SQUIRE PATTON BOGGS

Conduct of the Case in the Court's Hands: Standard & Poor's Ordered to Explain Ratings Modelling and Methodology in Multiple Australian Class Actions

On 20 May 2016, the Federal Court of Australia published its reasons for judgment in *Mitsub Pty Limited v McGraw-Hill Financial Inc* [2016] FCA 559 in which it has ordered the Respondents (S&P), by their Chief Executive Officer (CEO), to identify by affidavit the real issues relating to the ratings methodology used in rating various structured financial products known as collateralised debt obligations (CDOs). The credit ratings assigned to those CDOs by S&P are the subject of 8 separate representative proceedings currently before the Federal Court (S&P Proceedings). Amanda Banton is the lead partner, with Lisa Gallate, Of Counsel, for the Applicants in 7 of the 8 S&P Proceedings.

CEO to Provide Affidavit in Defence of Ratings

The order requires the CEO to confirm by affidavit, at a very early stage of each of the S&P Proceedings, whether the Federal Court's judgment in *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5)(2014) 224 FCR 1 and the decision on appeal, that concerned S&P's rating of another financial instrument (a constant proportion debt obligation (CPDO)) and which concerned the inappropriateness of the use of the Gaussian copula, apply to S&P's ratings of the CDOs in the S&P Proceedings. Those earlier proceedings, in which Amanda Banton acted for multiple plaintiffs against S&P, were the first time that S&P had ever been sued in relation to its credit ratings.

In addition, the Court ordered the CEO to confirm by affidavit, whether the Court's findings in *Wingecarribee Shire Council v Lehman Brothers Australia Limited (In Liq)* (2012) 301 ALR 1[1], in relation to reports by the Bank for International Settlements[2] and Banque de France[3], concerning the inappropriateness of ratings agencies' methodologies address systemic events, do or do not apply to the respondents' ratings methodologies used for each CDO in the S&P Proceedings.

If the CEO believes that those findings do not so apply, then the CEO must explain why they do not apply in the affidavit, and why the Court will need to deal with the issue of reliability of the respondents' ratings that are impugned at a final hearing.

In its Reasons for Judgment, the Court referred to the Honourable Justice Jagot's decision in *Bathurst Regional Council v Local Government Financial Services Pty Ltd* that in relation to modelling defaults (at [2556]):

> …the expert evidence discloses that S&P would or ought to have known what was common knowledge in the industry, *that modelling defaults using the Gaussian copula would seriously underestimate the potential for joint severe events because it "severely underestimates the correlation out in the tail of distribution"*. The expert evidence also discloses that S&P must have known that its model modelled default risk separately from spreads which is not how markets actually work….[emphasis added]

His Honour referred to his earlier decision in the Wingecarribee Proceedings about the 2005 reports by the Bank for International Settlements and Banque de France that (301 ALR at [851]):

> A feature of the claim SCDOs as structured products was their particular susceptibility to extreme events that could lead to significant loss. As the 2005 working group observed:
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> > The Working Group believes that *risks associated with structured products may not have been fully grasped by some investors.* Similarly, with consensus on "best practice" regarding the modelling of portfolio credit risk still lacking, *"model risk" in instruments such as collateralised debt obligations (CDOs) is an issue for even the most sophisticated market participants. Use of structured finance instruments, together with the occurrence of worst case scenarios relating to mispriced or mismanaged exposures, might thus lead to situations in which extreme market events could have unanticipated systemic consequences.* Given these issues and the fact that structured finance markets are still largely untested, continued growth in structured finance activity warrants ongoing central bank awareness." (emphasis in original)

His Honour considered that it was appropriate to require S&P to explain whether or to what extent the findings in earlier judgments about ratings methodology are relevant to issues in the S&P Proceedings.

S&P's Submissions

S&P argued that the Court had no power to make such an order and that, even if there were, it should not be made because, *inter alia:*

- The CEO would need to rely on hearsay, the affidavit would thus be of no probative weight and would not narrow the issues
- The earlier findings about the Gaussian copula and ratings methodology did not directly relate to the CDOs and did not decide that use of the Gaussian copula in rating those products was inappropriate or resulted in the assigned ratings being erroneous
- The proposed order was "more akin to a punitive sanction", where there was nothing in S&P's conduct that warranted censure. Moreover, in some of the 8 S&P Proceedings, the pleadings have not yet even closed
- The making of the order would give rise to real and legitimate concerns as to whether His Honour had prejudged the issues in the S&P Proceedings, including what will be a live issue as to the use of the Gaussian copula

1 Amanda Banton is the lead partner with Lisa Gallate of counsel for the Applicants and 69 Group Members in the Wingecarribee Proceedings
2 "The role of ratings in structured finance: issues and implications" (CGFS publication No 23)
3 "The CDO Market: Functioning and Implications in Terms of Financial Stability" (Financial Stability Review, No 6 June 2005)

Decision

His Honour, in rejecting S&P's submissions, noted that the purpose for which the affidavit from the CEO was sought was to assist in the case management of the S&P Proceedings.

His Honour referred to the Court's case management powers, contained in Part VB of the *Federal Court of Australia Act 1976* (Cth), that are intended to facilitate the just resolution of disputes according to law and as quickly, inexpensively and efficiently as possible (at [8]). The Court can give directions about the practice and procedure to be followed in relation to the whole or any part of a proceeding, including requiring things to be done (s 37P(2), (3)(a), (7)). The Court's Practice Note CM1, *Case Management and the Individual Docket System*, also explains that parties and their lawyers can expect the Court to have regard to the desirability of, *first*, identifying and narrowing the issues in dispute as early as possible and, secondly, ascertaining the degree of difficulty or complexity of the issues really in dispute (see [3.2](a), (b)).

His Honour noted at [9] that:

> "Provisions such as Pt VB have the purpose of ensuring that the conduct of civil proceedings, as French CJ, Kiefel, Bell, Gageler and Keane JJ said in *Expense Reduction Analysts Group Pty Ltd v Armstrong Strategic Management and Marketing Pty Ltd* (2013) 250 CLR 303 at 323 [56], "is firmly in the hands of the Court"."

Having regard to the above matters, Justice Rares wished to be assured that the CEO of S&P, as the person ultimately responsible for the decision to litigate the S&P Proceedings, had actually turned his or her mind to those issues and explained, at a high level, why the Court, having already spent considerable time and resources on different, but apparently related issues, should revisit those generated in the S&P Proceedings involving the use of the Gaussian copula.

His Honour further noted that the order was not punitive or any other kind of sanction, nor based on any prejudgment about any of the complex and, as yet, protean matters potentially in issue. But, for the purpose of case management the Court can require a party, by its proper officer, to explain the reason why it needs to litigate particular issues in the proceedings and thus to require the Court and the other parties to devote resources to deal with those issues.

Implications

The decision is significant in its timing, requiring S&P's CEO to provide affidavit evidence very early in the S&P Proceedings, when pleadings have not yet closed. It is also significant in confirming the Federal Court's broad case management powers, which include the power to give directions and make orders to facilitate the just resolution of disputes as quickly, inexpensively and efficiently as possible. Where required, the Court is prepared to take a robust and proactive approach to case management by placing the conduct of proceedings firmly in its own hands. In the S&P Proceedings, these powers have extended to an order for the ultimate decision maker of the Respondents (the CEO of S&P) to explain S&P's defence of the credit ratings that it assigned to the CDOs. S&P are applying for leave to appeal the decision.

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