UNITED STATES DISTRICT COURT
DISTRICT OF COLUMBIA

UNITED STATES SECURITIES AND EXCHANGE COMMISSION, **Plaintiff,** **v.** **J.P. MORGAN SECURITIES LLC, EMC MORTGAGE, LLC, BEAR STEARNS ASSET BACKED SECURITIES I, LLC, STRUCTURED ASSET MORTGAGE INVESTMENTS II, INC., SACO I, INC., AND J.P. MORGAN ACCEPTANCE CORPORATION I,** **Defendants.**	**Civil Action No. 12-1862 (JEB)**

MOTION FOR APPROVAL OF PROPOSED AMENDED DISTRIBUTION PLAN FOR DELINQUENCY DISCLOSURE CONDUCT

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The Securities and Exchange Commission (the "SEC") hereby respectfully moves for approval of its Proposed Amended Plan of Distribution for the Delinquency Disclosure Conduct (the "Amended Distribution Plan").[1]

This litigation concerns the best way to distribute a Fair Fund of $74.5 million. The defendants agreed to pay $74.5 million in response to the SEC's Complaint, which alleged that they had misrepresented the number of delinquent loans underlying certain residential mortgage-backed securities ("RMBS") at the time of offering. The SEC's Amended Distribution Plan seeks to distribute this money to initial investors – *i.e.*, those investors who relied upon the defendants' misrepresentations.

As the Court is aware, the SEC's initial proposed distribution plan elicited objections from certain third-party investors. The SEC has carefully considered these objections. In response, and to address concerns raised by the Court, the SEC has developed an Amended Distribution Plan that provides for *pro rata* distribution to initial investors, while also ensuring that certain investors do not receive a windfall as a result of the distribution. The Amended Distribution Plan represents a "fair and reasonable" way to distribute the proceeds of the defendants' misconduct that is directly tied to the nature of the harm alleged in the Complaint. It is substantially similar to the distribution plan previously approved by the Court in connection with a second type of misconduct (the Bulk Settlement Practice) alleged in the Complaint. And it is more equitable and more efficient than the distribution scheme that the Objectors favor.

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[1] A copy of the proposed Amended Distribution Plan is attached hereto as Exhibit 1 ("Ex. 1").

In support of this Motion, the SEC also submits herewith the Declaration of Dr. Eugene P. Canjels ("Canjels Declaration" or "Canjels Decl."). Dr. Canjels is an economist in the SEC's Division of Economic and Risk Analysis, who has considered the implications of a *pro rata* distribution and of a distribution through the Trust's waterfall scheme.

For these reasons, and for the reasons set forth below, the SEC respectfully requests that the Court enter an order approving the Amended Distribution Plan.

I. BACKGROUND

A. The SEC's Complaint and the Original Final Judgment

On November 16, 2012, the SEC filed a Complaint against the JP Morgan Defendants alleging violations of Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(2) and (3). The Complaint specifically alleged that the JP Morgan Defendants had misled investors in RMBS through various material misrepresentations and omissions in initial offering disclosures. See ECF No. 1.

Although the current litigation involves only one type of misconduct, referred to here as the "Delinquency Disclosure Conduct," the Complaint in fact asserted that the JP Morgan Defendants had engaged in a second, entirely separate kind of misconduct, referred to here as the "Bulk Settlement Practice." See id. ¶¶ 1-8; see also ECF No. 36, at 5-6. The two types of misconduct involved different misrepresentations and implicated different features of the trusts that had issued the RMBS, but both types of misconduct arose from misleading statements and omissions made by the defendants in initial offering documents. See, e.g., ECF No. 1, ¶ 3 ("Certain disclosures in the Bear RMBS offering documents …. were rendered misleading by the failure to disclose the bulk settlement practice."); id. ¶ 6 (noting that the JP Morgan Defendants "made materially false and misleading statements" in the "prospectus supplement" through which they offered the RMBS).

The Delinquency Disclosure Conduct arose from the December 2006 offering of RMBS issued by a single trust, the WMC4 Trust. Id. ¶¶ 67, 82, 86-88. In a preliminary prospectus supplement filed on December 18, 2006, and a final prospectus supplement filed on December

20, 2006, the JP Morgan Defendants represented to investors that they were disclosing, among other things, the number of loans that were 30- or 60-days delinquent. Id. ¶¶ 82, 84, 86. Delinquency information was material to investors in the offering. Id. ¶ 93; see also Canjels Decl. ¶¶ 7, 9. Yet neither the preliminary nor final prospectus supplement accurately disclosed the number of delinquent loans in the WMC4 Trust. ECF No. 1, ¶¶ 84-88. Both represented that only 4 loans were 30-days delinquent, and that no loans were 60-days delinquent, when in fact, at the time that they made these disclosures, the JP Morgan Defendants had information indicating that several hundred loans were delinquent. Id. ¶¶ 71, 73, 83, 89-91.

On January 7, 2013, with the defendants' consent, the Court entered a Final Judgment (the "Original Final Judgment"). ECF No. 3, at 1. Under the Original Final Judgment, the JP Morgan Defendants were required to pay (1) over $222 million in disgorgement, prejudgment interest, and a civil penalty as to the Bulk Settlement Practice, and (2) $74.5 million in disgorgement, prejudgment interest, and a civil penalty as to the Delinquency Disclosure Conduct. Id. §§ II, III.

The Original Final Judgment also provided that as to each type of misconduct, the SEC "may propose a plan to distribute the Fund pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002 subject to the Court's approval." Id. The Original Final Judgment also stated (1) that the SEC "will use reasonable efforts to confirm with the Internal Revenue Service that the distribution of the Fund will be consistent with the continued treatment of the trust/trusts at issue as qualifying real estate investment conduits under the United States Internal Revenue Code," and (2) that "[i]n the event such confirmation … is obtained, the Commission *intends* to propose … a plan to distribute the Fund to the specific securitization trust/trusts affected by the [misconduct] alleged … in the Complaint." Id. (emphasis added).

While the Original Final Judgment required the SEC to "use reasonable efforts" to obtain confirmation from the IRS about the tax implications of distributing any Fair Fund through the affected trusts, the Original Final Judgment did not require the SEC to propose distribution through the trusts or indeed to propose distribution at all. See id. ("If the Commission staff determines that the Fund will not be distributed, the Commission shall transfer the funds paid pursuant to this Final Judgment to the United States Treasury.").

B. The SEC's Initial Proposed Distribution Plans and Approval of the Bulk Settlement Practice Plan

Following entry of the Original Final Judgment, the Court approved the establishment of two Fair Funds – one for each type of misconduct alleged in the Complaint. ECF No. 11. On June 9, 2016, the SEC filed its first motion seeking approval of proposed distribution plans as to each of the Fair Funds. ECF Nos. 12; see also ECF No. 18.

The proposed distribution plans (the "Initial Proposed Distribution Plans") were in all pertinent respects virtually identical. See ECF Nos. 12-2 (Proposed Distribution Plan for Bulk Settlement Practice), 12-3 (Proposed Distribution Plan for Delinquency Disclosure Conduct). Neither involved distribution through the affected RMBS trusts. Instead, each plan proposed distributing the Fair Fund to initial investors in the offering on a *pro rata* basis. See ECF No. 12-2, ¶¶ 56-57; ECF No. 12-3, ¶¶ 55-56.

No objections were raised regarding the SEC's Initial Proposed Distribution Plan for the Bulk Settlement Practice, which affected over 150 RMBS trusts. ECF No. 1, ¶ 5. On January 25, 2017, the Court entered an order approving that plan. ECF No. 38.

C. Objections by Third-Party Investors in the WMC4 Trust

In September 2016, two third-party investors in the WMC4 Trust (the "Objectors") filed objections to the SEC's Initial Proposed Distribution Plan for the Fair Fund established for the

Delinquency Disclosure Conduct. ECF No. 28. The Objectors complained first that the SEC had "failed to obtain any response from the IRS" and had thus failed to comply with the Original Final Judgment. Id. at 2. The Objectors further contended that the SEC's plan to distribute the Fair Fund to initial investors on a *pro rata* basis would be unfair to investors "who actually suffered losses as a result of the defendants' conduct," which occurred "over time" and that "[d]istribution through the Trust is more efficient and less costly." Id. at 2-3.

Following further briefing by the parties, the Court denied the SEC's motion without prejudice. ECF Nos. 33-36. The Court's ruling was not based upon the merits of the SEC's Initial Proposed Distribution Plan, but rather a procedural issue. The Court concluded that the SEC had failed to consult with the IRS regarding the tax implications of distributing the Fair Fund to the Trust, as the Original Final Judgment required it to do. ECF No. 36, at 10-12.

Regarding the Objectors' substantive complaints, the Court noted those objections, but decided "not [to] treat with these issues now," recognizing that "there is room for debate." Id. at 14; see also id. at 13 (noting "at least some uncertainty" about the "relative merits of *pro rata* versus waterfall distribution"). Indeed, having described the deferential standard that governs court review of distribution plans proposed by the SEC, id. at 8-9, the Court recognized that the Objectors' substantive claims might be "simply the result of the prototypical 'line-drawing' that occurs in Fair Fund distributions." Id. at 14.

D. The SEC's Proposed Modifications to the Judgment and Distribution Plan

Since the Court's ruling, the SEC has pursued a number of paths in order to present the Court with the best options for distributing the Fair Fund.

First, as required by the Original Final Judgment and the Court's January 7, 2017 order, the SEC has endeavored to make all "reasonable efforts to confirm" the tax implications of a

distribution through the Trust with the IRS. As the SEC has advised the Court, a letter ruling from the IRS can only be requested by the WMC4 Trust itself – either by the Trustee or the Securities Administrator of the Trust. The SEC itself does not have standing to request a letter ruling. The process of obtaining a letter ruling typically takes approximately 6-12 months. The SEC remains willing to assist in the process of obtaining a letter ruling. ECF No. 39, ¶¶ 2-4.

Second, because the SEC believes that distribution of the Fair Fund on a *pro rata* basis would be more efficient and equitable than distribution through the WMC4 Trust, the SEC has candidly advised both the Court and the Objectors that it does not intend to seek distribution through the Trust, and that seeking a letter ruling from the IRS may therefore involve needless expense and delay.[2] See, e.g., ECF No. 39, ¶¶ 5-6; ECF No. 41, ¶ 3.

Third, the SEC has conferred with counsel for the J.P. Morgan Defendants and has confirmed that the defendants do not oppose a modification of the Original Final Judgment that would eliminate the requirement that the SEC seek confirmation from the IRS regarding the tax implications of a distribution through the Trust. See ECF No. 39, ¶ 7; ECF No. 41, ¶ 4. Entry of a Modified Final Judgment would allow the parties and the Court to explore the possibility of a *pro rata* distribution plan, without first requiring the Trust to go through the lengthy, costly, and potentially unnecessary process of obtaining a letter ruling from the IRS.[3] The proposed Modified Final Judgment does not limit the Court's ability to consider any particular distribution

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[2] If distribution does not occur through the Trust, a letter ruling is unnecessary. If the Court orders distribution through the Trust, which the SEC has not proposed, the SEC agrees that it makes sense to obtain a letter ruling.

[3] Pursuant to the Court's Minute Order dated March 22, 2017, the SEC is filing simultaneously herewith an Unopposed Motion for Modification of Judgment Under Federal Rule of Procedure 60(b).

plan, including a distribution through the Trust; it simply eliminates the requirement that a letter ruling be obtained before the Court can consider the merits of the SEC's proposed plan.[4]

Finally, the SEC has further considered the consequences of a *pro rata* distribution plan versus a distribution through the WMC4 Trust waterfall. The SEC has given particular attention to the questions raised by the Court regarding the merits of a *pro rata* distribution plan and has developed a proposed Amended Distribution Plan to address the Court's concerns. See ECF No. 36, at 13-14 (noting that "SEC's argument – that the *pro rata* Plan is unqualifiedly fairer and more reasonable than the Trust's waterfall-priority scheme" was not "altogether convincing"). The Amended Distribution Plan includes provisions intended to prevent any investor from receiving an unanticipated windfall as a result of the Fair Fund distribution. Specifically, the Amended Distribution Plan: (1) excludes investors who both purchased and sold their certificates within the first month of issuance from receiving a distribution, and (2) caps distributions to initial investors based upon their expected or realized losses to date.

II. ARGUMENT

A. Governing Law

As this Court has recognized, courts review proposed distribution plans and focus on whether the plan is "fair and reasonable." ECF No. 36, at 8 (quoting SEC v. E-Smart Techs., Inc., 139 F. Supp. 3d 170, 193 (D.D.C. 2015)); see also Official Comm. of Unsecured Creditors of Worldcom, Inc. v. SEC, 467 F.3d 73, 81-83 (2d Cir. 2006) ("[O]nce the district court satisfies itself that the distribution of proceeds in a proposed SEC disgorgement plan is fair and reasonable, its review is at an end."); see also SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991) ("[U]nless the consent decree specifically provides otherwise[,] once the district court satisfies

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[4] The Modified Final Judgment preserves the requirement that the parties will not propose a distribution that would jeopardize the Trust's tax status.

itself that the distribution of proceeds in a proposed SEC disgorgement plan is fair and reasonable, its review is at an end.").

By exercising deferential review of SEC distribution plans, courts have recognized – as this Court has – that "[s]ome investors will invariably be excluded." ECF No. 36, at 8. Almost every distribution plan requires the SEC and the court to decide how the amounts recovered will be divided among potential claimants. For any distribution, multiple reasonable options may exist. "The SEC is charged by statute with enforcing the securities laws, and therefore [courts] defer to its 'experience and expertise' in determining how to distribute the funds." Worldcom, 467 F.3d at 82 (citing Wang, 944 F.2d at 88). As the Second Circuit further elaborated in WorldCom:

> Because 'the primary purpose of disgorgement is not to compensate investors, but to ensure that those guilty of securities-fraud are not unjustly enriched,' any subsequent SEC plan to distribute disgorged profits 'is reviewed under th[e] court's general equitable powers to ensure that [the plan] is fair and reasonable.' . . . (citation omitted). So long as the district court is satisfied that 'in the aggregate, the plan is equitable and reasonable,' the SEC may engage in the 'kind of line-drawing [that] inevitably leaves out some potential claimants.' [Citations omitted]

467 F.3d 82-83.

B. The SEC's Amended Distribution Plan Is Fair and Reasonable

1. Distributing the Fair Fund to initial investors on a pro rata basis is both fair and reasonable.

The SEC's Amended Distribution Plan seeks to distribute the Fair Fund to investors in a manner that is directly tied to the harms at the root of this case. This case is about the misleading misrepresentations and omissions made at the time of offering, in the preliminary and final prospectus supplement. The Complaint's allegations focus solely on these initial disclosures. See, e.g., ECF No. 1, ¶ 6 ("In the prospectus supplement, JP Morgan and JPMAC made

materially false and misleading statements….”); id. ¶ 7 (discussing inaccurate information “[i]n the prospectus supplement”); id. ¶ 84 (discussing the precise misrepresentations made in the preliminary and final prospectus supplement); id. at 34 (“The Delinquency Disclosures that JP Morgan and JPMAC Made in the Prospectus Supplement and Preliminary Prospectus Supplement Were Materially False and Misleading.”). Indeed, this theory of liability is evident from the statutory violations alleged, which concern misconduct “in the offer or sale of any securities.” See id. ¶ 9 (alleging violations of Sections 17(a)(2) and (3) of the Securities Act); see also 15 U.S.C. §§ 77q(a)(2), (3).

Because this case is about misrepresentations made to investors who relied upon misleading information in the offering documents, the Amended Distribution Plan appropriately focuses upon those investors and seeks to distribute to them on a *pro rata* basis based upon their initial investments.[5] The Amended Distribution Plan defines “Eligible Claimants” as those investors who purchased certificates before January 25, 2007. Ex. 1, ¶¶ 17-18. Beginning on January 25, 2007, and continuing every month thereafter, the Securities Administrator for the WMC4 Trust issued an Investor Report that contained detailed, accurate information about delinquencies, payments, and losses on the underlying collateral. Canjels Decl. ¶ 8. Because

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[5] A *pro rata* distribution reflects each eligible investor’s relative position at the time of offering. See ECF No. 33-2, at 7 (Commission Order approving *pro rata* distribution plan in another RMBS matter and noting that a “proportionate harm accrued to all investors at the time of the initial offering when … investors were deprived of the benefit of their bargain”). Another possible method for compensating investors who were deprived of the benefit of their bargain would be to distribute the Fair Fund based on the difference between the price that such investors paid and the price that they would have paid had accurate disclosures been made. Determining that difference would, however, be nearly impossible, and such a plan would accordingly be unworkable.

delinquency information quickly becomes stale, investors would have relied upon the most current information available – *i.e.*, the information in Investor Reports. Id. ¶ 9.[6]

As the Court has recognized, investors who purchased their certificates after January 25, 2007 therefore possessed and relied upon accurate information that was unavailable at the time of the offering and presumably did not rely upon the misleading information in the prospectus. See ECF No. 36, at 14 (noting that "investors knew after a month that the Trust held far more than the four advertised delinquent mortgages, and citing first Investor Report, which disclosed over 300 delinquencies); see also Canjels Decl. ¶¶ 9, 39. Unlike investors who bought during the first month and relied only upon the misleading disclosures, subsequent investors were not dependent on the misrepresentations at issue in the SEC's complaint for information about the performance of WMC4's underlying collateral.

Indeed, the Court has already approved a nearly identical distribution plan that will distribute the Bulk Settlement Practice Fair Fund to initial investors in the affected RMBS trusts. ECF No. 38. Like the Delinquency Disclosure Conduct, the Bulk Settlement Practice involved misrepresentations made to investors in certain RMBS trusts at the time of offering. See, e.g., ECF No. 1, ¶¶ 3 (referring to "disclosures in the Bear RMBS offering documents" that "led investors to believe … Bear would repurchase loans from the trusts," which disclosures were "rendered misleading by the failure to disclose the bulk settlement practice"). And like the proposed plan at issue here, the approved Bulk Settlement Practice Plan defines Eligible Claimants as those who purchased their certificates during the first month of the offering. See

[6] Investor Reports were issued on a monthly basis beginning on January 25, 2007. See Canjels Decl. ¶ 8. The reports for January through April 2007 were previously filed with the Court. ECF Nos. 28-2, 28-3, 28-4, 28-5. Certain Investor Reports are also attached to the Canjels Declaration as Exhibits 5-8 thereto.

ECF No. 12-2, ¶¶ 17-18. *Pro rata* distribution to initial investors – those harmed by the wrongdoing at the heart of this case – is a fair and reasonable method of allocating the proceeds collected for that wrongdoing.

2. The SEC's proposed modifications to the plan further ensure that distribution of the Fair Fund will be equitable.

The SEC maintains that a *pro rata* distribution to initial investors is the best available method for distributing the Fair Fund. But the SEC has also carefully considered the questions raised both by the Objectors and by the Court regarding such a plan, and in particular to concerns that the simple *pro rata* distribution plan initially proposed might result in windfalls to certain investors.[7] In response to these concerns, and in an effort to develop an efficient and equitable plan, the SEC has amended the proposed plan by introducing provisions – described in further detail below – intended to eliminate potential windfalls as a result of the Fair Fund distribution.

a. Initial Investors Who Sold Before January 25, 2007

In its memorandum opinion, the Court highlighted the Objectors' concern that the SEC's Initial Proposed Distribution Plan was "too broad because some first-month investors may have cashed out before public disclosures revealed the extent of J.P. Morgan's non-disclosures and brought the price of WMC4 securities down." ECF No. 36, at 14. And the Court recognized that this "overbreadth argument has some truth to it, as the Plan does not preclude those who sold their certificates before this disclosure from gaining a windfall." Id.

The SEC recognizes the merits of this argument. See Canjels Decl. ¶ 25 (noting that such investors would have both bought and sold at a price reflecting the same information and would

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[7] The Initial Proposed Distribution Plan contained a provision that addressed the possibility of a windfall accruing to certain claimants if not all eligible investors submitted claims, resulting in an excess *pro rata* share falling to those who did submit claims. See ECF No. 12-3, ¶ 58. That provision is also included in the proposed Amended Distribution Plan. See Ex. 1, ¶ 63.

not have suffered the harm of purchasing at a price based upon misleading offering documents, while selling at a price reflecting more accurate information available after January 25, 2007). To address this concern, the SEC has included in its Amended Distribution Plan provisions that preclude recovery by investors who both bought and sold their certificates during the first month, before the release of the January 25, 2007 Investor Report. See Ex. 1 ¶¶ 25, 30, 58-63 (placing "Recovery Cap" of $0 on claim amounts for investors who both purchased and sold certificates before January 25, 2007); see also id. ¶ 29 (providing that potentially eligible claimants will be required to submit proof of claim forms, including documentation regarding sales of certificates).

b. Initial Investors Who Sold After January 25, 2007

The SEC has also considered the Objectors' claim that "no losses [on the WMC4 certificates] occurred within the first 120 days after issuance." ECF No. 28, at 2. The Objectors contend that in light of this fact, the Initial Proposed Distribution Plan might "provide a windfall to some early investors while depriving investors who suffered actual losses from any recovery" because it did not "require any showing that Eligible Claimants continued to hold the certificates as the certificates suffered the losses alleged in the Complaint." Id. at 12; see also ECF No. 34, at 11 (asserting that investor reports from months after the issuance showed "no losses at that time").

This case is not about investment losses. It is about misleading representations and omissions that initial investors relied upon at the time of the WMC4 offering. And the primary purpose of a Fair Fund, as this Court has recognized, is not to compensate investors. See, e.g., ECF No. 36, at 8 (noting that "investor compensation is only a 'secondary goal'" and citing Worldcom, 467 F.3d at 81). The purpose of a Fair Fund distribution is to "punish… the individual violator and deter[] … future violations." Id. (quoting Worldcom, 467 F.3d at 81). Here, the violations were the misrepresentations in the offering documents, and the SEC's

proposed plan for distributing the Fair Fund to investors who relied upon those misrepresentations reflects the nature of those violations.

Nevertheless, the SEC has taken into account the fact that initial investors who purchased their certificates before January 25, 2007 and sold at some point thereafter might – depending upon when they sold their certificates, and in which tranche they invested – not have suffered any significant losses. See Canjels Decl. ¶ 26. Such investors might, under a simple *pro rata* distribution plan, receive a Fair Fund distribution that exceeds their realized losses, if any. See id.

The proposed Amended Distribution Plan therefore requires initial investors who have sold their certificates to submit documentation regarding their sales. Ex. 1, ¶ 29. The Plan limits recovery for such investors by setting a "Recovery Cap" at the amount of realized losses. Id. ¶¶ 60.b, 62. These provisions eliminate the risk that distribution of the Fair Fund will result in a windfall to initial investors who sold their certificates without realizing significant losses.

c. Initial Investors Who Still Hold Their Certificates

Finally, the SEC has examined the current status of initial investors who continue to hold their WMC4 certificates. Different tranches have – due to the specific structure of the WMC4 Trust waterfall and the losses suffered to date on the underlying collateral – received varying amounts of principal payments thus far. See Canjels Decl. ¶¶ 10-21, 27-30, and Exhibit 4 thereto. In particular, as of March 27, 2017 (the date of the most recent Investor Report), holders of A-2 certificates have received 96% of the original principal amount because of the manner in which principal payments were distributed through the waterfall until July 2010. Id. ¶¶ 21, 30 & n.30, and Exhibits 4 and 8 thereto. Expected losses also vary by tranche. All of the Mezzanine tranches have been completely written off, while the A-2 tranche is currently expected to sustain losses of only 2.2%. Id. ¶¶ 28-30, and Exhibit 4 thereto.

Based upon current information, it appears that initial investors in at least one tranche would, under a simple *pro rata* distribution, receive a distribution from the Fair Fund that exceeds expected losses. To avoid this potential windfall, the SEC's Amended Distribution Plan includes a "Recovery Cap" that limits distributions to current certificate holders to the amount of expected losses as of the date of the Court's order approving the plan. See Ex. 1, ¶¶ 60.c, 62.[8]

3. Distribution through the Trust's waterfall structure would be inequitable and impractical.

The SEC has also carefully considered the arguments raised by the Objectors and noted by the Court regarding the potential merits of a distribution through the waterfall. For the following reasons, the SEC still maintains that distribution through the Trust would be inequitable and inefficient.

a. Distribution Only to Current Investors

First, the Trust is only capable of distributing to investors who *currently* hold certificates, as the Objectors themselves have admitted. See Canjels Decl. ¶ 32 & n.25 (citing Prospectus Supplement); id. ¶ 35 & n.27; see also ECF No. 34, at 13 ("[A] securitization trust can only distribute funds … to current investors."). Such a distribution would exclude all investors who sold their certificates at any point before the first "distribution date" after the Trust received the Fair Fund proceeds. Canjels Decl. ¶ 35. Distribution through the Trust would thus exclude any initial investor who actually relied upon the misleading statements that are at the core of this case, but subsequently sold his certificates. Such a distribution would not correspond to the misconduct alleged in the Complaint and would be inequitable.

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[8] Based upon current information, it appears unlikely that any other tranches have expected losses that would be exceeded by a straight *pro rata* distribution. See Canjels Decl. ¶ 30 and Exhibit 4 thereto. This provision nevertheless applies to all initial investors who still hold their certificates.

Indeed, a distribution to current certificate holders might well reward an investor who purchased his certificates well after the delinquencies in the WMC4 collateral pool were disclosed and even after the financial crisis. Such an investor would not have relied upon the misleading information in the offering documents, but instead would have relied upon current and accurate information regarding delinquencies, payments, and losses disclosed in the monthly Investor Reports issued by the Trust's Securities Administrator. See Canjels Decl. ¶¶ 7-9, 38-39. A distribution through the Trust could very well reward an investor who (1) purchased certificates with full knowledge of the delinquencies in the WMC4 Trust; (2) during or after the financial crisis; and (3) at a deep discount due to both (1) and/or (2). See id. ¶ 39. Many such investors hold certificates that are currently profitable. Id. A distribution through the Trust would reward investors who, rather than being harmed by the misrepresentations made in the offering documents, have made a profitable investment that bears absolutely no connection to the defendants' misconduct.

b. The "Secondary Market" Argument

The Objectors contend that it is fine for the Fair Fund to be distributed only and entirely to current certificate holders, some of whom have made investments totally divorced from the conduct underlying the Complaint. According to the Objectors, such investors "valued the certificates in part based on the Final Judgment and the anticipated distribution of the Fund to the Trust." ECF No. 28, at 12; see also id. at 10 ("This was the expectation of investors given the language of the Final Judgment, and the market has priced those expectations into the certificates for nearly four years."); ECF No. 36, at 14 (noting but declining to address this argument).

This argument bears little relation to the law. The method of distributing a Fair Fund should not turn on speculation regarding how investors in the secondary market have factored the

potential for a distribution – among all other information that they may consider – into their investment decisions. Instead, Fair Fund allocations should be "fair and reasonable" and reflect the underlying violations that the entry of judgment is intended to redress. See ECF No. 36, at 8-9 (noting that Fair Fund allocations should be "fair and reasonable," with the primary goal of punishing the violator and deterring future violations).

While the Objectors assert that the Final Judgment promised investors that the Fair Fund would be distributed through the Trust, see, e.g., ECF No. 34, at 13, in fact, no such promise was ever made. Distribution through the Trust was, after all, made contingent upon obtaining confirmation from the IRS regarding the tax consequences. ECF No. 3, at 7. And even though the Judgment stated that the SEC "intend[ed]" to propose a distribution through the Trust, it also contemplated the possibility that another method of distribution might ultimately be proposed, as well as the possibility that the Fair Fund might simply be transferred to the Treasury. Id. The Objectors say nothing about whether investors in the secondary market factored these contingencies into their investment decisions.

Taking the Objectors' argument to its logical conclusion, it is hardly clear that current certificate holders necessarily expect to receive a distribution through the Trust. Under the Objectors' theory, investors in the secondary market have doubtless taken into account more recent information regarding the distribution of the Fair Fund. They may, for example, have considered the course of proceedings in this case, such as the SEC's first motion to approve a *pro rata* distribution plan, filed in June 2016. ECF No. 12. They may have considered the fact that in September 2015, the Commission issued an Order establishing a *pro rata* distribution plan in a case involving substantially similar conduct as the present matter. See ECF Nos. 33-2, 33-3. Perhaps the market has priced into its expectations the Court's January 2017 order approving a

pro rata distribution plan in this very case, as to the Bulk Settlement Practice. See ECF No. 3, § 2; ECF No. 12-2; ECF No. 38. The expectations of investors in the secondary market do not provide grounds for favoring distribution through the Trust over a *pro rata* distribution scheme and should not influence the Court's assessment of whether the proposed Amended Distribution Plan is fair and reasonable.

c. The Exclusion of Investors in Mezzanine Tranches

Finally, the SEC has considered the Objectors' contentions that distributing through the Trust (1) would be "simple and straightforward,"[9] and (2) would "ensure[] that investors receive payments according to the priorities all agreed to when they purchased their certificates." ECF No. 28, at 12; see ECF No. 36, at 13-14 ("The Investors argue, in effect, that junior investors bought in at a price point reflecting the risk that delinquencies would fall on their pocketbooks, and so they were (comparatively) harmed less by J.P. Morgan's delinquency non-disclosures.").

As an initial matter, it is far from clear that distribution through the Trust would be "simple and straightforward." Distribution through the Trust would require more than the simple transfer of funds to the Trust. The prospectus supplement and the Pooling and Servicing Agreement ("PSA") for the Trust specify how different categories of proceeds should be distributed. See Canjels Decl. ¶¶ 32-34; see also ECF No. 34, at 4-5. Counsel for the Securities Administrator has advised the SEC that because the PSA does not specify how Fair Fund proceeds should be characterized, the Court would need to order that the proceeds be

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[9] The Objectors argue that a *pro rata* distribution would "needlessly increase the costs of distributing the Fund." ECF No. 28, at 12. But the Court has already approved such a distribution plan as to the Bulk Settlement Practice, which involves distribution to investors in over 150 RMBS trusts, while the Amended Distribution Plan at issue here involves only one trust. Under the terms of the Final Judgment, the SEC developed and proposed both the Bulk Settlement Practice Plan and this Amended Distribution Plan only after determining that the plan was "feasible given the costs and burden." ECF No. 3, at 4.

characterized in a particular way in order for the Trust to proceed with distribution. The Objectors suggest that the Fair Fund should be distributed according to Section 3.16 of the PSA. See ECF No. 34, at 4-5. But that Section specifies the treatment of proceeds that are "Realization Upon Defaulted Mortgage Loans," and it is far from clear that the proceeds of the Fair Fund are proceeds arising from "defaulted" loans. See Canjels Decl. ¶ 33 & n.33. In fact, the Objectors themselves recognize that even under Section 3.16, the Fair Fund proceeds could be treated either as "proceeds received" in connection with a "Final Recovery Determination," or as a "Recovery" received after a "Final Recovery Determination." ECF No. 34, at 4-5.

The more significant problem with a distribution through the WMC4 waterfall, however, is that – in addition to flowing only to current certificate holders – all investors in Mezzanine certificates would be excluded. See Canjels Decl. ¶¶ 36, 40-43; see also ECF No. 34, at 9 (recognizing that "some classes" would not receive a distribution if the Fair Fund were distributed through the waterfall).[10] It is true that junior certificate holders accepted a somewhat higher risk of non-payment in exchange for a higher interest rate. See Exhibit 3 to Canjels Decl. But it is also true that investors in Mezzanine tranches – as the ones most likely to be affected by losses in the underlying collateral – were the ones who had the greatest interest in the quality of that pool and, therefore, in receiving accurate information about delinquencies. Canjels Decl. ¶¶ 41-43. These investors, who have suffered the greatest losses, are arguably the ones who were

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[10] The Objectors contend that distribution of the Fair Fund to the Trust would benefit the Mezzanine tranches because if the Fund proceeds are treated as a "Subsequent Recovery," the Mezzanine tranches can be written back up, allowing payments to once again flow to those tranches through the waterfall. See ECF No. 34, at 9. The Objectors fail to advise the Court that even if the entire Fair Fund were used to write the Mezzanine tranches back up, only two tranches (M-1 and M-2) would be written back up (and M-2 only partially), and more importantly, the tranches would be written back down to zero, either that same month or the following month.

most harmed by the misrepresentations in the offering documents. In this case in particular, the most junior tranche, M-9, was rated investment grade and offered a modest return of 2% over Libor. Id. It is not fair to say that these Mezzanine investors should not receive a distribution because, in accepting these terms, they also accepted the risk that the disclosures upon which they – perhaps more than any other class of investors – relied were misleading and inaccurate.

III. CONCLUSION

For the foregoing reasons, the SEC respectfully requests that the Court enter an order approving the Proposed Amended Distribution Plan for the Delinquency Disclosure Conduct.

Dated: April 12, 2017

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on April 12, 2017, copies of the following documents were filed electronically:

- The SEC's Motion for Approval of Proposed Amended Plan of Distribution (the "Motion") and Exhibit 1 thereto
- Declaration of Dr. Eugene P. Canjels and all exhibits thereto

Notice of these filings will be sent by operation of the Court's electronic filing system to all parties indicated on the electronic filing receipt. Parties may access these filings through the Court's system.

/s/ Olivia S. Choe
Olivia S. Choe