No. 15-88

IN THE

Supreme Court of the United States

BOCA RATON FIREFIGHTERS AND POLICE PENSION FUND,
Petitioner,

v.

ROBERT J. BAHASH, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF AMICUS CURIAE DEAN RICHARD K. LYONS IN SUPPORT OF THE PETITION

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TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

INTEREST OF AMICUS CURIAE...................... 1

REASONS FOR GRANTING THE WRIT 2

I. Business Conflicts of Interest Are a Hazard to Economic Stability and a Primary Concern of Financial Regulation....................... 4

II. Statements Concerning the Resolution of Conflicts of Interest Are Particularly Material to Investors. 9

III. This Case Squarely Raises Whether Misstatements About a Business's Inherent Conflict of Interest Can Be Excused as "Puffery." 10

CONCLUSION 15

TABLE OF AUTHORITIES

Cases

Ernst & Ernst v. Hochfelder,
425 U.S. 185 (1976) 6

Landreth Timber Co. v. Landreth,
471 U.S. 681 (1985) 5

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328 U.S. 293 (1946) 5

Statutes

15 U.S.C. §77a *et seq.* 5

15 U.S.C. §78a *et seq.* 2, 3, 6

Legislative Materials

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H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 5

S. Rep. No. 792, 73d Cong., 2d Sess. (1934)............. 6

Other Materials

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Lyons, R. & M. Moore, *An Information Approach to International Currencies,* 79 J. Int'l Econ. 211 (2009) 2

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INTEREST OF AMICUS CURIAE[1]

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From 2006 to 2008, Lyons was the Chief Learning Officer at Goldman Sachs, where he was responsible for leadership development for managing directors.

Dean Lyons is a member of the Council on Foreign Relations, a research associate with the National Bureau of Economic Research, and on the advisory board for the *Economic Policy Review* (published by the Federal Reserve Bank of New York). Lyons has consulted for the International Monetary Fund, World Bank, Federal Reserve Bank, and European Commission.

Dean Lyons has long been interested in the manner by which law, regulation, and public and

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[1] Counsel of record for all parties received notice at least ten days prior to the due date of amicus Dean Lyons' intention to file this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amicus curiae and his counsel has made a monetary contribution intended to fund the preparation or submission of the brief. The parties have consented to the filing of this brief.

company-specific policies address conflicts of interest at companies. His academic specialties include international finance and business leadership. As Dean, Lyons' focus is the renewal of business ethics and business leaders' care for the health and vitality of the economy. He has published extensively on how dispersed information is reflected in prices via trading,[2] and is thus well versed in the concept of materiality to investors.

REASONS FOR GRANTING THE WRIT

This case is about when financial institutions and their leaders are shielded from liability under the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. §78a *et seq.,* for false statements—and specifically when courts should treat such statements as immaterial "puffery."

In this case, the question of materiality is framed exceptionally clearly because the statements at issue concerned conflicts of interest. Standard &

[2] *See* R. Lyons et al., "Is There Private Information in the Foreign Exchange Market? The Tokyo Experiment," reprinted in *New Developments in Exchange Rate Economics,* ed. L. Sarno & M. Taylor (2002); R. Lyons & M. Evans, *Informational Integration and FX Trading,* 21(6) J. Int'l Money & Fin. 807 (2002); R. Lyons & M. Evans, *Do Currency Markets Absorb News Quickly?,* 24 J. Int'l Money & Fin. 197 (2005); R. Lyons & M. Evans, *How is Macro News Transmitted to Exchange Rates?,* 88 J. Fin. Econ. 26 (2008); R. Lyons & M. Moore, *An Information Approach to International Currencies,* 79 J. Int'l Econ. 211 (2009).

Poor's (S&P)[3] executives misled investors about how the company manages its conflicts of interest—specifically, the inherent conflict between reporting accurate ratings to the public, and satisfying the securities issuers who pay S&P. S&P claimed to resolve this conflict by prioritizing the interests of the investing public, and disclaimed any accommodation to issuers, but those statements were verifiably false.

Statements like these must not be treated as puffery. A company's statements regarding how it handles conflicts of interest are highly material to investors. They are key to the company's long-term prospects, particularly when they go to the heart of the company's core product—here, opinions about the value of securities.

More broadly, the proper resolution of financial institutions' conflicts of interest is crucial to sound business management, maintaining a stable financial system, preventing destructive events like the 2008 economic crash, and effectuating the overall purpose of the Exchange Act.

Certiorari is necessary to provide securities issuers and investors alike with clarity about this fundamental question.

[3] As described in the Petition, this case arises from S&P's conduct and its senior leaders' statements. S&P is a division of McGraw Hill Financial, formerly named The McGraw-Hill Companies, Inc. The named respondents are McGraw-Hill Companies, Inc.; McGraw-Hill chairman Harold McGraw, III; and former McGraw-Hill executive Robert Bahash. This brief mainly refers to S&P, unless accuracy requires otherwise.

I. Business Conflicts of Interest Are a Hazard to Economic Stability and a Primary Concern of Financial Regulation.

"[C]onflicts of interest, when not eliminated or properly mitigated, are a leading indicator of significant regulatory issues for individual firms, and sometimes even systemic risk for the entire financial system." Carlo di Florio, *Conflicts and Risk Governance,* U.S. Securities & Exchange Commission (Oct. 22, 2012), https://www.sec.gov/-News/Speech/Detail/Speech/1365171491600.[4] Weak ethical leadership, misaligned financial incentives, herd behavior, or simply personal weakness can result in a firm's failure to properly address conflicts of interest, with ensuing reputational and regulatory risks that may devastate the firm's health and long-term prospects. *See ibid.*

Managing conflicts of interest is therefore one of the most fundamental challenges facing senior business leaders in every industry. Such conflicts are pervasive throughout the economy—and especially so in the modern finance sector, where firms have ready access to inside information and often face contradictory incentives.

Market forces alone are not sufficient to ensure proper resolution of conflicts of interest. *See* Edward Altman et al., "Regulation of Rating Agencies," in *Regulating Wall Street: The Dodd–Frank Act and the New Architecture of Global Finance,* ed. Viral Acharya et al. 468, 470–71

[4] When di Florio presented this speech, he was Director of the SEC Office of Compliance Inspections and Examinations.

(2011).[5] In particular, market competition provides insufficient "incentive for the rating agencies to produce quality ratings, because they are not rewarded for doing so. In fact, since issuers pay the raters, one could argue the reverse, leading to a race to the bottom." *Id.* at 476–77. In theory, the market could "punish" a rating agency for altering its evaluations of the quality of securities based on its own economic self-interest. But any such discipline would only be after the fact, and it would require more information than is ordinarily available to market participants.

The securities laws and other business regulations therefore require businesses to mitigate and manage their conflicts—typically by prioritizing the interests of the investing public.[6] When companies

[5] Altman et al. cite several studies supporting the need for government regulation of rating agency conflicts of interest: Patrick Bolton et al., *The Credit Ratings Game* (Nat'l Bureau of Econ. Research, Working Paper No. 14712, 2008); Jerome Mathis et al., *Rating the Raters,* 56 J. Monetary Econ. 657–74 (2009); F. Sangiorgi et al., *Credit-rating Shopping, Selection and the Equilibrium Structure of Ratings* (Carnegie Mellon, working paper, 2009); Vasiliki Skreta and Laura Veldkamp, *Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation,* 56 J. Monetary Econ. 678 (2009).

[6] For instance, the Securities Act of 1933, 15 U.S.C. §77a *et seq.,* requires issuers to place investors' interests above their own self-interest by "compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.' " *SEC v. W.J. Howey Co.,* 328 U.S. 293, 299 (1946), quoting H.R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933); accord, *Landreth Timber Co. v. Landreth,* 471 U.S. 681, 687 (1985).

fail to do so, the consequences can be ruinous for the company and, if the behavior is systemic, for the financial system as a whole.

A prime example is the Great Depression. While its causes are complex and subject to debate, one factor was the mismanagement of finance sector conflicts of interest, including underwriters' self-interested advice to investors. *See Financial Services Competitiveness Act of 1995: Hearing on H.R. 1062 Before the H. Comm. on Banking & Fin. Serv.,* 104th Cong. (1995) (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission), 3 & fn. 4, https://www.sec.gov/news/testimony/testarchive/1995/spch029.txt; see also di Florio, *supra.* The results were 24% unemployment, a 47% decline in US industrial production, and a 30% decline in real GDP. Rosemary Marcuss & Richard Kane, *Born of the Great Depression and World War II,* U.S. Department of Commerce Bureau of Economic Analysis, 32 (Feb. 2007), http://www.bea.gov/scb/pdf/2007/02%20February/-0207_history_article.pdf; Christina Romer, *Great Depression,* University of California Berkeley Economics, 2 (2003), http://eml.berkeley.edu/-~cromer/great_depression.pdf [Encyclopaedia Britannica article].

Another example is the Exchange Act, which "protect[s] investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets. . . ." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 195 (1976), citing S. Rep. No. 792, 73d Cong., 2d Sess., 1–5 (1934).

Conflicts of interest have again come to a head in the economic upheavals of the last 15 years. "The bursting of the internet bubble in 2000 and 2001 exposed problems with conflicted research analysts who appeared to be influenced in their reports by their firms' investment banking interests. . . ." Di Florio, *supra*. In 2003, ten top investment firms agreed to pay $1.4 billion in a global settlement of conflicts of interest between research and investment banking. FINRA, *2003 Global Settlement,* Financial Industry Regulatory Authority, http://-www.finra.org/industry/2003-global-settlement; SEC, *Federal Court Approves Settlement of SEC Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking,* U.S. Securities & Exchange Commission (Oct. 31, 2003), http://www.sec.gov/news/press/2003-144.htm. As part of the SEC's "ongoing efforts to restore investors' faith in the fairness and integrity of our markets," the settlement both imposed penalties and required reforms to prevent investment bankers from pressuring analysts for favorable appraisals. *Ibid.*; SEC, *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking,* U.S. Securities & Exchange Commission (Apr. 28, 2003), http://-www.sec.gov/news/press/2003-54.htm.

The aftermath of the internet or dot-com bubble included the destruction of $6.5 trillion in wealth, and what was then the largest bankruptcy in U.S. history. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report,* 391 (2011), http://-

www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.-pdf; Simon Romero & Riva Atlas, *Worldcom's Collapse: the Overview; Worldcom Files for Bankruptcy; Largest U.S. Case,* New York Times (July 22, 2002), http://www.nytimes.com/2002/07-/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html.

A final example is the 2007–2009 Great Recession, the most significant economic event in the United States since the Great Depression. The Financial Crisis Inquiry Commission report noted numerous conflicts underlying the 2008 crash: underwriters assisting collateralized debt obligation (CDO) managers in selecting collateral; hedge fund managers selecting collateral from their funds to place in CDOs that they offered to other investors; Citigroup's offering "liquidity puts" with potential for short-term fees but long-term financial risk; and conflicts in rating agencies' evaluations of CDOs. FCIC Report, *supra* at 131, 136, 139, 211–212; *see also* di Florio, *supra*; Altman et al., *supra* at 462–463. In the Great Recession, eight million people lost their jobs, unemployment reached 10.1%, four million homes were foreclosed, $17 trillion in household net wealth was lost, worldwide stock prices dropped over 40%, and retirement accounts lost $2.8 trillion or approximately a third of their value. FCIC Report, *supra* at 389–393, 402.

II. Statements Concerning the Resolution of Conflicts of Interest Are Particularly Material to Investors.

Because conflicts of interest are so important to sound business management, a firm's representation that it has identified and addressed a conflict of interest is critical information for investors. Without candid information from a company itself, the public cannot meaningfully evaluate its effectiveness at managing its conflicts. The investing public does not have access to most internal decisions, processes, or communications—many of which may be regarded as trade secrets.

Considering the scarcity of such information, investors attach great weight to a company's statements about resolving conflicts of interest—especially if made by an executive manager. These statements are among the most fundamental and relevant information available to aid in understanding or evaluating the company's economic health and the quality of its financial products.

When a statement describes the resolution of a conflict of interest that affects the core value and legitimacy of the business or its products, the statement is even more crucial. The statement establishes that the company is operating in a manner that ensures both regulatory compliance and long-term stability.

However, when a company's statements regarding its conflicts of interest are false, the impact on its financial health may be severe. A company's misstatement about managing a known conflict of

interest evidences a willingness to disregard ethical and legal norms, to the detriment of investors and the public. It is damaging for its own sake, and also because it strongly suggests a broader pattern of malfeasance with respect to other business conflicts.

For these reasons, courts should look with skepticism on any effort to label statements about conflicts—especially conflicts that relate to a business's key products—as mere "puffery."

Here, the statements at issue were from S&P, a rating agency. The statements were highly material because they were among the only information available to investors concerning S&P's resolution of the conflict of interest inherent in the rating agencies' business model.

III. This Case Squarely Raises Whether Misstatements About a Business's Inherent Conflict of Interest Can Be Excused as "Puffery."

The Court should grant certiorari to address whether S&P's statements—false claims about its resolution of a core conflict of interest—are mere "puffery."

The conflict of interest inherent to the rating agencies' business model is well-known:

> [T]he prevalent business model of the major rating agencies is the "issuer pays" model. That is, the issuer of a security both chooses and pays the rating agency for rating the security. This leads to a potential conflict of interest because the rating agency has a

> financial incentive to pander to issuers in order to be chosen as the rater. Of course, this creates tension with the rating agencies' mission of providing an objective analysis of credit risk of the security.

Altman et al. at 462–63. Indeed, "[t]he conflicts of interest stem not only from who pays for the rating, but also from the fact that the rating agencies provide other revenue-generating services to the rated companies." *Id.* at 468.

In the years leading up to the 2008 financial crisis, the rating of mortgage-backed bonds (as opposed to standard bond issuances that predominated in earlier years) exacerbated this conflict of interest:

> [T]he volumes of rated bonds were large, the profit margins wide, and issuers far fewer; thus, an issuer's threat to take its business to a different rating agency was far more compelling. In addition, the rated securities were far more complex and opaque than plain-vanilla bonds, so that errors were less likely to be spotted quickly. The issuers also figured out how to game the ratings criteria and were perceived to receive debt structuring advice from the rating agencies themselves.

Altman et al. at 467–468.

Each agency determined how to manage this conflict—and described those efforts to its investors and the public. S&P's legitimacy depends on effectively addressing its inherent conflict of interest. Thus, its alleged false statements in this

case are exactly the kind of statements to which investors attach great weight:[7]

- In July 2007, McGraw-Hill acknowledged that more accurate ratings could impede them from obtaining or retaining customers (who pay for those ratings), but said to investors, "that's not what we're concerned about. We're concerned about calling it as it is." Proposed Third Am. Compl., ¶479.
- In August 2007, McGraw-Hill told investors: "In theory, one way to increase revenue would be for us to weaken our criteria to ensure that a transaction that would not have been economically viable can take place. This would, of course, violate our internal rules. . . . [W]e do not engage in such behavior." *Id.,* ¶484.
- In September 2007, McGraw-Hill told investors that S&P's ratings were based on "predetermined, nonnegotiable and publicly available criteria." *Id.*, ¶491.

Precisely at a time of growing awareness and concern over rating agencies' inherent conflicts of interest, these statements informed investors that S&P was addressing that conflict. The Petition, at pages 6–7 and 9–10, explains how each of these and other statements were false. S&P conveyed that its rating models were accurate, when its senior leaders knew they were not.

The Petition also describes how S&P's misrepresentations damaged its own brand as well as the

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[7] *See also* Pet. for Cert. 9–10, July 20, 2015.

economy as a whole. Rating agency conflicts of interest were at the heart of the 2008 financial crisis:

> The three largest U.S.-based credit rating agencies—Moody's Investors Service, Standard & Poor's (S&P), and Fitch Ratings—were clearly central players in the subprime residential mortgage debacle of 2007 to 2008. Their initially favorable ratings were crucial for the successful sale of bonds that were securitized from subprime residential mortgages and similar debt obligations. The sale of these bonds, in turn, was an important underpinning for the U.S. housing boom and fall, default rates on the underlying mortgages rose sharply, and the initial ratings proved to be wildly overoptimistic. The prices of mortgage bonds cratered, and massive downgrades of the initially inflated ratings wreaked havoc throughout the U.S. financial system and damaged the financial systems of many other countries as well.

Altman et al. at 463–464. It was not only investors who relied on the ratings (and the rating agencies' credibility). The government used them to set policy:

> [B]ecause the government sets its regulatory structure around these ratings, investors like AIG, Citigroup, ABN Amro, UBS, Fannie Mae, Freddie Mac, and, for that matter, Merrill Lynch and Lehman Brothers, among others, were able to engage in risky activities without having to hold a sufficient capital buffer due to the inflated ratings. . . . The crisis, and the

> taxpayer-funded bailouts that followed, could not have transpired the way it did without rating agencies planted in the center of the financial system.

Id. at 479–480.

This case's significance extends beyond recent disastrous events. As the economy recovers, structured financial products—including instruments that are new to the marketplace—have resumed their rapid growth. Studies show that "ratings inflation is more likely to occur during high-volume periods," and ratings for more opaque mortgage-backed securities are more likely to be inflated. Altman at 468–469. The issue of ratings conflicts can be expected to become still more important, not less.

The Court should take this opportunity to establish a clear standard for the materiality of statements concerning conflicts of interest. A clear standard will guide market participants, protect market stability, and maintain public trust in markets—thereby effectuating the fundamental purpose of the securities laws.

CONCLUSION

For the foregoing reasons, this Court should grant the Petition for a writ of certiorari.

Respectfully submitted,

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