August 16, 2012

SEC TAGS BANK AND COLLATERAL MANAGER OF FAILED CDO WITH SECURITY VIOLATIONS

The SEC this month added yet another CDO to the list of failed CDO securities that have warranted civil penalties for the banks and others involved. The CDO was Delphinus CDO 2007-1 ("Delphinus"), a $1.6 billion offering issued in July 2007 as the housing market was collapsing. Mizuho Securities USA, Inc., which structured, marketed, and obtained ratings for Delphinus, settled by agreeing to pay $127,500,000 in disgorgement, interest and penalties. The SEC also took the less common step of pursuing the collateral manager for Delphinus. Delaware Asset Advisors ("DAA") agreed to disgorge its fees of $2,228,372, as well as pay a civil penalty in the same amount, plus interest.

The SEC focused on a discrete aspect of the Delphinus transaction, involving false statements made to Standard and Poor's ("S&P") on the evening before Delphinus closed. On the day before the scheduled closing, S&P changed its criteria for rating Residential Mortgage Backed Securities ("RMBS"). This change negatively affected many of the RMBS that Mizuho and/or DAA had already purchased for the Delphinus portfolio. To disguise this fact, and to ensure that Delphinus would close, Mizuho sent dummy portfolios to S&P (i.e., securities indicative of the final portfolio that S&P should use for the rating), and S&P rated Delphinus based on dummy assets that Mizuho and DAA knew had a superior credit quality to the assets in the actual portfolio. Without this bait and switch, Delphinus would not have been rated and would never have issued.

The SEC's decision to highlight Mizuho's bait and switch tactic is understandable. However, the more problematic aspect of Delphinus is whether it was purposely designed to be a vehicle to permit Magnetar, a large hedge fund, to short the housing market. Although not disclosed, Delphinus appears to have been a Magnetar deal. If Delphinus followed the pattern of other Magnetar deals, Magnetar likely worked closely with Mizuho and DAA to select a weak portfolio of RMBS in order that Magnetar could profit by taking a short position. In the typical pattern, Magnetar invested in the equity tranche and shorted the higher tranches.

Mizuho and DAA marketed Delphinus as a rated investment product that would deliver bond-like returns, above the returns for similarly-rated corporate bonds, but with lower risk. In fact, Delphinus appears to have been designed to short a housing market that was beginning to collapse. It is probably no accident that Delphinus was marketed principally to investors outside the United States, who were removed from the immediacy of the impending crisis foreseen by insiders.

Investors would be well advised to check their portfolios for Delphinus as well as other CDO Magnetar deals constructed by the same individual who put together Delphinus. These include Orion 2006-1, Pyxis ABS CDO 2006-1, Cetus ABS CDO 2006-3, Orion 2006-2, Volans Funding 2007-1 and Tigris CDO 2007-1.

At least one piece of unfinished business remains open regarding Delphinus. A string of internal S&P e-mails released by the U.S. Senate in 2010 strongly suggest that S&P became aware of Mizuho's bait and switch within days, but did nothing, choosing to let the AAA rating stand, even though S&P managers knew the rating was obtained by fraud. Published reports state that the SEC served S&P with a Wells notice in connection with its rating of Delphinus. None of the public proceedings thus far mention S&P, so this is an issue worth watching.

Investors in Delphinus are likely to have excellent grounds to bring a fraud claim against Mizuho, and fraud and breach of contract claims against DAA. The SEC proceedings provide strong support for the view that Mizuho and DAA engaged in actual fraud to obtain the necessary ratings from S&P. Investors also may have a separate claim against DAA for breach of contract. DAA, as the collateral manager, had obligations pursuant to its collateral management contract to manage Delphinus in a proper fashion. The SEC administrative action states that DAA and its employees participated in knowingly providing inaccurate information to S&P, and to the trustee of Delphinus. Such actions would likely constitute a breach of the collateral management contract. In addition to the foregoing, DAA may have abdicated its responsibility to select collateral for the benefit of the investors in Delphinus. As noted, Magnetar's standard operating procedure was to influence the selection of collateral to benefit its position as the party shorting Delphinus. Whether that happened with Delphinus or the other Magnetar CDO's remains a subject for inquiry.

For further information or advice regarding these issues, please contact:
Eric Lewis at eric.lewis@lewisbaach.com or +1.202.659.7203
Bruce Grace at bruce.grace@lewisbaach.com or +1.202.659.6742

The foregoing is for informational purposes only. It is not intended as legal advice and no attorney-client relationship is formed by the provision of this information.