the provisions of this paragraph.

(ii) No liability after assignment and sale

If an assignment and sale described under clause (i) is consummated, the conservator or receiver shall have no further liability under the contract described under subparagraph (A), or with respect to the real property which was the subject of such contract.

(7) Service contracts

(A) Services performed before appointment

In the case of any contract for services between any person and any regulated entity for which the Agency has been appointed conservator or receiver, any claim of such person for services performed before the appointment of the conservator or receiver shall be—

(i) a claim to be paid in accordance with subsections (b) and (e); and

(ii) deemed to have arisen as of the date on which the conservator or receiver was appointed.

(B) Services performed after appointment and prior to repudiation

If, in the case of any contract for services described under subparagraph (A), the conservator or receiver accepts performance by the other person before the conservator or receiver makes any determination to exercise the right of repudiation of such contract under this section—

(i) the other party shall be paid under the terms of the contract for the services performed; and

(ii) the amount of such payment shall be treated as an administrative expense of the conservatorship or receivership.

(C) Acceptance of performance no bar to subsequent repudiation

The acceptance by the conservator or receiver of services referred to under subparagraph (B) in connection with a contract described in such subparagraph shall not affect the right of the conservator or receiver to repudiate such contract under this section at any time after such performance.

(8) Certain qualified financial contracts

(A) Rights of parties to contracts

Subject to paragraphs (9) and (10), and notwithstanding any other provision of this chapter (other than subsection (b)(9)(B) of this section), any other Federal law, or the law of any State, no person shall be stayed or prohibited from exercising—

(i) any right of that person to cause the termination, liquidation, or acceleration of any qualified financial contract with a regulated entity that arises upon the appointment of the Agency as receiver for such regulated entity at any time after such appointment;

(ii) any right under any security agreement or arrangement or other credit enhancement relating to one or more qualified financial contracts; or

(iii) any right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more contracts and agreements described in clause (i), including any master agreement for such contracts or agreements.

(B) Applicability of other provisions

Subsection (b)(10) shall apply in the case of any judicial action or proceeding brought against any receiver referred to under subparagraph (A), or the regulated entity for which such receiver was appointed, by any party to a contract or agreement described under subparagraph (A)(i) with such regulated entity.

(C) Certain transfers not avoidable

(i) In general

Notwithstanding paragraph (11), or any other provision of Federal or State law relating to the avoidance of preferential or fraudulent transfers, the Agency, whether acting as such or as conservator or receiver of a regulated entity, may not avoid any transfer of money or other property in connection with any qualified financial contract with a regulated entity.

(ii) Exception for certain transfers

Clause (i) shall not apply to any transfer of money or other property in connection with any qualified financial contract with a regulated entity if the Agency determines that the transferee had actual intent to hinder, delay, or defraud such regulated entity, the creditors of such regulated entity, or any conservator or receiver appointed for such regulated entity.

(D) Certain contracts and agreements defined

In this subsection the following definitions shall apply:

(i) Qualified financial contract

The term "qualified financial contract" means any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the Agency determines by regulation, resolution, or order to be a qualified financial contract for purposes of this paragraph.

(ii) Securities contract

The term "securities contract"—

(I) means a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, or any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including any interest therein or based on the value thereof) or any option on any of the foregoing, including any option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option;

(II) does not include any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan, unless the Agency determines by regulation, resolution, or order to include any such agreement within the meaning of such term;

(III) means any option entered into on a national securities exchange relating to foreign currencies;

(IV) means the guarantee by or to any securities clearing agency of any settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, certificates of deposit, or mortgage loans or interests therein (including any interest therein or based on the value thereof) or option on any of the foregoing, including any option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option;

(V) means any margin loan;

(VI) means any other agreement or transaction that is similar to any agreement or transaction referred to in this clause;

(VII) means any combination of the agreements or transactions referred to in this clause;

(VIII) means any option to enter into any agreement or transaction referred to in this clause;

(IX) means a master agreement that provides for an agreement or transaction referred to in subclause (I), (III), (IV), (V), (VI), (VII), or (VIII), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this clause, except that the master agreement shall be considered to be a securities contract under this clause only with respect to each agreement or transaction under the master agreement that is referred to in subclause (I), (III), (IV), (V), (VI), (VII), or (VIII); and

(X) means any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this clause, including any guarantee or reimbursement obligationin connection with any agreement or transaction referred to in this clause.

(iii) Commodity contract

The term "commodity contract" means—

(I) with respect to a futures commission merchant, a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;

(II) with respect to a foreign futures commission merchant, a foreign future;

(III) with respect to a leverage transaction merchant, a leverage transaction;

(IV) with respect to a clearing organization, a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization;

(V) with respect to a commodity options dealer, a commodity option;

(VI) any other agreement or transaction that is similar to any agreement or transaction referred to in this clause;

(VII) any combination of the agreements or transactions referred to in this clause;

(VIII) any option to enter into any agreement or transaction referred to in this clause;

(IX) a master agreement that provides for an agreement or transaction referred to in subclause (I), (II), (III), (IV), (V), (VI), (VII), or (VIII), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a commodity contract under this clause, except that the master agreement shall be considered to be a commodity contract under this clause only with respect to each agreement or transaction under the master agreement that is referred to in subclause (I), (II), (III), (IV), (V), (VI), (VII), or (VIII); or

(X) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this clause, including anyguarantee or reimbursement obligationin connection with any agreement or transaction referred to in this clause.

(iv) Forward contract

The term "forward contract" means—

(I) a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than 2 days after the date on which the contract is entered into, including a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement;

(II) any combination of agreements or transactions referred to in subclauses (I) and (III);

(III) any option to enter into any agreement or transaction referred to insubclause (I) or (II);

(IV) a master agreement that provides for an agreement or transaction referred to in subclauses (I), (II), or (III), together with all supplements to any such masteragreement, without regard to whether the master agreement provides for an agreement or transaction that is not a forward contract under this clause, except that the master agreement shall be considered to be a forward contract under this clause only with respect to each agreement or transaction under the master agreement that is referred to in subclause (I), (II), or (III); or

(V) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in subclause (I), (II), (III), or (IV), including any guarantee or reimbursement obligation in connection with any agreement or transaction referred to in any such subclause.

(v) Repurchase agreement

The term "repurchase agreement" (including a reverse repurchase agreement)—

(I) means an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage-related securities (as such term is defined in section 78c of title 15), mortgage loans, interests in mortgage-related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined for purposes of this clause as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development, as determined by regulation or order adopted by the appropriate Federal banking authority), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests as described above, at a date certain not later than 1 year after such transfers or on demand, against the transfer of funds, or any other similar agreement;

(II) does not include any repurchase obligation under a participation in a commercial mortgage loan, unless the Agency determines by regulation, resolution, or order to include any such participation within the meaning of such term;

(III) means any combination of agreements or transactions referred to in subclauses

(I) and (IV);

(IV) means any option to enter into any agreement or transaction referred to in subclause (I) or (III);

(V) means a master agreement that provides for an agreement or transaction referred to in subclause (I), (III), or (IV), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a repurchase agreement under this clause, except that the master agreement shall be considered to be a repurchase agreement under this subclause only with respect to each agreement or transaction under the master agreement that is referred to in subclause (I), (III), or (IV); and

(VI) means any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in subclause (I), (III), (IV), or (V), including any guarantee or reimbursement obligation in connection with any agreement or transaction referred to in any such subclause.

(vi) Swap agreement

The term “swap agreement” means—

(I) any agreement, including the terms and conditions incorporated by reference in any such agreement, which is an interestrate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap; a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metals agreement; a currency swap, option, future, or forward agreement; an equity index or equity swap, option, future, or forward agreement; a debt index or debt swap, option, future, or forward agreement; a total return, credit spread or credit swap, option, future, or forward agreement; a commodity index or commodity swap, option, future, or forward agreement; or a weather swap, weather derivative, or weather option;

(II) any agreement or transaction that is similar to any other agreement or transaction referred to in this clause and that is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets (including terms and conditions incorporated by reference in such agreement) and that is a forward, swap, future, or option on one or more rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(III) any combination of agreements or transactions referred to in this clause;

(IV) any option to enter into any agreement or transaction referred to inthis clause;

(V) a master agreement that provides for an agreement or transaction referred to in subclause (I), (II), (III), or (IV), together with all supplements to any such master agreement, without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this clause, except that the master agreement shall be considered to be a swap agreement under this clause only with respect to each agreement or transaction under the master agreement that is referred to in subclause (I), (II), (III), or (IV); and

(VI) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in subclause (I), (II), (III), (IV), or (V), including any guarantee or reimbursement obligation in connection with any agreement or transaction referred to in any such subclause.

(vii) Treatment of master agreement as one agreement

Any master agreement for any contract or agreement described in any preceding clause of this subparagraph (or any master agreement for such master agreement or agreements), together with all supplements to such master agreement, shall be treated as a single agreement and a single qualified financial contract. If a master agreement contains provisions relating to agreements or transactions that are not themselves qualified financial contracts, the master agreement shall be deemed to be a qualified financial contract only with respect to those transactions that are themselves qualified financial contracts.

(viii) Transfer

The term "transfer" means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the equity of redemption of the regulated entity.

(E) Certain protections in event of appointment of conservator

Notwithstanding any other provision of this section, any other Federal law, or the law of any State (other than paragraph (10) of this subsection and subsection (b)(9)(B)), no person shall be stayed or prohibited from exercising—

(i) any right such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a regulated entity in a conservatorship based upon a default under such financial contract which is enforceable under applicable noninsolvency law;

(ii) any right under any security agreement or arrangement or other credit enhancement relating to 1 or more such qualified financial contracts; or

(iii) any right to offset or net out any termination values, payment amounts, or other transfer obligations arising under or in connection with such qualified financial contracts.

(F) Clarification

No provision of law shall be construed as limiting the right or power of the Agency, or authorizing any court or agency to limit or delay in any manner, the right or power of the Agency to transfer any qualified financial contract in accordance with paragraphs (9) and (10), or to disaffirm or repudiate any such contract in accordance with subsection (d)(1).

(G) Walkaway clauses not effective

(i) In general

Notwithstanding the provisions of subparagraphs (A) and (E), and sections 4403 and 4404 of this title, no walkaway clause shall be enforceable in a qualified financial contract of a regulated entity in default.

(ii) Walkaway clause defined

For purposes of this subparagraph, the term "walkaway clause" means a provision in a qualified financial contract that, after calculation of a value of a party's position or an amount due to or from 1 of the parties in accordance with its terms upon termination, liquidation, or acceleration of the qualified financial contract, either does not create a payment obligation of a party or extinguishes a payment obligation of a party in whole or in part solely because of the status of such party as a nondefaulting party.

(9) Transfer of qualified financial contracts

In making any transfer of assets or liabilities of a regulated entity in default which includes any qualified financial contract, the conservator or receiver for such regulated entity shall either—

(A) transfer to 1 person—

(i) all qualified financial contracts between any person (or any affiliate of such person) and the regulated entity in default;

(ii) all claims of such person (or any affiliate of such person) against such regulated entity under any such contract (other than any claim which, under the terms of any such contract, is subordinated to the claims of general unsecured creditors of such regulated entity);

(iii) all claims of such regulated entity against such person (or any affiliate of such person) under any such contract; and

(iv) all property securing, or any other credit enhancement for any contract described in clause (i), or any claim described in clause (ii) or (iii) under any such contract; or

(B) transfer none of the financial contracts, claims, or property referred to under subparagraph (A) (with respect to such person and any affiliate of such person).

(10) Notification of transfer

(A) In general

The conservator or receiver shall notify any person that is a party to a contract or transfer by 5:00 p.m. (Eastern Standard Time) on the business day following the date of the appointment of the receiver in the case of a receivership, or the business day following such transfer in the case of a conservatorship, if—

(i) the conservator or receiver for a regulated entity in default makes any transferof the assets and liabilities of such regulated entity; and

(ii) such transfer includes any qualified financial contract.

(B) Certain rights not enforceable

(i) Receivership

A person who is a party to a qualified financial contract with a regulated entity may not exercise any right that such person has to terminate, liquidate, or net such contract under paragraph (8)(A) of this subsection or under section 4403 or 4404 of this title, solely by reason of or incidentalto the appointment of a receiver for the regulated entity (or the insolvencyor financial condition of the regulated entity for which the receiver has been appointed)—

(I) until 5:00 p.m. (Eastern Standard Time) on the business day following the date of the appointment of the receiver; or

(II) after the person has received notice that the contract has been transferred pursuant to paragraph (9)(A).

(ii) Conservatorship

A person who is a party to a qualified financial contract with a regulated entity may not exercise any right that such person has to terminate, liquidate, or net such contract under paragraph (8)(E) of this subsection or under section 4403 or 4404 of this title, solely by reason of or incidental to the appointment of a conservator for the regulated entity (or the insolvency or financial condition of the regulated entity for which the conservator has been appointed).

(iii) Notice

For purposes of this paragraph, the conservator or receiver of a regulated entity shall be deemed to have notified a person who is a party to a qualified financial contract with such regulated entity, if the conservator or receiver has taken steps reasonably calculated to provide notice to such person by the time specified in subparagraph (A).

(C) Business day defined

For purposes of this paragraph, the term "business day" means any day other than any Saturday, Sunday, or any day on which either the New York Stock Exchange or the Federal Reserve Bank of New York is closed.

(11) Disaffirmance or repudiation of qualified financial contracts

In exercising the rights of disaffirmance or repudiation of a conservator or receiver with respect to any qualified financial contract to which a regulated entity is a party, the conservator or receiver for such institution shall either—

(A) disaffirm or repudiate all qualified financial contracts between—

(i) any person or any affiliate of such person; and

(ii) the regulated entity in default; or

(B) disaffirm or repudiate none of the qualified financial contracts referred to in subparagraph (A) (with respect to such person or any affiliate of such person).

(12) Certain security interests not avoidable

No provision of this subsection shall be construed as permitting the avoidance of any legally enforceable or perfected security interest in any of the assets of any regulated entity, except where such an interest is taken in contemplation of the insolvency of the regulated entity, or with the intent to hinder, delay, or defraud the regulated entity or the creditors of such regulated entity.

(13) Authority to enforce contracts

(A) In general

Notwithstanding any provision of a contract providing for termination, default, acceleration, or exercise of rights upon, or solely by reason of, insolvency or the appointment of, or the exercise of rights or powers by, a conservator or receiver, the conservator or receiver may enforce any contract, other than a contract for liability insurance for a director or officer, or a contract or a regulated entity bond, entered into by the regulated entity.

(B) Certain rights not affected

No provision of this paragraph may be construed as impairing or affecting any right of the conservator or receiver to enforce or recover under a liability insurance contract for an officer or director, or regulated entity bond under other applicable law.

(C) Consent requirement

(i) In general

Except as otherwise provided under this section, no person may exercise any right or power to terminate, accelerate, or declare a default under any contract to which a regulated entity is a party, or to obtain possession of or exercise control over any property of the regulated entity, or affect any contractual rights of the regulated entity, without the consent of the conservator or receiver, as appropriate, for a period of—

(I) 45 days after the date of appointment of a conservator; or

(II) 90 days after the date of appointment of a receiver.

(ii) Exceptions

This subparagraph shall not—

(I) apply to a contract for liability insurance for an officer or director;

(II) apply to the rights of parties to certain qualified financial contracts under subsection (d)(8); and

(III) be construed as permitting the conservator or receiver to fail to comply with otherwise enforceable provisions of such contracts.

(14) Savings clause

The meanings of terms used in this subsection are applicable for purposes of this subsection only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any similar terms under any other statute, regulation, or rule, including the Gramm-Leach-Bliley Act, the Legal Certainty for Bank Products Act of 2000 [7 U.S.C. 27 to 27f], the securities laws (as that term is defined in section 78c(a)(47) of title 15), and the Commodity Exchange Act [7 U.S.C. 1 et seq.].

(15) Exception for Federal Reserve and Federal Home Loan Banks

No provision of this subsection shall apply with respect to—

(A) any extension of credit from any Federal Home Loan Bank or Federal Reserve Bank to any regulated entity; or

(B) any security interest in the assets of the regulated entity securing any such extension of credit.

(e) Valuation of claims in default

(1) In general

Notwithstanding any other provision of Federal law or the law of any State, and regardless of the method which the Agency determines to utilize with respect to a regulated entity in default or in danger of default, including transactions authorized under subsection (i), this subsection shall govern the rights of the creditors of such regulated entity.

(2) Maximum liability

The maximum liability of the Agency, acting as receiver or in any other capacity, to any person having a claim against the receiver or the regulated entity for which such receiver is appointed shall be not more than the amount that such claimant would have received if the Agency had liquidated the assets and liabilities of the regulated entity without exercising the authority of the Agency under subsection (i).

(f) Limitation on court action

Except as provided in this section or at the request of the Director, no court may take any action to restrain or affect the exercise of powers or functions of the Agency as a conservator or a receiver.

(g) Liability of directors and officers

(1) In general

A director or officer of a regulated entity may be held personally liable for monetary damages in any civil action described in paragraph (2) brought by, on behalf of, or at the request or direction of the Agency, and prosecuted wholly or partially for the benefit of the Agency—

(A) acting as conservator or receiver of such regulated entity; or

(B) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator.

(2) Actions addressed

Paragraph (1) applies in any civil action for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care than gross negligence, including intentional tortious conduct, as such terms are defined and determined under applicable State law.

(3) No limitation

Nothing in this subsection shall impair or affect any right of the Agency under other applicable law.

(h) Damages

In any proceeding related to any claim against a director, officer, employee, agent, attorney, accountant, appraiser, or any other party employed by or providing services to a regulated entity, recoverable damages determined to result from the improvident or otherwise improper use or investment of any assets of the regulated entity shall include principal losses and appropriate interest.

(i) Limited-life regulated entities

(1) Organization

(A) Purpose

The Agency, as receiver appointed pursuant to subsection (a)—

(i) may, in the case of a Federal Home Loan Bank, organize a limited-life regulated entity with those powers and attributes of the Federal Home Loan Bank in default or in danger of default as the Director determines necessary, subject to the provisions of this subsection, and the Director shall grant a temporary charter to that limited-life regulated entity, and that limited-life regulated entity may operate subject to that charter; and

(ii) shall, in the case of an enterprise, organize a limited-life regulated entity with respect to that enterprise in accordance with this subsection.

(B) Authorities

Upon the creation of a limited-life regulated entity under subparagraph (A), the limited-life regulated entity may—

(i) assume such liabilities of the regulated entity that is in default or in danger of default as the Agency may, in its discretion, determine to be appropriate, except that the liabilities assumed shall not exceed the amount of assets purchased or transferred from the regulated entity to the limited-life regulated entity;

(ii) purchase such assets of the regulated entity that is in default, or in danger of default as the Agency may, in its discretion, determine to be appropriate; and

(iii) perform any other temporary function which the Agency may, in its discretion, prescribe in accordance with this section.

(2) Charter and establishment

(A) Transfer of charter

(i) Fannie Mae

If the Agency is appointed as receiver for the Federal National Mortgage Association, the limited-life regulated entity established under this subsection with respect to such enterprise shall, by operation of law and immediately upon its organization—

(I) succeed to the charter of the Federal National Mortgage Association, as set forth in the Federal National Mortgage Association Charter Act [12 U.S.C. 1716 et seq.]; and

(II) thereafter operate in accordance with, and subject to, such charter, this Act, and any other provision of law to which the Federal National Mortgage Association is subject, except as otherwise provided in this subsection.

(ii) Freddie Mac

If the Agency is appointed as receiver for the Federal Home Loan Mortgage Corporation, the limited-life regulated entity established under this subsection with respect to such enterprise shall, by operation of law and immediately upon its organization—

(I) succeed to the charter of the Federal Home Loan Mortgage Corporation, as set forth in the Federal Home Loan Mortgage Corporation Charter Act[1] [12 U.S.C. 1451 et seq.]; and

(II) thereafter operate in accordance with, and subject to, such charter, this Act, and any other provision of law to which the Federal Home Loan Mortgage Corporation is subject, except as otherwise provided in this subsection.

(B) Interests in and assets and obligations of regulated entity in default

Notwithstanding subparagraph (A) or any other provision of law—

(i) a limited-life regulated entity shall assume, acquire, or succeed to the assets or liabilities of a regulated entity only to the extent that such assets or liabilities are transferred by the Agency to the limited-life regulated entity in accordance with, and subject to the restrictions set forth in, paragraph (1)(B);

(ii) a limited-life regulated entity shall not assume, acquire, or succeed to any obligation that a regulated entity for which a receiver has been appointed may have to any shareholder of the regulated entity that arises as a result of the status of that person as a shareholder of the regulated entity; and

(iii) no shareholder or creditor of a regulated entity shall have any right or claim against the charter of the regulated entity once the Agency has been appointed receiver for the regulated entity and a limited- life regulated entity succeeds to the charter pursuant to subparagraph (A).

(C) Limited-life regulated entity treated as being in default for certain purposes

A limited-life regulated entity shall be treated as a regulated entity in default at such times and for such purposes as the Agency may, in its discretion, determine.

(D) Management

Upon its establishment, a limited-life regulated entity shall be under the management of a board of directors consisting of not fewer than 5 nor more than 10 members appointed by the Agency.

(E) Bylaws

The board of directors of a limited-life regulated entity shall adopt such bylaws as may be approved by the Agency.

(3) Capital stock

(A) No agency requirement

The Agency is not required to pay capital stock into a limited-life regulated entity or to issue any capital stock on behalf of a limited- life regulated entity established under this subsection.

(B) Authority

If the Director determines that such action is advisable, the Agency may cause capital stock or other securities of a limited-life regulated entity established with respect to an enterprise to be issued and offered for sale, in such amounts and on such terms and conditions as the Director may determine, in the discretion of the Director.

(4) Investments

Funds of a limited-life regulated entity shall be kept on hand in cash, invested in obligations of the United States or obligations guaranteed as to principal and interest by the United States, or deposited with the Agency, or any Federal reserve bank.

(5) Exempt tax status

Notwithstanding any other provision of Federal or State law, a limited-life regulated entity, its franchise, property, and income shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority.

(6) Winding up

(A) In general

Subject to subparagraphs (B) and (C), not later than 2 years after the date of its organization, the Agency shall wind up the affairs of a limited-life regulated entity.

(B) Extension

The Director may, in the discretion of the Director, extend the status of a limited-life regulated entity for 3 additional 1-year periods.

(C) Termination of status as limited-life regulated entity

(i) In general

Upon the sale by the Agency of 80 percent or more of the capital stock of a limited-life regulated entity, as defined in clause (iv), to 1 or more persons (other than the Agency)—

(I) the status of the limited-life regulated entity as such shall terminate; and

(II) the entity shall cease to be a limited-life regulated entity for purposes of this subsection.

(ii) Divestiture of remaining stock, if any

(I) In general

Not later than 1 year after the date on which the status of a limited-life regulated entity is terminated pursuant to clause (i), the Agency shall sell to 1 or more persons (other than the Agency) any remaining capital stock of the former limited-life regulated entity.

(II) Extension authorized

The Director may extend the period referred to in subclause (I) for not longer than an additional 2 years, if the Director determines that such action would be in the public interest.

(iii) Savings clause

Notwithstanding any provision of law, other than clause (ii), the Agency shall not be required to sell the capital stock of an enterprise or a limited-life regulated entity established with respect to an enterprise.

(iv) Applicability

This subparagraph applies only with respect to a limited-life regulated entity that is established with respect to an enterprise.

(7) Transfer of assets and liabilities

(A) In general

(i) Transfer of assets and liabilities

The Agency, as receiver, may transfer any assets and liabilities of a regulated entity in default, or in danger of default, to the limited-life regulated entity in accordance with and subject to the restrictions of paragraph (1).

(ii) Subsequent transfers

At any time after the establishment of a limited-life regulated entity, the Agency, as receiver, may transfer any assets and liabilities of the regulated entity in default, or in danger of default, as the Agency may, in its discretion, determine to be appropriate in accordance with and subject to the restrictions of paragraph (1).

(iii) Effective without approval

The transfer of any assets or liabilities of a regulated entity in default or in danger of default to a limited-life regulated entity shall be effective without any further approval under Federal or State law, assignment, or consent with respect thereto.

(iv) Equitable treatment of similarly situated creditors

The Agency shall treat all creditors of a regulated entity in default or in danger of default that are similarly situated under subsection (c)(1) in a similar manner in exercising the authority of the Agency under this subsection to transfer any assets or liabilities of the regulated entity to the limited-life regulated entity established with respect to such regulated entity, except that the Agency may take actions (including making payments) that do not comply with this clause, if—

(I) the Director determines that such actions are necessary to maximize the value of the assets of the regulated entity, to maximize the present value return from the sale or other disposition of the assets of the regulated entity, or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the regulated entity; and

(II) all creditors that are similarly situated under subsection (c)(1) receive not less than the amount provided in subsection (e)(2).

(v) Limitation on transfer of liabilities

Notwithstanding any other provision of law, the aggregate amount of liabilities of a regulated entity that are transferred to, or assumed by, a limited-life regulated entity may not exceed the aggregate amount of assets of the regulated entity that are transferred to, or purchased by, the limited-life regulated entity.

(8) Regulations

The Agency may promulgate such regulations as the Agency determines to be necessary or appropriate to implement this subsection.

(9) Powers of limited-life regulated entities

(A) In general

Each limited-life regulated entity created under this subsection shall have all corporate powers of, and be subject to the same provisions of law as, the regulated entity in default or in danger of default to which it relates, except that—

(i) the Agency may—

(I) remove the directors of a limited-life regulated entity;

(II) fix the compensation of members of the board of directors and senior management, as determined by the Agency in its discretion, of a limited-life regulated entity; and

(III) indemnify the representatives for purposes of paragraph (1)(B), and the directors, officers, employees, and agents of a limited-life regulated entity on such terms as the Agency determines to be appropriate; and

(ii) the board of directors of a limited-life regulated entity—

(I) shall elect a chairperson who may also serve in the position of chief executive officer, except that such person shall not serve either as chairperson or as chief executive officer without the prior approval of the Agency; and

(II) may appoint a chief executive officer who is not also the chairperson, except that such person shall not serve as chief executive officer without the prior approval of the Agency.

(B) Stay of judicial action

Any judicial action to which a limited-life regulated entity becomes a party by virtue of its acquisition of any assets or assumption of any liabilities of a regulated entity in default shall be stayed from further proceedings for a period of not longer than 45 days, at the request of the limited-life regulated entity. Such period may be modified upon the consent of all parties.

(10) No Federal status

(A) Agency status

A limited-life regulated entity is not an agency, establishment, or instrumentality of the United States.

(B) Employee status

Representatives for purposes of paragraph (1)(B), interim directors, directors, officers, employees, or agents of a limited-life regulated entity are not, solely by virtue of service in any such capacity, officers or employees of the United States. Any employee of the Agency or of any Federal instrumentality who serves at the request of the Agency as a representative for purposes of paragraph(1)(B), interim director, director, officer, employee, or agent of a limited-life regulated entity shall not—

(i) solely by virtue of service in any such capacity lose any existing status as an officer or employee of the United States for purposes of title 5 or any other provision of law; or

(ii) receive any salary or benefits for service in any such capacity with respect to a limited-life regulated entity in addition to such salary or benefits as are obtained through employment with the Agency or such Federal instrumentality.

(11) Authority to obtain credit

(A) In general

A limited-life regulated entity may obtain unsecured credit and issue unsecured debt.

(B) Inability to obtain credit

If a limited-life regulated entity is unable to obtain unsecured credit or issue unsecured debt, the Director may authorize the obtaining of credit or the issuance of debt by the limited-life regulated entity—

(i) with priority over any or all of the obligations of the limited-life regulated entity;

(ii) secured by a lien on property of the limited-life regulated entity that is not otherwise subject to a lien; or

(iii) secured by a junior lien on property of the limited-life regulated entity that is subject to a lien.

(C) Limitations

(i)[3] In general

The Director, after notice and a hearing, may authorize the obtaining of credit or the issuance of debt by a limited-life regulated entity that is secured by a senior or equal lien on property of the limited-life regulated entity that is subject to a lien (other than mortgages that collateralize the mortgage-backed securities issued or guaranteed by an enterprise) only if—

[3] So in original. No cl. (ii) has been enacted.

(I) the limited-life regulated entity is unable to otherwise obtain such credit or issue such debt; and

(II) there is adequate protection of the interest of the holder of the lien on the property with respect to which such senior or equal lien is proposed to be granted.

(D) Burden of proof

In any hearing under this subsection, the Director has the burden of proof on the issue of adequate protection.

(12) Effect on debts and liens

The reversal or modification on appeal of an authorization under this subsection to obtain credit or issue debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so issued, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the issuance of such debt, or the granting of such priority or lien, were stayed pending appeal.

(j) Other Agency exemptions

(1) Applicability

The provisions of this subsection shall apply with respect to the Agency in any case in which the Agency is acting as a conservator or a receiver.

(2) Taxation

The Agency, including its franchise, its capital,reserves, and surplus, and its income, shall be exempt from all taxation imposed by any State, county, municipality, or local taxing authority, except that any real property of the Agency shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed, except that, notwithstanding the failure of any person to challenge an assessment under State law of the value of such property, and the tax thereon, shall be determined as of the period for which such tax is imposed.

(3) Property protection

No property of the Agency shall be subject to levy, attachment, garnishment, foreclosure, or sale without the consent of the Agency, nor shall any involuntary lien attach to the property of the Agency.

(4) Penalties and fines

The Agency shall not be liable for any amounts in the nature of penalties or fines, including those arising from the failure of any person to pay any real property, personal property, probate, or recording tax or any recording or filing fees when due.

(k) Prohibition of charter revocation

In no case may the receiver appointed pursuant to this section revoke, annul, or terminate the charter of an enterprise.