Forbes

Halah Touryalai, Forbes Staff
I stalk Wall Street. Stopping short of phone hacking, of course.

INVESTING | 2/08/2013 @ 9:03PM | 2,828 views

Eric Schneiderman Is The Biggest Threat To S&P, Moody's And Fitch

If S&P thought this week's lawsuit from the Justice Department was a problem wait until the New York Attorney General figures out a way to sue the agency.

New York Attorney General Eric Schneiderman has something the Feds and other AGs don't have: The Martin Act.

Earlier this week the United States Department of Justice sued Standard & Poor's for giving top-notch ratings to mortgage securities it knew were toxic in order to win business. This same week NY Attorney General Eric Schneiderman quietly launched his own investigation into the credit rating agency–one that could become more damning than the Fed's case.

The federal suit received a lot of attention in the industry for a couple of reasons. For one thing, it only went after one credit rating agency leaving the two other major firms, Fitch and Moody's, out of its complaint. There's been no indication as to why but plenty of chatter that the Feds may be singling out S&P because of its downgrade of U.S. credit in 2011.

Another reason the Fed's complaint received extra attention was that it seemed to be suing S&P on behalf of federally insured financial institutions, or banks. Banks like Citigroup, Bank of America and JPMorgan Chase were defrauded by S&P's manipulated ratings on mortgage securities, the Department of Justice argues in its complaint. If that seems a little odd that's because it is.

Many of those same banks were underwriting the very toxic loans that were packaged into mortgage securities and then rated by S&P and others. But the Justice Department argues that S&P was giving the securities high ratings to keep the business of banks who pay them for ratings.

Here's how *Bloomberg*'s Jonathan Weil puts it:

> Under the government's theory, Citigroup and Bank of America paid S&P for ratings that convinced the banks their own CDO offal was rock-solid. And because S&P deceived them into thinking the best of their own rubbish, these banks and other lenders suffered more than $5 billion of investment losses, according to the suit.

Then there's the fact that the DoJ filed a civil, not criminal, suit against S&P. That's less of a mystery though since civil suits are easier to win than criminal ones. The DoJ brought its suit under the Financial Institutions Reform, Recovery, and Enforcement Act which protects federally backed financial firms from fraud; it has a low burden of proof and long statute of limitations. *Reuters* notes that previously unsuccessful criminal inquiries prompted the DoJ to try a new path in the way it goes after firms involved in the crisis.

Enter New York Attorney General Eric Schneiderman. He's launched his own investigation of credit rating agencies and could build a case much more powerful and damaging than the Department of Justice's. His office has subpoenaed S&P and requested information from Moody's and Fitch, according to a source. That makes the whole thing a lot more interesting.

Why? Well, for one thing Schneiderman and the Department of Justice seem to be after the same thing but they're acting on their own. That's noteworthy because Schneiderman leads a state-federal task force created by President Obama. The task force's mission is to bring together state and federal agencies including the DoJ to collectively investigate fraud in the mortgage securities market. That task force helped bring the $11.2 lawsuit against Credit Suisse in November–a suit led by Schneiderman's office.

Why then did the DoJ and Schneiderman go their separate ways in the credit rating agencies investigations? It may have to do with a 2008 agreement that former New York Attorney General and current Governor Andrew Cuomo made with the three ratings agencies. That agreement said there would be no investigations or lawsuits against the ratings agencies by the NY AG so long as they agreed to and did not violate reforms.

The agreement ended in 2011 but it was enough to complicate matters and prevent Schneiderman's office from leading the charge on one big case against the ratings agencies like the one against S&P.

That's unfortunate for the DoJ in a way; had Schneiderman been left in charge he could have sued under a much more powerful law dubbed the Martin Act which makes it easier to prosecute fraud. New York's Martin Act was signed in 1921, prior to major federal securities laws, to protect against fraudulent stock schemes.

The Martin Act is fierce in that it can preempt federal law and it does not require the New York Attorney General to prove that defendants acted with *intent* to defraud, only that they acted negligently. The other zinger: Schneiderman could bring criminal charges under the Martin Act and still wouldn't have to prove intent to defraud. That's a big advantage for the NY AG and one the Feds do not have in its case against S&P.

Don't count Schneiderman out of the credit rating crusade just yet though. Schneiderman is no stranger to striking out on his own. He was a big thorn in big banks' sides during the nationwide foreclosure settlement. Had it not been for Scheiderman's opposition to an early agreement that prevented individual states from suing banks in the future the foreclosure settlement would have likely ended much sooner than it did and for less money.

He's already subpoenaed S&P and has been in touch with Moody's and Fitch which means he's gathering information for a possible case of his own. "As a former Assistant Attorney General in the N.Y. Attorney General's Office of Investor Protection and Financial Crimes, under both Eliot Spitzer and his predecessor, I know that office does not issue such high profile Martin Act subpoenas without careful consideration," says New York attorney Stuart Meissner.

If Schneiderman finds a way to get around the 2008 Cuomo agreement (by finding that the agencies violated the terms, for instance) and push his own case forward he could make the DoJ's civil case look a lot less ominous. Sources familiar with the New York Attorney's General investigation and the DoJ's case say the two sides are coordinating but that won't stop them from competing with one another.

Says Miessner, "The New York Attorney General's office does not like to take deference to Federal authorities when it comes to its securities division and I have no doubt that this will not be an exception." He adds, "They are different animals and they live to compete with each other."

He thinks the competition will force both sides to be more aggressive in their pursuit of gathering evidence and building a strong case. It may lengthen the overall process but it will ensure there won't be a rush to settle.

That kind of competition among regulators is something more cases stemming from the financial crisis could benefit from.

S&P and Moody's would not comment for this story. Fitch Ratings said in a statement, "We are unable to comment on the S&P matter as it does not involve us, other than to say we have absolutely no reason to believe Fitch is a target of any such action."

Neither the New York Attorney General's office nor the U.S. Department of Justice would not comment for this story.

This article is available online at:
http://www.forbes.com/sites/halahtouryalai/2013/02/08/eric-schneiderman-is-the-biggest-threat-to-sp-moodys-and-fitch/