IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, on Behalf of Itself and All Others Similarly Situated,	)	Case No. 02 C 5893
Plaintiff,	)	Judge Jorge L. Alonso
v.	)	
HOUSEHOLD INTERNATIONAL, INC., et al.,	)	
Defendants.	)	

APPENDIX TO DEFENDANTS' MEMORANDUM OF LAW IN SUPPORT OF THEIR MOTION TO EXCLUDE THE TESTIMONY OF PLAINTIFFS' EXPERT PROFESSOR DANIEL R. FISCHEL

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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, On Behalf of Itself and All Others Similarly Situated, Plaintiff, vs. HOUSEHOLD INTERNATIONAL, INC., et al., Defendants.	)))))))))))))	Lead Case No. 02-C-5893 (Consolidated) <u>CLASS ACTION</u> Honorable Jorge L. Alonso

<u>SECOND SUPPLEMENTAL REPORT OF DANIEL R. FISCHEL</u>

SECOND SUPPLEMENTAL REPORT OF DANIEL R. FISCHEL

I. INTRODUCTION

1. In this Second Supplemental Report,[1] I have been asked by counsel for the Plaintiffs to address three issues following the 7th Circuit Court of Appeals decision in *Glickenhaus & Co. v. Household International, Inc.*: (1) whether my analysis of the evidence and stock price movements demonstrates loss causation; (2) whether the Quantification Including Leakage I presented at trial and accepted by the jury to measure artificial inflation needs to be adjusted to account for significant, firm-specific, nonfraud related information; and (3) whether I can provide a reasonable estimate of the effect of predatory lending alone for the three trading days prior to March 28, 2001. In response to these questions, I have concluded that:

- My analysis of statistically significant stock price movements when the fraud was revealed and the evidence of leakage demonstrate loss causation.
- No adjustment to the Quantification Including Leakage analysis of inflation that I presented at trial due to significant, firm-specific, non-fraud related information is required.
- For the three trading days prior to March 28, 2001, a reasonable estimate of the effect of predatory lending alone is at least $3.06 per share.

1. I previously submitted: a report dated August 15, 2007 (the "Fischel Report," attached as Appendix A); a rebuttal report dated February 1, 2008 which responded to criticisms of the Fischel Report by Defendants' expert Mukesh Bajaj (the "Fischel Rebuttal," attached as Appendix B); and a supplemental report dated February 9, 2009 which responded to criticisms by Defendants' expert Bradford Cornell of the Quantification Including Leakage presented in the Fischel Report (the "Fischel Supplemental," attached as Appendix C). The Fischel Report provides information on my qualifications and defines capitalized terms. Appendix D presents my current CV. My current hourly billing rate is $1,250. The Fischel Report, the Fischel Rebuttal, and the Fischel Supplemental are collectively referred to herein as the "Fischel Reports." The Fischel Reports and my trial testimony are incorporated herein by reference.

I provide the bases for these conclusions below.[2]

II. MY ANALYSIS OF STATISTICALLY SIGNIFICANT STOCK PRICE MOVEMENTS WHEN THE FRAUD WAS REVEALED AND THE EVIDENCE OF LEAKAGE DEMONSTRATE LOSS CAUSATION

2. In the Fischel Reports and as presented at trial, I concluded that the economic evidence demonstrates loss causation. Specifically, I used an event study to control for market and industry factors and establish that the revelation of the fraud caused Household's stock price to decline by statistically significant amounts on: November 15, 2001, the first trade day after the press reported on a lawsuit filed by the California Department of Corporations regarding abusive lending practices; December 3, 2001, the first trade day after a *Barron's* article was published that questioned Household's accounting and re-aging practices; December 12, 2001, the first trade day after Legg Mason published a report regarding the Company's re-aging practices; July 26, 2002, when an article published in *The Bellingham Herald* reported that the Company acknowledged its employees may have misrepresented mortgage loan terms to some homeowners; August 14, 2002, the day Household announced its restatement; August 16, 2002, the first trade day after a negative *Forbes* article titled "Home Wrecker" was available to the market; August 27, 2002, when Keefe, Bruyette & Woods published a report that described Household as "uninvestable;" September 3, 2002, when Bernstein Research published a report that discussed the analysts' belief that Household will need to lower its EPS growth target; September 23, 2002, the first trade day after CIBC published a report in which the analysts lowered their target price to $36 from $57 and reduced their earnings estimate for 2003; and October 4, 2002, the date an article concerning a forthcoming settlement with state attorneys

2. I have been assisted by Compass Lexecon's staff. The materials I have relied upon in reaching the conclusions contained in this report are cited herein and in Exhibit 2.

general over the Company's predatory lending practices was published in *The Wall Street Journal*.[3] Fischel Report § III & Trial Transcript, e.g., 2603:10-2671:13. In addition to these statistically significant stock price declines, I also presented in the Fischel Reports and testified at trial about other evidence supporting my conclusion of loss causation, including the long-run underperformance of Household's stock price relative to an industry index and market participants' attribution of this underperformance to the leakage of fraud-related information. Fischel Report § III, Fischel Rebuttal § II.A. & Trial Transcript, e.g., 2671:14-2678:17.

III. BEGINNING ON MARCH 28, 2001, NO ADJUSTMENT TO THE QUANTIFICATION INCLUDING LEAKAGE ANALYSIS OF INFLATION THAT I PRESENTED AT TRIAL IS REQUIRED

3. The Appellate Court stated:

> If the plaintiffs' expert testifies that no firm-specific, nonfraud related information contributed to the *decline* in stock price during the relevant time period and explains in nonconclusory terms the basis for this opinion, then it's reasonable to expect the defendants to shoulder the burden of identifying some significant, firm-specific, nonfraud related information that could have affected the stock price. If they can't, then the leakage model can go to the jury; if they can, then the burden shifts back to the plaintiffs to account for that specific information or provide a loss-causation model that doesn't suffer from the same problem, like the specific disclosure model. *One possible way to address the issue is to simply exclude from*

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3. The residual return on November 15, 2001 was -3.06% and the t-statistic was -2.21; the residual price change was -\$1.86. *See* Exhibit 1. The residual return on December 3, 2001 was -3.22% and the t-statistic was -2.33; the residual price change was -\$1.90. *See id.* The residual return on December 12, 2001 was -4.22% and the t-statistic was -3.06; the residual price change was -\$2.39. *See id.* The residual return on July 26, 2002 was -5.67% and the t-statistic was -4.08; the residual price change was -\$2.20. *See id.* The residual return on August 14, 2002 was -2.49% and the t-statistic was -1.77; the residual price change was -\$0.94. *See id.* The residual return on August 16, 2002 was -4.66% and the t-statistic was -3.37; the residual price change was -\$1.84. *See id.* The residual return on August 27, 2002 was -3.06% and the t-statistic was -2.21; the residual price change was -\$1.19. *See id.* The residual return on September 3, 2002 was -3.36% and the t-statistic was -2.39; the residual price change was -\$1.21. *See id.* The residual return on September 23, 2002 was -5.24% and the t-statistic was -3.77; the residual price change was -\$1.52. *See id.* The residual return on October 4, 2002 was -4.74% and the t-statistic was -3.41; the residual price change was -\$1.26. *See id.*

> *the model's calculation any days identified by the defendants on which significant, firm-specific, nonfraud related information was released.*

Glickenhaus & Co. v. Household International, Inc., Case No. 13-3532, 7th Cir., May 21, 2015 ("Appellate Opinion") at 24 (emphasis added; footnote excluded). Accordingly, I analyzed whether there were any days on which "significant, firm-specific, nonfraud related information was released" that could reasonably explain the statistically significant residual declines in Household's stock price during the period from November 15, 2001 through October 11, 2002 (the "Leakage Period"). To perform this analysis, I used the event study presented in the Fischel Report, which controlled for market and industry factors and determined whether residual stock price changes were statistically significant.

4. For the reasons described below, I conclude that beginning on March 28, 2001, no adjustment to the Quantification Including Leakage analysis of inflation that I presented at trial is required.[4]

1) <u>January 11, 2002</u>

5. My event study finds that Household's residual return of -3.04 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.20. *See* Exhibit 1.[5]

6. We reviewed the available market evidence and found that negative firm-specific, nonfraud related information could reasonably explain the price decline. *See* Exhibit 2.[6]

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4. I also used my event study to perform an alternative calculation of artificial inflation in my Quantification Using Specific Disclosures, which analyzed statistically significant residual price decreases and increases caused by fraud-related information. The net effect of these decreases and increases is $7.97. Fischel Report ¶¶ 34-36. We did not find significant firm-specific, nonfraud related information that could reasonably explain these price movements. Fischel Rebuttal § II & Trial Transcript 4273:11-14.

5. Exhibit 1 presents the statistical results of my event study analysis for the Leakage Period, along with headlines from articles published by *Dow Jones News Service* and *The Wall Street Journal* that mention Household.

Specifically, debt ratings agency Fitch revised its long-term Rating Outlook of all Household entities to Negative from Stable, which affected $65 billion of rated debt.[7] *See* Exhibit 3. The agency stated that it "believes that Household has not demonstrated adequate market accessibility in [its real estate secured and unsecured consumer loan portfolios], which could be tapped in the event of stress." *See id.* In particular, Fitch noted that Household had securitized relatively less of these portfolios than other asset classes in its portfolio and had not engaged in whole loan sales. *See id.*

7. However, on January 15, 2002, two trading days later, Credit Suisse First Boston issued a report in which its analysts opined that "Fitch Outlook Change Unwarranted, In Our View" and explained the basis for their belief that Fitch is "giving [the funding element in the credit rating equation] too much weight in the case of HI."[8, 9] *See* Exhibit 4. The analysts concluded that "we believe funding vulnerability at HI is quite low and already factored into

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6. Exhibit 2 presents the Bates numbers for the materials we collected and reviewed from the trade day before through the trade day after each date on which a statistically significant residual price decline occurred during the Leakage Period. Specifically, we reviewed all news articles and analyst reports on these dates that were collected when the Fischel Reports were prepared as well as any additional news articles and analyst reports that have since been made available from the following vendors either explicitly regarding Household or that had the word "Household" within one word of variations on "International": Dow Jones Factiva; LexisNexis; Bloomberg; Thomson Research's Investext Investment Research; Reuters Knowledge; and S&P Capital IQ.
7. Fitch also lowered the senior debt rating of Household's wholly-owned subsidiary Household Finance Corp. "by one notch to 'A' from 'A+', equalizing the rating with that of its parent" to "reflect[] an evolution in our perspective with respect to ratings distinctions between a parent company and its subsidiaries." *See* Exhibit 3. Fitch stated: "The change is not a result of underlying credit changes at HFC." *See id.*
8. In the same Credit Suisse First Boston report, the analysts also addressed press reports from January 10, 2002 that indicated Household was taking a look at purchasing Providian Financial and opined that an acquisition was "highly unlikely." *See* Exhibit 4. My event study finds that Household's residual return was not statistically significant on January 10, 2002. *See* Exhibit 1.
9. We reviewed the available market evidence (as described in footnote 6) and did not find any positive firm-specific information that could reliably explain the price increase on January 15, 2002 other than the Credit Suisse First Boston analyst report.

current ratings, not only at Fitch, but more importantly, at Moody's and S&P as well." *See id.* My event study finds that Household's residual return of 2.53 percent on this date was both positive and statistically significant at the 95 percent confidence level with a t-statistic of 1.82. *See* Exhibit 1.

8. The cumulative t-statistic for these two days is -0.27 (= (-2.20 + 1.82) / √2), which is not statistically significant at the 95 percent level of confidence. Consequently, there is no reliable evidence that the net effect of this firm-specific, nonfraud related information had any significant impact on Household's stock price, i.e., the positive nonfraud information "canceled out" the negative nonfraud information. Trial Transcript 2683:17-2684:6.

2) <u>January 28, 2002</u>

9. My event study finds that Household's residual return of -2.77 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.00. *See* Exhibit 1.

10. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on January 28, 2002 was caused by significant firm-specific, nonfraud related information.

11. We did find information related to the fraud that is consistent with leakage on this date. A *Barron's* article reported that among short seller Jim Chanos' current shorts "are lenders with large exposures to the sub-prime credit market, including Household International …." *See* Exhibit 5. The article states that "[t]he sector has also engaged in aggressive accounting to burnish current results." *See id.*

3) February 6, 2002

12. My event study finds that Household's residual return of -5.13 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -3.71. *See* Exhibit 1.

13. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on February 6, 2002 was caused by significant firm-specific, nonfraud related information.

14. We did find information related to the fraud that is consistent with leakage on this date. On the next day, February 7, 2002, an ABN-AMRO analyst report stated:

> HI's stock has continued to be even weaker than most financials and was down 6% yesterday and is now down 25% over the past month despite reporting a solid, high quality, fourth quarter and reiterating a bright outlook. Bond spreads have also widened materially. We have never seen a market with as many different rumors about so many different companies as currently, and we think the rumors are having an effect as evidenced by HI's stock decline and widening of its bond spreads. Concerns around HI primarily involve accounting concerns, which appear to be unfounded, in our opinion. Adding fuel the fire, aggressive consumer activist group ACORN is at it again, leading a lawsuit by 3 California residents.

See Exhibit 6. Also on February 7, 2002, a Deutsche Banc Alex. Brown analyst report stated: "The shares of Household International continue to plummet on unsubstantiated claims, in our opinion, of issues with liquidity, accounting, and lawsuits." *See* Exhibit 7.

4) February 21, 2002

15. My event study finds that Household's residual return of -3.06 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.21. *See* Exhibit 1.

16. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on February 21, 2002 was caused by significant firm-specific, nonfraud related information.

17. We did find information related to the fraud that is consistent with leakage on this date. A *Banking Wire* article titled "Household Gets Rapped" discussed an agreement with California regulators and related Household to Providian, a company that "was fined hundreds of millions of dollars for bilking consumers." *See* Exhibit 8. The article also noted that "Household claims it made a mistake" in California and stated: "Only California has picked up on Household, but one must wonder whether the company has made similar mistakes elsewhere in the country." *See id.*

5) <u>April 25, 2002</u>

18. My event study finds that Household's residual return of -2.68 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.94. *See* Exhibit 1.

19. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on April 25, 2002 was caused by significant firm-specific, nonfraud related information.

6) <u>April 29, 2002</u>

20. My event study finds that Household's residual return of -3.36 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.43. *See* Exhibit 1.

21. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on April 29, 2002 was caused by significant firm-specific, nonfraud related information.

7) <u>May 10, 2002</u>

22. My event study finds that Household's residual return of -2.53 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.83. *See* Exhibit 1.

23. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on May 10, 2002 was caused by significant firm-specific, nonfraud related information.

24. We did find information related to the fraud that is consistent with leakage on this date. Bernstein Research issued a report a report titled "Household International: Legal Risk to Business Model Increasing" that stated: "While negotiations around federal legislation continue, we expect additional restrictive state laws to be enacted. These will tend to reduce profitability in subprime lending and make lending to some high-risk segments uneconomic (thereby reducing the size of the addressable market). In addition, the new laws increase the risk of settlement costs for new and ongoing complaints." *See* Exhibit 9.

8) <u>May 15, 2002</u>

25. My event study finds that Household's residual return of -2.28 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.65. *See* Exhibit 1.

26. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on May 15, 2002 was caused by significant firm-specific, nonfraud related information.

27. We did find information related to the fraud that is consistent with leakage on this date. *American Banker* reported that "[a]n activists' plan to tie executive compensation at Household International Inc. to its efforts to combat predatory lending won support from 25% to 27% of shares voted Tuesday … the plan won only 5% support last year." *See* Exhibit 10. The article also reported that "[a]lmost identical measures proposed to shareholders of Citigroup Inc. were less popular, winning only 5% of shares voted last year and 7.3% this year …." *See id.*

9) July 1, 2002

28. My event study finds that Household's residual return of -2.42 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.74. *See* Exhibit 1.

29. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on July 1, 2002 was caused by significant firm-specific, nonfraud related information.

10) July 9, 2002

30. My event study finds that Household's residual return of -2.75 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.98. *See* Exhibit 1.

31. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See*

Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on July 9, 2002 was caused by significant firm-specific, nonfraud related information.

11) July 10, 2002

32. My event study finds that Household's residual return of -3.74 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.68. *See* Exhibit 1.

33. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on July 10, 2002 was caused by significant firm-specific, nonfraud related information.

12) July 17, 2002

34. My event study finds that Household's residual return of -7.22 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -5.20. *See* Exhibit 1.

35. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. On this date, Household reported its "sixteenth consecutive record quarter" of financial results, stating '[t]he company's operating performance has been very strong in the first half of 2002, and, although the economic environment is likely to remain uncertain, we believe our businesses are well-positioned for the remainder of the year.'" *See* Exhibit 11. The *Associated Press* reported that "[e]arnings matched Wall Street expectations." *See* Exhibit 12. CIBC analysts said that "Household's second quarter results were positive and held few surprises." *See* Exhibit 13. Accordingly, there is no reliable basis to conclude that the significant stock price decline on July 17, 2002 was caused by significant firm-specific, nonfraud

related information.

36. We did find information related to the fraud that is consistent with leakage on this date. Capital One shares fell after "regulators required it to increase reserves for loan losses." *See* Exhibit 14. Although Defendants distinguished Household from Capital One saying there was "nothing analogous" to the Capital One news at Household, (*see* Exhibit 15), analysts from Fox-Pitt, Kelton related the announcement to the fraud and lowered their target price for the stock, stating:

> While HI may be less directly affected by the potentially regulatory changes of capital levels, the overhang of regulatory hostility does impact the stock. Accusations of predatory lending, however baseless they may be, gain additional currency in a market, seized by fear of events outside of management's control. Whether legislators jump on the bandwagon that the trial lawyers and regulators and [*sic*] riding is a rising risk for HI. Additionally, as HI goes further down the rode [*sic*] to securitization, additional questions regarding the quality of earnings arise. When investors pay attention to key fundamental drivers like loan growth, margin, credit quality, and cost control, HI does fine, because it delivers. When the focus moves away from the fundamentals towards unquantifiable factors like litigation and regulatory risk, the upside on the stock will be capped. We do not see HI trading at better than 12 times earnings in this charged environment, and thus have lowered our target price to $63.

See Exhibit 16.

13) <u>July 19, 2002</u>

37. My event study finds that Household's residual return of -2.55 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.81. *See* Exhibit 1.

38. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on July 19, 2002 was caused by significant firm-specific, nonfraud related information.

39. We did find information related to the fraud that is consistent with leakage on this date. Legg Mason issued a report titled "HI: Solid 2Q02; Remain Concerned" in which the analysts raised their EPS estimates but stated:

> More importantly, we remain concerned about the broader issues in this highly uncertain environment. Essentially, we think the level of scrutiny being applied to both companies with unclear accounting practices and companies with subprime lending activities puts HI at risk. As such, we simply don't find HI's valuation compelling enough in this market environment. Accordingly, despite better-than-expected asset quality trends and a decent quarter, we are maintaining our Hold rating on the shares until the environment improves.

See Exhibit 17.

14) July 25, 2002

40. My event study finds that Household's residual return of -2.83 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.05. *See* Exhibit 1.

41. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on July 25, 2002 was caused by significant firm-specific, nonfraud related information.

15) August 5, 2002

42. My event study finds that Household's residual return of -3.08 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.21. *See* Exhibit 1.

43. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See*

Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on August 5, 2002 was caused by significant firm-specific, nonfraud related information.

44. We did find information related to the fraud that is consistent with leakage on this date. Portales Partners issued a report which stated: "While Household continually defends its lending practices as non-predatory, it recently ceased offering the high LTV second mortgage at the time of closing of a Household first mortgage loan. In our opinion, the change is practically an admission of predatory lending." *See* Exhibit 18. In addition, Bernstein Research issued a report that stated: "… there will be some earnings impact from the reform of sales practices whose extent will depend on whether borrower confusion has arisen because of the work of a few rogue loan officers, as the firm has suggested, or because of wider systemic factors such as training and compensation. Either way, it is almost sure that Household will have to compensate borrowers who have been confused as a result of private lawsuits and a likely national settlement with State Attorneys General." *See* Exhibit 19.

16) <u>August 7, 2002</u>

45. My event study finds that Household's residual return of -4.89 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -3.52. *See* Exhibit 1.

46. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. On this date, *Reuters* reported that Household "paid about $1 billion in cash to buy back nearly all of its zero-coupon convertible senior bonds maturing in August 2021." *See* Exhibit 20. However, stock investors were aware that holders of these bonds could force Household to repurchase the securities at a prescribed price on August 2, 2002 and that by this date, the repurchase price of $827.36 substantially exceeded the conversion value of only

$372.25.[10] *See* Household International SEC Form 424(b)(5) dated July 31, 2001 at S-16 & S-17 *and*, e.g., Exhibit 21 ("In the next 18 months, almost $30 billion in convertible securities issued by companies such as … Household … could come due …."). The divergence between the repurchase and conversion values (the latter of which was established on or around July 31, 2001 when the Company's stock price was artificially inflated) was in substantial part driven by the decline in Household's stock price due to the revelation of the fraud.

17) August 9, 2002

47. My event study finds that Household's residual return of -2.50 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.81. *See* Exhibit 1.

48. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on August 9, 2002 was caused by significant firm-specific, nonfraud related information.

18) August 13, 2002

49. My event study finds that Household's residual return of -2.76 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.99. *See* Exhibit 1.

50. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See*

10. Holders of the convertible bonds had the right to convert them into shares of Household common stock at a conversion ratio of 9.022 per bond, subject to certain conditions. Household International SEC Form 424(b)(5) dated July 31, 2001 at cover. Based on the closing price of the Company's stock on August 1, 2002 of $41.26 (*see* Exhibit 1), the conversion value of each bond was $372.25 (= $41.26 x 9.022). In addition, the zero coupon bonds only yielded about one percent per year. *Id.* at S-16.

Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on August 13, 2002 was caused by significant firm-specific, nonfraud related information.

19) August 23, 2002

51. My event study finds that Household's residual return of -5.41 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -3.90. *See* Exhibit 1.

52. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on August 23, 2002 was caused by significant firm-specific, nonfraud related information.

20) September 10, 2002

53. My event study finds that Household's residual return of -2.37 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.70. *See* Exhibit 1.

54. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on September 10, 2002 was caused by significant firm-specific, nonfraud related information.

21) September 16, 2002

55. My event study finds that Household's residual return of -2.98 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.16. *See* Exhibit 1.

56. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on September 16, 2002 was caused by significant firm-specific, nonfraud related information.

57. We did find information related to the fraud that is consistent with leakage on this date. *Reuters* reported that a Merrill Lynch analyst cut his price target for Household stating "'[w]e are lowering our price objective to reflect the general depressed market multiples for financials, and to reflect that it appears Household's current legal concerns aren't going to go away anytime soon.'" *See* Exhibit 22. In addition, an editorial in *National Mortgage News* titled "Worst Practices" stated: "The practices alleged against Household by the DFI, and the practices alleged against Associates by the FTC, could be ginned together to form a 'worst practices' of predatory lending, a primer on how to be an abusive lender." *See* Exhibit 23.

22) September 17, 2002

58. My event study finds that Household's residual return of -10.41 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -7.50. *See* Exhibit 1.

59. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price

decline on September 17, 2002 was caused by significant firm-specific, nonfraud related information.

23) September 27, 2002

60. My event study finds that Household's residual return of -3.15 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.26. *See* Exhibit 1.

61. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on September 27, 2002 was caused by significant firm-specific, nonfraud related information.

24) October 1, 2002

62. My event study finds that Household's residual return of -3.70 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -2.63. *See* Exhibit 1.

63. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on October 1, 2002 was caused by significant firm-specific, nonfraud related information.

25) October 7, 2002

64. My event study finds that Household's residual return of -2.69 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.93. *See* Exhibit 1.

65. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on October 7, 2002 was caused by significant firm-specific, nonfraud related information.

26) <u>October 8, 2002</u>

66. My event study finds that Household's residual return of -2.76 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -1.96. *See* Exhibit 1.

67. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on October 8, 2002 was caused by significant firm-specific, nonfraud related information.

68. We did find information related to the fraud that is consistent with leakage on this date. UBS issued a report in which its analysts wrote "[w]e are cutting our 2003 estimate to reflect the impact of a regulatory fine on HI's earnings and capital base. We believe the fine levied against Citi/Associates for predatory lending practices makes a fine against Household more likely, and we estimate this fine could exceed $500 million." *See* Exhibit 24. The UBS analysts also wrote:

> We also believe that any agreement with the FTC or the Attorneys General would also have a longer-term impact on HI's business model. Specifically, we suspect that HI would be forced to change certain of its marketing and pricing practices. In fact, this process has already begun to some extent, as HI has voluntarily reduced the number of points it charges on loans, thereby decreasing its pricing at the margin. Nonetheless, we believe an agreement with regulatory or legal

> authorities would require additional pricing and other concessions. As a consequence, we believe HI will not be able to sustain its current level of balance sheet growth or profit margins, and as a result, the earnings power of HI's model would be diminished to some extent.

Id.

27) October 9, 2002

69. My event study finds that Household's residual return of -6.99 percent on this date was both negative and statistically significant at the 95 percent confidence level with a t-statistic of -4.98. *See* Exhibit 1.

70. We reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline. *See* Exhibit 2. Accordingly, there is no reliable basis to conclude that the significant stock price decline on October 9, 2002 was caused by significant firm-specific, nonfraud related information.

IV. FOR THE THREE TRADING DAYS PRIOR TO MARCH 28, 2001, A REASONABLE ESTIMATE OF THE EFFECT OF PREDATORY LENDING ALONE IS AT LEAST $3.06 PER SHARE

71. My Quantification Using Specific Disclosures provides a reliable minimum estimate of the effect of predatory lending alone during the three trading days prior to March 28, 2001 because I can isolate explicit amounts of artificial inflation caused solely by predatory lending. The specific disclosures on the following dates relate solely to this issue: November 14, 2001, February 27, 2002, July 26, 2002, August 15, 2002, August 27, 2002, September 3, 2002, October 4, 2002, October 10, 2002 and October 11, 2002; artificial inflation

related to these disclosures totals $3.06. Fischel Report ¶¶ 7, 12, 16-18, 20-21 *and* notes 16 & 19-21.[11]

72. This estimate understates the full effect of predatory lending alone because a substantial portion of the Quantification Including Leakage is attributable to predatory lending. As documented in the Fischel Report, the cascade of incomplete information related to Defendants' fraud principally regarded predatory lending. *Compare id.* ¶¶ 12-21 (regarding predatory lending) *with* ¶¶ 22-26 (regarding re-aging) *and* ¶ 27 (regarding the restatement). Moreover, market participants predominantly attributed Household's stock price decline to concerns regarding predatory lending. *Id.* ¶ 28. In addition, I understand that a Household internal e-mail attributed a decrease in the Company's stock price from May 2002 to August 2002 to the gradual leakage of contents of the Washington DFI Report and that a Defendant testified that market concerns about the regulatory response to Household's predatory-lending scheme dragged down the Company's stock price. Likewise, Defendants' expert Mukesh Bajaj specifically tied Household's stock price underperformance to "headline risk" about predatory lending. *See*, e.g., Bajaj Report at 67. Additionally, the artificial inflation related to the specific disclosures solely regarding re-aging and the restatement (December 1, 2001, December 5, 2001, December 11, 2001, and August 14, 2002) totals only $3.39.[12] Fischel Report ¶¶ 22-23, 27 *and* notes 16 & 19. All of the above further supports my conclusion that a reasonable estimate is at

11. Note that on September 22, 2002, information about both predatory lending and re-aging was disclosed; artificial inflation related to this disclosure totals $1.52. Fischel Report ¶ 28 & note 19. I do not include any of this amount in my analysis of artificial inflation related solely to predatory lending. In addition, the sum of the residual price changes presented in the cited notes of the Fischel Report is slightly lower due to rounding.
12. The sum of the residual price changes presented in the cited notes of the Fischel Report is slightly lower due to rounding.

least $3.06 because, given the leakage about the predatory lending fraud, the entire amount related to this aspect of the fraud is likely much greater.

73. Exhibit 25 lists Household's stock price and the true value and artificial inflation estimates on each day from March 23, 2001 through October 11, 2002 under my Quantification Using Specific Disclosures and my Quantification Including Leakage. Exhibit 26 is a graph of the stock price and estimated true value lines under these analyses.

Daniel R. Fischel

September 22, 2015

TAB 2

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, On Behalf of Itself and All Others Similarly Situated,	)	Case No. 02-C-5893
Plaintiff	)	
vs.	)	Honorable Jorge L. Alonso
HOUSEHOLD INTERNATIONAL, INC., et al.,	)	
Defendants.	)	

EXPERT REPORT OF PROFESSOR BRADFORD CORNELL

Table of Contents

I. Qualifications

1. I am currently a Visiting Professor of Financial Economics at the California Institute of Technology ("Caltech"). Previously, I was a Professor of Finance and Director of the Bank of America Research Center at the Anderson Graduate School of Management at the University of California, Los Angeles, for 26 years.

2. I earned a master's degree in Statistics from Stanford University in 1974 and earned my doctorate in Financial Economics from Stanford in 1975. I have served as an editor of numerous journals relating to business and finance and have written more than 100 articles and two books on finance and securities, including *Corporate Valuation: Tools for Effective Appraisal and Decision Making* (1993), published by McGraw-Hill, and *The Equity Risk Premium and the Long-Run Future of the Stock Market* (1999), published by John Wiley & Sons. To complement my academic writing, I have also authored articles for the *Wall Street Journal* and the *Los Angeles Times*.

3. My research has been widely recognized. In 1988, I was cited by the Financial Management Association as one of the ten most prolific authors in the field of finance. I have received prizes and grants for my research from the Chicago Board of Trade, the Chicago Mercantile Exchange, and the Institute for Quantitative Research in Finance. My article, "Corporate Stakeholders and Corporate Finance," received the 1987 Distinguished Applied Research Award from the Financial Management Association. In 1999, I was awarded the I/B/E/S prize for empirical work in finance and accounting (with Wayne Landsman and Jennifer Conrad). Richard Roll and I received a Graham and Dodd Scroll Award in 2006 from the Financial Analyst Society for our work on delegated agent asset pricing theory. I won this award

again in 2011 for my work on economic growth and equity investing. My paper entitled "Luck, Skill, and Investment Performance" in the *Journal of Portfolio Management* won an Outstanding Article prize from the 11th Annual Bernstein Fabozzi/Jacobs Levy Awards. My work in valuation has also been cited and relied upon by the Delaware Court of Chancery.

4. I have also been active in my profession. I have served as a Vice President of the Western Finance Association. I am also a past Director of both the American Finance Association and the Western Finance Association. I have served as an Associate Editor of numerous professional journals, including the *Journal of Finance,* the *Journal of Futures Markets,* the *Journal of Financial Research*, and the *Journal of International Business Studies*. I have served as a reviewer for nearly a dozen other professional journals.

5. My teaching and writing have focused on a number of different financial and economic issues, many of which are relevant to the subject matter of this report. I currently teach Applied Corporate Finance and Investment Banking at Caltech. Examples of other classes I have taught over the course of my academic career include Corporate Valuation, the Law and Finance of Corporate Acquisitions and Restructurings, Corporate Financial Theory, and Security Valuation and Investments.

6. In addition to my teaching, writing, and research studies, I serve as a Senior Consultant to Compass Lexecon, an international consulting firm. In my position as a Senior Consultant, I advise business and legal clients on financial economic issues. Prior to joining Compass Lexecon in December 2011, I served as a Senior Consultant to Charles River Associates from March 1999 through December 2011. Between 1990 and March 1999, I operated FinEcon, a financial economic consulting company, through which I also advised business and legal clients on financial economic issues.

7. I have served as a consultant and have given testimony for both plaintiffs and defendants in a variety of securities, regulatory, and commercial lawsuits. During my many years of experience as an expert witness and consultant, I have provided economic analyses and expert testimony (again, for both plaintiffs and defendants) related to valuation, corporate finance, portfolio management, and damages issues.

8. In this matter, I have previously provided:

- Affidavit of Bradford Cornell dated October 30, 2008
- Affidavit of Bradford Cornell dated October 13, 2011

9. My background is described more fully in my curriculum vitae, which is attached as Appendix A. A list of my publications may also be found in Appendix A. A list of testimony I have given in deposition or at trial over the past five years, compiled to the best of my knowledge and recollection, may be found in Appendix B. A list of the documents that I have relied upon in forming my opinions is attached as Appendix C.

10. I am being compensated for my work on this matter, including the preparation of this report and any testimony I will render at trial, at my regular hourly rate of $1,050 per hour and am also being reimbursed for reasonable expenses incurred in connection with such services. I receive compensation from Cornerstone Research based on its collected staff billings for its support of me in this matter. Neither my compensation in this matter nor my compensation from Cornerstone Research is in any way contingent or based on the content of my opinion or the outcome of this or any other matter.

II. Assignment

11. I have been asked by counsel for Defendants to review and respond to the Second Supplemental Report of Daniel R. Fischel dated September 22, 2015 ("September 2015 Fischel Report"), which incorporates by reference all of his prior reports in this case. In particular, I have been asked to address whether Prof. Fischel's Leakage Model is consistent with a paper that I co-authored, and upon which Prof. Fischel relies, entitled "Using Finance Theory to Measure Damages in Fraud on the Market Cases," or is supported by any other academic literature or accepted principles of financial economics.[1]

12. My work in this matter is ongoing. The opinions presented in this report are the result of the information available to me as of the report date. I reserve the right to supplement or modify my opinions if new information comes to light and to respond to any additional report(s) or opinions offered by other experts.

III. Background Regarding Prof. Fischel's Leakage Model

13. The jury in the initial trial in this matter found damages starting on March 23, 2001 based on Prof. Fischel's Leakage Model.[2,3] This Leakage Model does not rely on the 14 specific fraud-

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[1] Bradford Cornell and R. Gregory Morgan, "Using Finance Theory to Measure Damages in Fraud on the Market Cases," *UCLA Law Review*, Vol. 37, No.2, 1990 ("Cornell and Morgan"), pp. 883-924.

[2] Appellate Order, *Glickenhaus & Company et al. v. Household International, Inc. et al.*, May 21, 2015 ("Appellate Order"), p. 12.

[3] Prof. Fischel offered another approach in the initial trial. His "Specific Disclosures Model" identified 14 purportedly statistically significant days during the period from November 15, 2001 to October 11, 2002 (the "Observation Window") on which he asserted that Household's residual stock price movement was attributable to the revelation of fraud-related information ("Specific Disclosure Days"). Prof. Fischel's Specific Disclosures Model estimated the "amount of artificial inflation on a particular day during the Class Period [as] the sum of the subsequent residual price changes" on Specific Disclosure Days. Report of Daniel R. Fischel, August 15, 2007 ("August 2007 Fischel Report"), ¶36. However, Prof. Fischel also asserted that "a steady stream and extensive

related disclosures identified by Prof. Fischel that serve as the basis for his Specific Disclosures Model, but rather for every day during the 228-trading day Observation Window, attributes the difference between the return predicted by Prof. Fischel's regression model and the actual Household return to the disclosure and leakage of fraud-related information.[4] In the August 2007 Fischel Report, he claims to base his Leakage Model on Cornell and Morgan. Specifically, he writes: "… I quantified the amount of artificial inflation in Household's stock price including the leakage of information related to the alleged fraud using the 'event study approach' described by Cornell and Morgan."[5] My paper is the only article Prof. Fischel cites in support of his Leakage Model.

14. I understand that Defendants appealed the verdict in the initial trial because, among other reasons, the Leakage Model did not account for firm-specific, nonfraud factors. I further understand that the Seventh Circuit granted a new trial because, among other reasons, "the leakage model, which the jury adopted, didn't account for the extent to which firm-specific, nonfraud related information may have contributed to the decline in Household's share price."[6] Both Prof. Fischel himself and the Seventh Circuit agree that the Leakage Model potentially suffers from the flaw that the model "attributes any decline in the security price that is not due to movements in the market or the industry to disclosure of the fraud," and thus overstates damages

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amount of incomplete information related to Defendants' alleged fraud was disclosed beginning at least as early as November 15, 2001," but that "only some of these disclosures were associated with statistically significant residual returns" (August 2007 Fischel Report, ¶39), and thus,"[a]s a result of this leakage," his Specific Disclosures Model "likely significantly understates the amount of artificial inflation in the stock price during the Class Period." August 2007 Fischel Report, ¶40.

[4] Prof. Fischel also includes a small adjustment to the predicted returns using a capital asset pricing model approach. August 2007 Fischel report, ¶41, FN 30.

[5] August 2007 Fischel Report ¶41.

[6] Appellate Order, p. 20.

"[i]f the disclosure of the fraud is associated with the release of other company-specific bad news..."[7] The Seventh Circuit required that, in order for the Leakage Model to go to the jury in the new trial, Plaintiffs' expert must opine that "no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explain[] in nonconclusory terms the basis for this opinion…."[8]

15. In response to the Seventh Circuit's decision, Prof. Fischel submitted the September 2015 Fischel Report in which he opined that "[n]o adjustment to the Quantification Including Leakage analysis of inflation [Leakage Model] that I presented at trial due to significant, firm-specific, non-fraud related information is required."[9] The basis for his assertion is a purported review of the public mix of information on each of the 27 days during the Observation Window on which there was a statistically significant decline in Household's stock price (according to Prof. Fischel's regression model) that were not Specific Disclosure Days.[10]

IV. Summary of Opinions

16. Prof. Fischel's assertion that his Leakage Model adequately accounts for firm-specific, nonfraud factors, and thus provides a reliable estimate of inflation and damages, is fundamentally flawed and unsupported by Cornell and Morgan or other financial economics literature. The reasons for this conclusion are summarized below and detailed in the sections that follow.

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[7] Cornell and Morgan, p. 903.
[8] Appellate Order, p. 24.
[9] Second Supplemental Report of Daniel R. Fischel, September 22, 2015 ("September 2015 Fischel Report"), ¶1.
[10] Prof. Fischel also states in a footnote that he did not did not find significant firm-specific, nonfraud related information that could reasonably explain the price movements on the 14 Specific Disclosure days. September 2015 Fischel Report, ¶4, FN 4.

- I am aware of no academic support for the conclusions that Prof. Fischel draws regarding his Leakage Model. Given Prof. Fischel's implementation, Cornell and Morgan provides no basis for any assertion that his Leakage Model provides reliable estimates of inflation and damages, and Prof. Fischel cites no other academic support for such an assertion. Prof. Fischel's attribution of Household's residual stock price changes to the fraud on days when no fraud-related news was disclosed—a critical assumption of his Leakage Model— is pure assertion and speculation.

- As discussed in Cornell and Morgan, models such as the Leakage Model that attempt to adjust for only market and industry movements reliably measure inflation only if there is no value-relevant, firm-specific, nonfraud information (confounding information) affecting the company's stock price and if the model predicts stock price movements with sufficient accuracy such that the resulting firm-specific price movements (residuals) can reliably be attributed to firm-specific information. The failure of Prof. Fischel's Leakage Model to satisfy these conditions results in unreliable estimates of inflation and damages.

- Any estimate of inflation produced by Prof. Fischel's Leakage Model cannot be relied upon because his model does not take account of firm-specific factors. Specifically, it suffers from the problem discussed in Cornell and Morgan and noted by the Seventh Circuit in its appellate ruling, that is, "it attributes any decline in the security price that is not due to movements in the market or the industry to disclosure of the fraud," and, "[i]f the disclosure of the fraud is associated with the release of other company-specific bad news, the comparable index approach [which is what Prof. Fischel's Leakage Model is] will overestimate the true damages."[11]

- Another reason to be skeptical of the results produced by Prof. Fischel's Leakage Model is that errors inherent in his estimation of Household's "true value" compound over his long (228-trading day) Observation Window, and such compounding, in turn, can produce significant errors in measured inflation.

- Prof. Fischel's discussion of firm-specific, nonfraud factors in his September 2015 Report is conclusory and does not establish that his Leakage Model adequately accounts for nonfraud factors, including firm-specific, nonfraud information (confounding information) and other factors such as statistical noise, or trading volatility, and thus it does not produce reliable estimates of inflation and damages.

[11] Cornell and Morgan, p. 903.

V. Cornell and Morgan Provides No Basis for Prof. Fischel's Assertion that the Leakage Model Reliably Estimates Inflation and Damages and Prof. Fischel Cites No Other Basis

17. I am not aware of any academic support for the conclusions that Prof. Fischel draws regarding his Leakage Model. Prof. Fischel's implementation of the Leakage Model in this matter fails to adequately account for value-relevant, firm-specific, non-fraud information. Even setting that aside, error compounding over the 228-day Observation Window renders Prof. Fischel's estimate of "true value" speculative. Given the facts and Prof. Fischel's implementation in this matter, Cornell and Morgan provides no basis for Prof. Fischel's conclusion that his Leakage Model provides reliable estimates of inflation and damages, and Prof. Fischel cites no other academic support for such an assertion.

18. Prof. Fischel's attribution of Household's residual stock price changes to the fraud on days when no fraud-related news was disclosed—a critical assumption of his Leakage Model— is pure assertion. Prof. Fischel's September 2015 Report does not address the 171 days during the Observation Window for which his model does not find a statistically significant stock price change, yet his Leakage Model attributes those price changes to the fraud. I am aware of no academic literature that would support this attribution. Indeed, Prof. Fischel's deposition testimony in this matter indicates that he cannot be certain within his specified confidence level (95%) that the returns are not due to "chance alone."[12] Similarly, his testimony in another matter

[12] Deposition of Daniel R. Fischel, March 21, 2008, 55:4–9.

undermines any attribution of price changes that are not statistically significant to firm-specific information, let alone firm-specific information related to the fraud:[13]

> When performing event studies... [i]f the null hypothesis cannot be rejected at conventional levels of significance, then the residual returns are not considered to be statistically significant, i.e., they are not considered to be significantly different from zero. Under these circumstances, one concludes that the observed stock return on a particular date can be explained by the independent variable(s) considered in the estimation model (and is not attributable to the firm-specific events which occurred on that date).

19. Prof. Fischel's September 2015 Report identifies 15 statistically significant price declines during the Observation Window for which his review of the public mix of information finds no value-relevant, firm-specific information (fraud-related, or otherwise), yet his Leakage Model attributes those price changes to the fraud. I am aware of no academic literature that would support this attribution. Indeed, I am aware of literature noting that even large price changes are often unexplainable, due to random factors such as trading volatility.[14]

A. Prof. Fischel's Failure to Account for Confounding Information Renders the Estimation of Inflation from His Implementation of the Leakage Model Unreliable

20. As discussed in Cornell and Morgan, in order for a leakage model to reliably estimate inflation, and thus damages, there must have been no value-relevant, firm-specific information unrelated to the fraud (confounding information) disclosed during the period over which the leakage model is employed: "[i]f the disclosure of the fraud is associated with the release of other

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[13] *United States of America v. Joseph P. Nacchio*, "Corrected Report of Daniel R. Fischel," January 12, 2010, p. 3.
[14] Richard Roll, "R^2," *Journal of Finance*, vol. 63, no 2, July 1988, p. 541-566; David Cutler, James Poterba, and Lawrence Summers, "What Moves Stock Prices?" *The Journal of Portfolio Management*, vol. 15, no. 3, March 1988, pp. 4-12.

company-specific bad news, the comparable index approach will overestimate the true damages."[15]

21. My analysis of the September 2015 Fischel Report reveals that this failure to adequately account for confounding information is more than a theoretical possibility for Prof. Fischel's Leakage Model. I understand that others will address the disclosure of nonfraud, firm-specific information during Prof. Fischel's disclosure period in more depth. However, I note that even a cursory review of the information that Prof. Fischel himself cites in his September 2015 Report demonstrates that firm-specific, nonfraud information affected Household's stock price on days that he identifies as having a statistically significant decline during the Observation Window.

22. For example, Prof. Fischel identifies a Deutsche Banc Alex. Brown analyst report on February 7, 2002 that states that "shares of Household International continue to plummet on unsubstantiated claims, in our opinion, of *issues with liquidity*, accounting, and lawsuits."[16] Similarly, Prof. Fischel cites a September 16, 2002 *Reuters* article about a Merrill Lynch analyst lowering his price target for Household "to reflect the general depressed market multiples for financials" in addition to the analyst's opinion that "Household's current legal concerns [were not] going to go away anytime soon."[17] Concerns regarding Household's liquidity and generally depressed market multiples for financials are not related to the alleged fraud in this matter.

23. In sum, Prof. Fischel's failure to reliably control for value-relevant, firm-specific, non-fraud information during the relevant period—a necessary precondition for a leakage model to

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[15] Cornell and Morgan, p. 903.
[16] September 2015 Fischel Report, ¶14 (emphasis added).
[17] September 2015 Fischel Report, ¶57.

produce a reliable inflation estimate—means that Prof. Fischel's Leakage Model does not reliably estimate inflation.

B. Wide Error Bands Resulting from Prof. Fischel's Implementation of the Leakage Model Render Resulting Inflation Estimates Unreliable

24. In order for a leakage model like Prof. Fischel's to reliably estimate inflation, and thus damages, the regression analysis (or event study analysis) on which the leakage model is based must predict stock price movements with sufficient accuracy such that the resulting firm-specific price movements can reliably be attributed to firm-specific information. Otherwise, there is no reliable basis to conclude that the leakage model is accurately estimating the effects of firm-specific information, and thus no reliable basis to conclude that the resulting inflation measures the effect of fraud-related information as opposed to non-fraud factors, such as statistical noise.

25. Indeed, Prof. Fischel's regression model, on which the Leakage Model is based, produces substantial error in measuring firm-specific returns, and such error compounds when the model is used to predict returns over long periods, such as his 228-trading day Observation Window.[18] Accordingly, even setting aside Prof. Fischel's failure to account for firm-specific, nonfraud

[18] Note that the discussion in this section takes Prof. Fischel's regression analysis as given. The leakage model approach discussed in Cornell and Morgan assumes: "that all parties to the litigation agree on how to measure the market and the industry," "that the industry variable includes all systematic factors that affect the security's return other than the market," and "that litigants agree on the form of the model and on how to estimate the parameters" (Cornell and Morgan, p. 898, FN 41-42). Cornell and Morgan also notes that "[i]n practice, debate may arise about issues such as adding other explanatory variables [and] choosing the sample period…"(Cornell and Morgan, p. 898 FN 42). I understand that there have been certain criticisms of Prof. Fischel's regression model specification and assumptions (See, e.g., the December 2007 Expert Report of Mukesh Bajaj, pp. 77-82). However, the discussion in this section assumes for purposes of analysis that there are no flaws in how Prof. Fischel measured the market and industry, ensured that the industry variable includes all systematic factors, and arrived at the form and parameters of the model.

information during the Observation Window, the substantial error bands around his estimate of the "true value" stock price renders his estimate of inflation speculative.

26. The estimation error inherent in the regression model utilized by Prof. Fischel results from both forecast error, *i.e.* the model's inability to accurately predict stock price returns, and prediction error, *i.e.* uncertainty in the model's estimation of the relationship between Household's stock price returns and the returns of the market and industry. The first source of error contained in Prof. Fischel's Leakage Model is that there is substantial forecast error when utilizing a regression model to predict the "true value" of the stock price based on the market and industry returns. This forecast error, or "random error," is discussed in Cornell and Morgan:[19]

> On days when there are no disclosures, however, the two value lines [one using the comparable index approach, which is what the Leakage Model uses, and the other using the event study approach] differ. The [Leakage Model] approach calculates the value from returns predicted by the market model; the [event study] approach [which is what the Specific Disclosures Model is] uses the actual returns on the security. Because actual returns differ from predicted returns by random error, which reflects firm-specific developments, the two lines are not identical. Ex-ante, the expected damages are the same using either approach because the expected value of the actual return is equal to the predicted return. Ex-post, however, the damage estimates will differ because of the random error.
>
> In many situations, this apparently minor distinction between the two approaches can lead to large differences in the estimated value lines.

27. The second source of error arises from uncertainty in the precise relationship between Household's stock price returns and the returns of the market and industry indices. As discussed in Cornell and Morgan:[20]

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[19] Cornell and Morgan, p. 900.
[20] Cornell and Morgan, p. 900, FN 47.

> Actual returns and predicted returns will differ by more than random error if the model used to calculate predicted returns is not properly specified. In most situations errors in the daily predicted returns caused by improper specification will be small relative to random errors caused by firm-specific factors. Over longer periods of time, though, misspecification errors cumulate and become more important. Thus, proper specification of the model is more important when using the [Leakage Model] approach than when using the [Specific Disclosures Model] approach.

28. In other words, errors in estimating the relationship between Household's returns and the market and industry returns will impact the estimation of the Leakage Model for reasons unrelated to the disclosure or leakage of fraud-related information.

29. Importantly, in the context of the Leakage Model, these errors compound as Prof. Fischel estimates the "true value" stock price over the Observation Window. This is because the Leakage Model works backwards over the Observation Window from the last day of the Observation Window, October 11, 2002, to the first day, November 15, 2001, and builds in error on each day. Specifically, Prof. Fischel starts with the actual Household stock price on October 11, 2002, and then computes the "true value" stock price on October 10, 2002 using his model's predicted return for October 11, 2002. This predicted return has forecast and prediction error, as discussed above. Prof. Fischel's Leakage Model next estimates the "true value" for October 9, 2002 by using his estimate of the "true value" for October 10, 2002 and using his model's predicted return for October 10, 2002, which also includes forecast and prediction error. Thus, the estimate for October 9, 2002 includes the errors associated with predicting the October 10, 2002 stock price return and predicting the October 11, 2002 stock price return. By the start of the Observation Window, Prof. Fischel's Leakage Model includes 228 compounded prediction errors. The end result is that at the beginning of the Observation Window, the error in estimating inflation and damages is substantial.

30. Exhibit 1 displays the increasing, compounded errors associated with the Leakage Model, and demonstrates that at the beginning of the Observation Window, the 95% confidence interval around Prof. Fischel's true value stock price spans $24 to $53.[21]

VI. Conclusion

31. In sum, because Prof. Fischel has not reliably controlled for value-relevant, firm-specific, non-fraud factors, the conclusions about inflation and damages he draws from his Leakage Model are unsupported by Cornell and Morgan or other peer-reviewed literature.

Executed on this 23 day of October in 2015 in Pasadena, CA.

Bradford Cornell

[21] For robustness, I calculated two additional 95% confidence intervals surrounding Prof. Fischel's true value line: (1) assigning no additional error to the 14 Specific Disclosure Days and (2) assigning no additional error to the 14 Specific Disclosure Days and the 11 days during the Observation Window on which Prof. Fischel purports in his September 2015 Report to have identified information consistent with leakage. The results are similar.

TAB 3

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, On Behalf of Itself and All Others Similarly Situated,	)	Case No. 02-C-5893
Plaintiff	)	
vs.	)	Honorable Jorge L. Alonso
HOUSEHOLD INTERNATIONAL, INC., et al.,	)	
Defendants.	)	

<u>EXPERT REPORT OF PROFESSOR ALLEN FERRELL</u>

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I. Qualifications

1. I am an economist and the Greenfield Professor of Securities Law at Harvard Law School. I received a Ph.D. in economics from the Massachusetts Institute of Technology with fields in econometrics and finance and a J.D. from Harvard Law School. My Ph.D. concerned the relationship between stock prices and financial disclosures. After law school I clerked for Judge Silberman of the United States Court of Appeals for the D.C. Circuit and Justice Kennedy of the Supreme Court of the United States.

2. I am also a faculty associate at the Kennedy School of Government at Harvard, a fellow at Columbia University's Program on the Law and Economics of Capital Markets, a research associate at the European Corporate Governance Institute, and a member of the editorial board of the *Journal of Financial Perspectives*. I formerly was a member of the Board of Economic Advisors to the Financial Industry Regulatory Authority ("FINRA"), an academic fellow at FINRA, Chairperson of Harvard's Advisory Committee on Shareholder Responsibility (which is responsible for advising the Harvard Corporation on how to vote shares held by its endowment), the ABA Task Force on Corporate Governance, American Law Institute Project on the Application of U.S. Financial Regulations to Foreign Firms and Cross-Border Transactions, and an executive member of the American Law School section on securities regulation.

3. I have testified before the U.S. Senate Subcommittee on Securities, Insurance, and Investment and presented to, among others, the Securities and Exchange Commission ("SEC"), the World Bank, International Monetary Fund, the Structured Products Association, and the National Bureau of Economic Research. I have published approximately 30 articles in leading journals in the general areas of law and finance, including papers on securities damages, loss causation, and event study analysis. I have also been an expert witness in a variety of securities matters. My testimony in the last four years and academic work are summarized on my curriculum vitae, which is attached hereto as Appendix A.

4. I am being compensated at my customary hourly rate of $1,050 for my work on this matter. I have received the assistance of the staff employed by Cornerstone Research, and I receive compensation from Cornerstone Research based on its collected staff billings for its support of me in this matter. My compensation is not contingent on the outcome of this matter.

II. Background

5. Household International, Inc. ("Household" or the "Company") (n/k/a HSBC Finance Corporation, a subsidiary of HSBC Holdings plc) was a diversified consumer finance company, with businesses centered on "mortgages, home-equity loans, auto financing, and credit-card loans."[1] In the initial trial in this matter, Plaintiffs alleged that Defendants[2] made misrepresentations during the "class period" (July 30, 1999 to October 11, 2002)—specifically, alleged misrepresentations relating to predatory lending, re-aging delinquent loans, and improper revenue recognition.[3] The jury ultimately found Household liable for 17 misrepresentations, beginning on March 23, 2001.[4]

6. At trial, Professor Fischel offered two damages methodologies—(1) a "specific disclosures model" based on Household's stock price changes on 14 days about which Professor Fischel testified that he was "reasonably confident that the fraud-related disclosure" was responsible for the "statistically significant price movement" ("specific disclosure days"),[5] and (2) a "leakage model" that the jury ultimately used to assess damages per share.[6]

7. The leakage model purports to measure inflation as the difference between Household's actual stock price and its "true value" (the value that Household stock would have been absent the misrepresentations). Professor Fischel's calculation of the true value relies on the "firm-specific" (residual) returns resulting from his regression model—a model measured over a period spanning November 15, 2000 to November 14, 2001 (the "control period") that includes as independent variables the S&P 500 Index and the S&P Financials Index in an attempt to control for general market and broad financial industry effects, respectively. To estimate the true value, Professor Fischel's leakage model works backward from Household's actual stock price on October 11, 2002, which represents the end of the "leakage period" (November 15, 2001 to

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[1] Appellate Order in *Glickenhaus & Co. et al. v. Household International, Inc.*, No. 13-3532 (7th Cir. May 21, 2015) ("Appellate Order"), p. 3.

[2] "The four defendants in this case are William Aldinger, Household's CEO; David Schoenholz, the CFO; Gilmer, Vice-Chairman and President of Consumer Lending; and Household itself." Appellate Order, p. 31.

[3] Appellate Order, pp. 11–12, 25.

[4] Appellate Order, p. 4.

[5] Direct Examination of Daniel R. Fischel in Trial Before the Honorable Ronald A. Guzman, *Lawrence E. Jaffe Pension Plan, et al., v. Household International, et al.* ("Fischel Trial Testimony"), April 16, 2009, 2628:15–21.

[6] Appellate Order, p. 12.

October 11, 2002). The actual stock price of $28.20 represents the "true value" of the stock on October 11, 2002. "True value" on earlier days during the leakage period uses the predicted returns from his regression,[7] with one exception—the "$23.94 inflation cap." According to Professor Fischel's leakage model, the sum of all the firm-specific price declines during the 228-day leakage period totals $23.94. Professor Fischel does not allow the estimated inflation to exceed that $23.94 on any day.

8. The leakage model presented by Professor Fischel assumes the entirety of Household's firm-specific stock price change (i.e., its price changes after adjusting for the market and broad industry factors, as well as the risk-free rate) during the leakage period is due to fraud-related information. However, the Seventh Circuit noted that the leakage model potentially "suffer[s]" from the issue that "the leakage model, which the jury adopted, didn't account for the extent to which firm-specific, nonfraud related information may have contributed to the decline in Household's share price."[8]

9. In the initial trial, Professor Fischel testified that he considered the effect of firm-specific, nonfraud information and found that positive and negative effects of firm-specific, nonfraud factors during the leakage period "cancel each other out." This testimony was not confined to any particular subset of leakage days but rather was a blanket statement covering the entire leakage period.[9] I understand that the Seventh Circuit found this testimony to be too conclusory and required that, in order for the leakage model to go to the jury in the new trial, Plaintiffs' expert must opine that "no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explain[] in nonconclusory terms the basis for this opinion…."[10]

10. In response to the Seventh Circuit's decision, Professor Fischel submitted a Second Supplemental Report on September 23, 2015 ("Second Supplemental Report") in which he

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[7] For the leakage model, predicted returns are calculated as $R_{predicted} = R_{rf} + -0.20929 \times (R_{S\&P500} - R_{rf}) + 1.06738 \times (R_{financials} - R_{rf})$, where $R_{predicted}$ is the daily predicted return, R_{rf} is the daily risk-free return, $R_{S\&P500}$ is the daily return of the S&P 500 Index, and $R_{financials}$ is the daily return of the S&P Financials Index. True Value $_{t-1}$ = (True Value $_t$ + Dividend $_t$) ÷ (1 + Constructed Return $_t$).

[8] Appellate Order, pp. 20, 24.

[9] Fischel Trial Testimony, April 16, 2009, 2684:21–2685:6.

[10] Appellate Order, p. 24.

opined that "[n]o adjustment to the Quantification Including Leakage analysis of inflation [leakage model] that [he] presented at trial due to significant, firm-specific, non-fraud related information is required."[11] The basis for his assertion is a purported review of the public mix of information on each of the 27 days during the leakage period on which there was a statistically significant decline in Household's stock price (according to Professor Fischel's regression model) that were not among the 14 specific disclosure days.

11. Of those 27 days, Professor Fischel found only one on which "negative firm-specific, nonfraud related information could reasonably explain the price decline."[12] However, he asserts that "the positive nonfraud information" just two trading days later "'canceled out' the negative nonfraud information."[13] For the remaining 26 days, Professor Fischel provides testimony that he "reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline."[14] Notably, he does not discuss a single news item that he believes to be firm-specific, nonfraud information on any of these 26 days, let alone provide a basis for his opinion that it could not reasonably explain the contemporaneous price decline.

12. The 26 days on which Professor Fischel "reviewed the available market evidence and did not find negative firm-specific, nonfraud related information that could reasonably explain the price decline"[15] can be divided into two categories. For 15 days, Professor Fischel finds no fraud-related information. For 11 days, he attempts to identify "information related to the fraud that is consistent with leakage." Notably, for none of the 26 days does he proffer the opinion, as he did for his 14 specific disclosure days, that he is "reasonably confident that the fraud-related disclosure" was responsible for the "statistically significant price movement."[16]

13. As mentioned above, the $23.94 inflation cap represents the sum of the residual stock price declines over the entire 228-day leakage period. Exhibit 1 demonstrates this $23.94

[11] Second Supplemental Report, ¶ 1.
[12] Second Supplemental Report, ¶ 6.
[13] Second Supplemental Report, ¶ 8.
[14] *See*, *e.g.*, Second Supplemental Report, ¶ 16.
[15] *See*, *e.g.*, Second Supplemental Report, ¶ 16.
[16] Fischel Trial Testimony, April 16, 2009, 2628:15–21.

residual stock price decline can be broken into several categories based on Professor Fischel's analysis and testimony:[17]

- The cumulative price decline on the 14 specific disclosure days for which Professor Fischel is "reasonably confident that the fraud-related disclosure" was responsible for the "statistically significant price movement"[18] equals $7.32.
- The cumulative price decline on the 43 additional days during the leakage period on which Household's stock price returns are statistically significant according to Professor Fischel's model ("additional statistically significant days") equals $9.86. Note that this category includes the 27 days with statistically significant declines that were the primary subject of the Second Supplemental Report.[19]
- The cumulative stock price decline on the 171 days on which the returns are not statistically significant equals $6.75.

III. Assignment and Summary of Opinions

14. I have been retained by counsel for Household to assess Professor Fischel's Second Supplemental Report in light of the economic evidence. Specifically, in the Second Supplement Report, Professor Fischel concludes that his "analysis of statistically significant stock price movements when the fraud was revealed and the evidence of leakage demonstrate loss causation" and "[n]o adjustment to the Quantification Including Leakage analysis of inflation that [he] presented at trial due to significant, firm-specific, non-fraud related information is required."[20] I was also asked to assess whether there was "some significant, firm-specific, nonfraud related information that could have affected [Household's] stock price."[21] The materials relied upon in reaching my opinions is documented in Appendix B.

15. My principal conclusions are:

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[17] As shown in Exhibit 1, cumulative residual price changes may differ slightly from Professor Fischel's estimates due to rounding. For example, Professor Fischel found that the cumulative residual price change over the entire leakage period is $23.94 rather than the $23.93 displayed in Exhibit 1.
[18] Fischel Trial Testimony, April 16, 2009, 2628:15–21.
[19] The cumulative price decline for the 15 statistically significant price decline days on which Professor Fischel found no fraud-related information whatsoever is $21.40.
[20] Second Supplemental Report, ¶ 1.
[21] Appellate Order, p. 24.

a. The Second Supplemental Report suffers from a fundamental gap: it discusses just 27 days during the leakage period,[22] notwithstanding the fact that the period for which the leakage model assumes only disclosure or leakage of fraud is affecting Household's residual stock price (with just two exceptions) consists of 228 days.

b. The leakage model suffers from a fundamental methodological flaw: it estimates inflation and damages per share in excess of the total price decline Professor Fischel himself attributes to the market impact of leakage of fraud-related information. In other words, a portion of his inflation and damages per share estimates is due to nonfraud information according to his own event study analysis.

c. Household was extensively covered by the public press and analysts during the leakage period. The fact that Professor Fischel only identifies and addresses two pieces of information that he believes to be firm-specific, nonfraud information during the 228-day leakage period belies the conclusory nature of his opinion that "no adjustment to the Quantification Including Leakage analysis of inflation that [he] presented at trial is required" due to firm-specific, nonfraud factors. My detailed review of the available market evidence documents the presence of significant firm-specific, nonfraud information, which Professor Fischel fails to address, let alone account for, throughout the leakage period (including but not limited to the 27 days Professor Fischel focuses on in his Second Supplemental Report).

d. Despite claims to the contrary, the leakage model cannot be cured by claiming that positive firm-specific information "cancels out" negative firm-specific information over the course of the leakage period.

The bases for these conclusions are provided below.

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[22] Professor Fischel also states in a footnote that he did not find significant firm-specific, nonfraud-related information that could reasonably explain the price movements on the 14 specific disclosure days. Second Supplemental Report, footnote 4.

IV. The Second Supplement Report Suffers from a Fundamental Gap

16. Despite the centrality of the residual stock price declines over the entire 228-day leakage period to his leakage model, Professor Fischel states at the outset of his Second Supplemental Report: "I analyzed whether there were any days on which 'significant, firm-specific, nonfraud related information was released' that could reasonably explain the *statistically significant residual declines* in Household's stock price during the period from November 15, 2001 through October 11, 2002…."[23] His report then attempts to support the use of the price declines that occur on the 14 specific disclosure days (through a brief footnote reference)[24] and the 27 additional statistically significant decline days.

17. Professor Fischel's Second Supplemental Report by its own terms therefore fails to provide support for the leakage model's inclusion of the cumulative residual stock price decline over the 171 days during the leakage period without statistically significant price changes (summing to $6.75) and, for the same reason, fails to provide any additional support for his trial testimony concerning the impact on these days of firm-specific, nonfraud-related information. Given that the leakage model by construction crucially depends on the use of residual stock price declines throughout the entire leakage period—not just the 14 specific disclosure days and the 27 additional statistically significant decline days—Professor Fischel's opinion that no adjustment of his leakage model is necessary remains unsupported for this reason alone.

18. Simply pointing to the fact that Household underperformed the S&P 500 and S&P Financials Indices during the leakage period does not provide a reliable basis for attributing all firm-specific price movements to fraud,[25] even when coupled with the analyst reports purportedly discussing the negative impact of the fraud to which Professor Fischel points.[26] Consistent with this, I understand the Seventh Circuit found this testimony to be insufficient when it agreed that loss causation had not been sufficiently established and required Professor Fischel to opine that "no firm-specific, nonfraud related information contributed to the decline in stock price during

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[23] Second Supplemental Report, ¶ 3 (emphasis added).
[24] Second Supplemental Report, footnote 4.
[25] Report of Daniel R. Fischel, August 15, 2007 ("Fischel Initial Report"), ¶ 29.
[26] *See*, *e.g.*, Fischel Initial Report, ¶ 28.

the relevant time period and explain[] in nonconclusory terms the basis for this opinion…."[27] And, in fact, as discussed in detail below, Professor Fischel fails to account for firm-specific, nonfraud information on the days that he does analyze in the Second Supplemental Report, as well as on his 14 specific disclosure days.

19. In sum, I find no reliable basis for Professor Fischel's attribution to the fraud of the residual price movements (cumulating to $6.75) on the 171 days during the leakage period without statistically significant price changes. Professor Fischel's claim that the stock price changed because of "leakage" of fraud-related information on all of the 171 non-statistically significant days, which is central to his leakage model, remains unsupported. Indeed, Professor Fischel's prior testimony establishes that, when price movements are not statistically significant, then "they are not considered to be significantly different from zero."[28] This means that "one concludes that the observed stock return…can be explained by the independent variable(s) considered in the estimation model," here, the S&P 500 and S&P Financials Indices, "and is not attributable to the firm-specific events which occurred on that date."[29]

V. The Leakage Model's Inflation and Damages Necessarily Reflects Nonfraud Factors

20. Although, as I set forth below, there is a substantial amount of significant firm-specific, nonfraud information that Professor Fischel fails to address, let alone account for, during the leakage period, it is also worth noting at the outset a basic methodological flaw relating to Professor Fischel's application of the leakage model in this case. That is, even if one were to fully accept Professor Fischel's claim that all residual price declines during the leakage period (with two exceptions) are attributable to leakage of the fraud (which is incorrect, as set forth below), his leakage model suffers from a fundamental methodological flaw: its damages estimates necessarily overestimate actual damages.

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[27] Appellate Order, p. 24.
[28] Corrected Report of Daniel R. Fischel, *In Re United States of America v. Nacchio*, No. 05-c-00545-EWN, 2010 WL 2786837, at *3 (D. Colo. Jan. 12, 2010).
[29] Corrected Report of Daniel R. Fischel, *In Re United States of America v. Nacchio*, No. 05-c-00545-EWN, 2010 WL 2786837, at *3 (D. Colo. Jan. 12, 2010).

21. As discussed above, Professor Fischel imposes the $23.94 inflation cap on his leakage model—where $23.94 is equal to the sum of all of the residual stock price changes during the leakage period.[30,31] Without this ad hoc cap, Professor Fischel's leakage model would commit him to the untenable position of estimating damages per share in excess of the actual economic losses according to his very own analysis. But the leakage model cannot be so easily patched to be consistent with the actual economic losses purportedly suffered by investors due to a fraud disclosure or leakage.

22. To illustrate this point, suppose an investor on Monday purchased a stock at $100. On Tuesday the stock price fell to $90, a 10% decline, with this decline being fully explained by movements in the market and industry (more technically, fully explained by a market model for this stock). On Wednesday the company fully discloses a fraud it had engaged in, and the stock in reaction to this information falls from $90 to $60 (with the market and industry movements explaining none of the stock drop on this day). Using the leakage model's calculations, the inflation in the stock due to the fraud on Monday would not be $30 but rather $33.3.[32] In other words, a portion of the $10 price decline on Tuesday is being ascribed to leakage of the fraud on Tuesday even though the movement on that day is entirely explained by nonfraud factors, that is, the market and industry movements on that day. The proposed leakage model suffers from the same flaw.

23. For example, consider Professor Fischel's $22.69 estimate of inflation and damages per share for shares purchased at the closing price on March 15, 2002 (a day within his leakage period) and held through the end of the class period.[33] The entire residual decline due to leakage of fraud according to Professor Fischel's own analysis that occurs after March 15, 2002 is

[30] "If the resulting inflation on any day was greater than the cumulative residual price decline during the [leakage period] of $23.94, I limited the inflation to $23.94 and adjusted the true value line accordingly" (Fischel Initial Report, ¶ 42).

[31] While Professor Fischel does not explain his rationale for the cap, the Seventh Circuit explains its understanding: "Since the net sum of price declines due to corrective disclosures under this model was $23.94, the stock was overpriced by that amount prior to those disclosures" (Appellate Order, p. 13).

[32] The value on Monday = the value on Tuesday adjusted for the return on Tuesday = $60 / (1 - 10%) = $66.7, and thus inflation = $100 - $66.7 = $33.3.

[33] *See* Exhibit B of Second Supplemental Report; *see also* Exhibit 56 of Fischel Initial Report.

$19.54.[34] In other words, the $19.54 is analogous to the $30 price decline in my example above *fully accepting* for purposes of this example only that Professor Fischel's claim that the entire residual return as calculated by his own event study during the entire leakage period is attributable to the market impact of fraud-related leakage. But the estimated inflation (and hence damages) given by the leakage model for this date is $22.69. Thus, $3.15 ($22.69 minus $19.54) of the damages estimated by the leakage model must logically be attributed to nonfraud factors according to Professor Fischel's event study.[35] As shown in Exhibit 2, the overwhelming majority of days in his leakage period (204 out of the 228 trading days) suffer from the same flaw.

24. In short, Professor Fischel's leakage model—which he reaffirms and relies upon in his Second Supplemental Report—fails to reliably identify economic losses suffered by investors attributable, according to his own analysis, to fraud-related information and instead attributes damages to the fraud that were necessarily nonfraud-related. This flaw is fundamental to how his leakage model works and for this reason alone renders his analysis of inflation and loss causation unreliable. More fundamentally, however, as set forth below, Professor Fischel fails to address, let alone account for, the substantial amount of significant firm-specific, nonfraud information relating to Household throughout the 228-trading day leakage period.

VI. Professor Fischel Assumes Fraud-Related Leakage Caused Losses on the 27 Statistically Significant Decline Days

25. Professor Fischel's Second Supplemental Report focuses on the 27 days during the leakage period on which there were statistically significant stock price declines. While a

[34] $19.54 is the cumulative residual price decline using Professor Fischel's event study supposedly attributable to the leakage of the fraud according to Professor Fischel over the March 16, 2002 to October 11, 2002 period. *See* Exhibit 2.

[35] This disparity between estimated inflation and losses purportedly caused by revelation of the fraud arises due to the mechanics of backcasting. To take another example, Professor Fischel estimates a residual return of 0.00%, and a corresponding residual price change of $0.00, on June 14, 2002. In other words, Professor Fischel's regression model perfectly (or near perfectly) predicts the stock price return on this day. Despite this finding of a zero residual return, Professor Fischel's estimate of inflation in the leakage model *increases* from $17.44 on June 13, 2002 to $17.62 on June 14, 2002. Thus, Professor Fischel's leakage model estimates that shares purchased on June 14, 2002 were potentially damaged to a greater extent than shares purchased on June 13, 2002 despite his finding that the entire stock price change on June 14, 2002 can be explained, according to his regression model, by the S&P 500 and S&P Financials Indices. *See* Fischel Initial Report, Exhibits 55 and 56.

statistically significant decline provides an indication of potential negative firm-specific information, Professor Fischel has provided no reliable basis upon which to attribute the declines on these 27 days to the fraud.

26. On its face, the stock price decline on the one day on which Professor Fischel found negative firm-specific, nonfraud information that could reasonably explain the decline cannot be reliably attributed to the fraud. For 15 of the remaining 26 days, Professor Fischel finds no fraud-related information. In light of this, Professor Fischel's attribution of this decline on these days to fraud-related information is unreliable and without a proper basis, particularly in light of the significant nonfraud, firm-specific information discussed in Sections VIII and IX below. For the other 11 days, Professor Fischel purports to identify "information related to the fraud that is consistent with leakage," but does not opine as he did with the 14 specific disclosure days that he is "reasonably confident that the fraud-related disclosure" was responsible for the "statistically significant price movement."[36] Moreover, he provides no evidence that he adequately considered the effect of contemporaneously disclosed nonfraud information. As discussed in Sections VIII and IX below, my review of the available market evidence indicates significant negative firm-specific, nonfraud information that Professor Fischel should have addressed.

VII. Firm-Specific, Nonfraud Information

27. Before delving into a detailed review of the significant firm-specific, nonfraud information disclosed throughout the leakage period, it is important to first identify generally firm-specific, nonfraud factors that can impact a stock's price. To start, firm-specific factors must be defined by reference to a model. I understand that the Seventh Circuit found that "Fischel's models controlled for market and industry factors and general trends in the economy" but that "the leakage model, which the jury adopted, didn't account for the extent to which firm-specific, non-fraud related information may have contributed to the decline in Household's share price."[37] In reaching this conclusion, the Seventh Circuit stated that "in order to prove loss

[36] Fischel Trial Testimony, April 16, 2009, 2628:15–21.
[37] Appellate Order, p. 20.

causation, plaintiffs in securities-fraud cases need to isolate the extent to which a decline in stock price is due to fraud related corrective disclosures and not *other factors*."[38]

28. "Other factors" that are firm-specific, in the sense that they are not captured by Professor Fischel's model, that can impact a stock's price would include nonfraud-related information relevant to Household. In particular, given Professor Fischel's leakage model specification, this would include information that impacts narrower segments of the financial services industry important to Household and that is not captured by Professor Fischel's industry index—which consists of the broad S&P Financials Index—in addition to factors specific to Household alone.[39] In this regard, the fact that Household was a consumer finance company that targeted its lending products to subprime consumers is of particular importance.[40]

29. Another potentially important firm-specific, nonfraud factor, also not explained by the estimation of the impact on Household's stock price from market and industry factors in Professor Fischel's model, that can impact a stock's price is firm-specific statistical (or random) noise. The "error term" in the model reflects firm-specific information, and includes the model's error in precisely estimating the impact of the market and industry factors on the stock price return. Firm-specific random noise by definition would not be explained by Professor Fischel's model. The very point of running an event study analysis, such as the one used to estimate Professor Fischel's model, is to ascertain whether one can reject such random noise as an explanation for an observed price movement at a certain level of confidence. Indeed, Professor Fischel's prior testimony acknowledges that when price movements are not statistically significant, "one concludes that the observed stock return…can be explained by the independent variable(s) considered in the estimation model (and is not attributable to the firm-specific events

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[38] Appellate Order, p. 20 (emphasis added).

[39] Professor Fischel acknowledged that Household could be disproportionately affected by the release of information that may be relevant to both Household and certain of its peers: "If [Household was] disproportionately affected by -- hypothetically -- a regulatory change, meaning that the regulatory change has a bigger effect on its expected future profitability than for other firms, then the industry index would maybe partially pick up the effect of the change. But there still could be hypothetically a firm specific effect for Household…. [A]s a matter of statistics, it is possible that a regulatory change that affects the entire industry could affect one firm, whether Household or any other firm, disproportionately. So even though you have a control for an industry variable, you still have a firm specific component to the return…" Deposition of Daniel R. Fischel, March 21, 2008 ("Fischel Deposition"), 200:5–201:17.

[40] Household International, Inc., SEC Form 10-K for the fiscal year ended December 31, 2001, filed March 13, 2002 ("Household 2001 Form 10-K"), p. 4.

which occurred on that date)."[41] While the errors are "firm-specific" in that they are not explained by the changes in the S&P 500 and S&P Financials Indices, they are not attributable to "firm-specific events," and hence are not related to firm-specific, fraud-related information in nature.

30. When discussing firm-specific, nonfraud factors, I understand that the Seventh Circuit explained that "[o]ne possible way to address the issue is to simply exclude from the model's calculation any days identified by the defendants on which significant, firm-specific, nonfraud related information was released," and cited to my 2007 paper with Atanu Saha.[42] In that paper we discuss the use of event studies in the context of addressing loss causation issues. As the Court noted, we explain that a potential method for addressing the problem of confounding information on corrective disclosure days—that is, days on which both the fraud as well as significant firm-specific, nonfraud-related information is revealed to the market—is to delete these days from the event study.[43] The reason for ignoring the firm-specific price movements on these days is simple: price declines on days for which one cannot reliably attribute the price decline to fraud-related information should not be used for purposes of calculating inflation or damages per share.

31. One way to account for firm-specific, nonfraud-related factors that would be consistent with the approach outlined in Ferrell and Saha (2007) would be to simply exclude from consideration for loss causation and damages purposes all days for which one cannot reliably attribute the firm-specific price decline to fraud-related information—whether it be because no fraud-related information was revealed, there was negative firm-specific, nonfraud information disclosed at the same time, and/or firm-specific random noise can account for the price decline.

32. Indeed, in the article we made three related points. First, if a day is not a corrective disclosure (or a misrepresentation date), one would not typically include it in the damages

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[41] Corrected Report of Daniel R. Fischel, *In Re United States of America v. Nacchio*, No. 05-c-00545-EWN, 2010 WL 2786837, at *3 (D. Colo. Jan. 12, 2010).
[42] Appellate Order, p. 24.
[43] Allen Ferrell and Atanu Saha, "The Loss Causation Requirement for Rule 10b-5 Causes-of-Action: The Implication of *Dura Pharmaceuticals v. Broudo," The Business Lawyer*, Vol. 63, November 2007, pp. 163–186 at 168 ("Ferrell and Saha (2007)").

analysis as an event of interest to begin with.[44] The vast majority of Professor Fischel's leakage period consists of a large number of days for which no contemporaneous fraud-related information has been identified. Second, we explain that a "sufficiently large value of the t-statistics (generally greater than 1.96 in absolute value for a 95% level of confidence) allows the investigator to conclude that the estimated abnormal return on the [event] day cannot be explained by chance alone, and is therefore attributable to firm-specific news."[45] Third, we explain that the problem of days with both nonfraud-related and fraud-related information (i.e., confounding events), all else equal, "is exacerbated when using multi-day event windows" and therefore the "consideration of confounding events emphasizes the advantage of using a *shorter* event window when possible."[46] In other words, while confounding information may be an issue over even short event windows, all else equal, the probability of confounding information increases as the length of the event window increases. Professor Fischel's leakage period spans 228 days, and the issue of significant firm-specific, nonfraud information is important throughout this entire time period.

VIII. Overview of Household and Select Firm-Specific, Nonfraud Information Released during the Leakage Period

33. As detailed in this section and the following, I find significant firm-specific, nonfraud information disclosed throughout Professor Fischel's 228-day leakage period that was not addressed, let alone accounted for, in his Second Supplemental Report.

34. Before detailing that information, I note that Household was a heavily traded, widely covered consumer finance company serving primarily subprime customers. The leakage period comprised the tail end of a recession, and its aftermath—during which there was significant

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[44] "A typical econometric model for measuring the effect of an alleged misrepresentation or a corrective disclosure on stock price is: $r_t = \ln\left(\frac{P_t}{P_{t-1}}\right) = \beta_0 + \beta_1 M_t + \beta_2 I_t + \sum_{i=1}^{k} \alpha_i D_i + \varepsilon_i$, where r is the daily return (i.e., logarithmic percent change) of the stock price, M is the return on a market index, such as the S&P 500 Index of the Dow Jones Index, I is the return on an industry index (e.g., S&P Telecom Index), and the t subscript denotes the t^{th} day. $D_1 \dots D_k$ are k day-dummy variables—that is, they are binary variables, each taking the value of one for the day at issue and a value of zero for all other days. These days may be the days of the alleged misrepresentations or days of the corrective disclosures." Ferrell and Saha (2007), pp. 166–167.

[45] Ferrell and Saha (2007), p. 167.

[46] Ferrell and Saha (2007), pp. 168–170 (emphasis added).

concern over the speed of recovery. There were also regulatory changes particularly relevant for companies lending primarily to subprime borrowers.

35. During the leakage period, Household filed its 2001 Form 10-K and two Form 10-Qs (excluding any restatements), there were in excess of a thousand press articles published discussing Household, and there were at least a hundred analyst reports regarding Household issued. Even acknowledging that some of these sources of information might have published duplicative information, it is not plausible that, as Professor Fischel suggests, there were only two pieces of negative firm-specific, nonfraud information published during the 228-day leakage period. Indeed, Professor Fischel in prior testimony in this matter stated:

> I noticed that there were *a lot of disclosures* that had some fraud-related information in it and some other…part…[that] dealt with something other [than that which] was fraud related. There were some…of those disclosures that had a positive effect, some had a negative effect; but overall it was impossible to conclude that the difference between the true value line and the actual price would have been any different had there been no disclosures about non-fraud related information during this particular period. Some positive, some negative. They cancel each other out.[47]

36. Particularly in light of (i) the length of the leakage period, (ii) the magnitude of economic and regulatory changes impacting firms like Household that are "firm-specific" in the context of Professor Fischel's regression model, (iii) the extent of the press and analyst coverage regarding Household, and (iv) the fact that Professor Fischel previously testified that he identified "a lot of" disclosures, I find the fact that Professor Fischel identifies and addresses in his Second Supplemental Report firm-specific, nonfraud information on only two days is evidence of the conclusory nature of his opinion that "no adjustment to the Quantification Including Leakage analysis of inflation that [he] presented at trial is required" due to firm-specific, nonfraud factors.

37. Household was a consumer finance company that targeted its lending products to subprime consumers.[48] As the Seventh Circuit describes, Household's businesses centered on

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[47] Fischel Trial Testimony, April 16, 2009, 2684:21–2685:6 (emphasis added).

[48] Household 2001 Form 10-K, p. 4. For purposes of this report, I do not distinguish between "non-prime" and "subprime" consumers, consistent with Professor Fischel's definition of subprime customers: "Household generally served nonconforming and nonprime ('subprime') customers, i.e., those who have limited credit histories, modest

"mortgages, home-equity loans, auto financing, and credit-card loans."[49] This focus on these consumer finance lines of business is also reflected in the information contained in Household's SEC filings and the analyst reports in this matter. For instance, an analyst report notes that Household was "a major provider of consumer financial services in the United States, Canada and the United Kingdom."[50] Household's subsidiaries included Household Bank and Household Finance Corporation.

38. Household Bank was "one of the largest issuers of private label and general-purpose credit cards in the United States."[51] As of October 2001, credit cards comprised approximately one-third of Household's managed receivables. Household held "the #2 position in private label [credit cards] (behind GECC [General Electric Capital Corporation])" and "#10 in general purpose credit cards."[52]

39. Household Finance Corporation, which was "the nation's oldest consumer-finance company" at the time, "offer[ed] home equity loans, and non-credit card unsecured loans, and automobile loans."[53] As of October 2001, Household's home equity business line held "#2 market share" and was the Company's largest business line (approximately 43% of its managed portfolio). Other unsecured and auto loans comprised approximately 19% and 5% of the Company's portfolio, respectively. Household held the "#3 position in indirect auto finance."[54] A November 2001 Ventana Capital report notes that "[w]hile Household's sub-prime auto finance business remains small relative to the overall size of the managed portfolio," it was a "significant driver of growth in recent quarters."[55]

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income, high debt-to-income ratios, high loan-to-value ratios (for real estate secured portfolios) or have experienced credit problems caused by occasional delinquencies, prior chargeoffs, or credit-related actions." Fischel Initial Report, ¶ 5.

[49] Appellate Order, p. 3.

[50] "Solid September Quarter At $1.07; Margin Expansion Drives Quarter, While Credit Basically Stable, But Something To Continue To Watch Closely; Headwinds Continue To Grow," *Piper Jaffray*, October 17, 2001.

[51] "Solid September Quarter At $1.07; Margin Expansion Drives Quarter, While Credit Basically Stable, But Something To Continue To Watch Closely; Headwinds Continue To Grow," *Piper Jaffray*, October 17, 2001.

[52] Analysts estimated bank cards and private label cards to be 19% and 13% of Household's managed receivables portfolio, respectively. *See* "HI: Continued Solid Performance," *Legg Mason*, October 18, 2001.

[53] "Solid September Quarter At $1.07; Margin Expansion Drives Quarter, While Credit Basically Stable, But Something To Continue To Watch Closely; Headwinds Continue To Grow," *Piper Jaffray*, October 17, 2001.

[54] "HI: Continued Solid Performance," *Legg Mason*, October 18, 2001.

[55] "Used Car Pile-Up," *Ventana Capital*, November 30, 2001.

40. Importantly, Household served primarily subprime customers. Professor Fischel, citing to Household's March 28, 2008 8-K, describes Household's customer base as "those who have limited credit histories, modest income, high debt-to-income ratios, high loan-to-value ratios (for real estate secured portfolios) or have experienced credit problems caused by occasional delinquencies, prior chargeoffs, or credit-related actions."[56] As noted by the Office of Inspector General, "[s]ubprime lending provides a credit source to borrowers that may not otherwise be available due to concerns with borrowers' credit history or repayment capacity…. The Federal Financial Institutions Examination Council (FFIEC) 1999 Interagency Guidelines for Subprime Lending define the term 'subprime lending' as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers."[57] In 2001, in its Expanded Guidance for Subprime Lending Programs, the FDIC specifically noted higher risk in the event of economic downturn: "[R]esponsible subprime lending can expand credit access for consumers and offer attractive returns. However, we expect institutions to recognize that the elevated levels of credit and other risks arising from these activities require more intensive risk management and, often, additional capital." The guidelines go on to note that, "[b]ecause of the elevated risk levels, the quality of subprime loan pools may be prone to rapid deterioration, especially in the early stages of an economic downturn."[58]

41. Household was one of five consumer finance companies included in the S&P Financials Index that Professor Fischel uses to control for industry factors in his model. His model's index also contains a broader set of financial services companies. As Professor Fischel points out, his industry index contained 81 constituents at the end of the class period.[59] The index's composition was heavily weighted towards other types of financial services companies. For example: 30 of the 81 companies were classified as banks, 12 as property and casualty insurance companies, 9 as life insurance companies, 6 as investment services companies, and 6 as asset

[56] Fischel Initial Report, ¶ 5.
[57] "The Division of Supervision and Consumer Protection's Examination Assessment of Subprime Lending," Office of Inspector General, March 18, 2003.
[58] *See* Expanded Guidance for Subprime Lending Programs at https://www.fdic.gov/news/news/press/2001/pr0901a.html.
[59] Fischel Initial Report, footnote 10.

managers.[60] This is important because companies such as these may be affected differently or to a different extent by economic and regulatory trends than Household and its closest peers.[61]

42. Household's peers comprised other consumer or specialty finance companies, particularly those with a subprime customer focus. For example, Household was part of the Credit Suisse First Boston (CSFB) Specialty Finance Universe, which contained credit card companies (Capital One, CompuCredit, MBNA, Metris, and Providian), auto finance companies (AmeriCredit Financial and WFS Financial), and more diversified companies (like American Express and The CIT Group) that competed in one or more of those spaces.[62] Of these specialty finance peer companies, many were engaged in substantial subprime lending and/or targeted subprime consumers, including Capital One, CompuCredit, Metris, Providian, and AmeriCredit.[63]

43. The effect on Household and narrower industry sub-segments such as consumer finance, credit card, auto finance, or subprime is "firm-specific" in the context of Professor Fischel's model, which controls only for the average effect during his control period of economic forces on the general economy (using the S&P 500 Index) and the financial services sector broadly defined (using the S&P Financials Index). Indeed, discussion by market observers indicates that changes in the economic and regulatory environment—firm-specific, nonfraud-related information—could have adversely affected Household and companies most like it during the leakage period.

44. More specifically, during the class period the United States experienced an economic downturn. Shortly after the terrorist attacks of September 11, 2001, economists determined that the United States was in a recession.[64] While the 2001 recession was somewhat short-lived,

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[60] *Bloomberg*.

[61] As noted above, Professor Fischel acknowledges that Household could be disproportionately affected by the release of information that may be relevant to both Household and certain of its peers. *See* Fischel Deposition, 200:5–201:18.

[62] "Specialty Finance: Poised for a Strong Rebound; Robust Fundamentals," *Credit Suisse First Boston*, March 2, 2001.

[63] *See*, *e.g.*, AmeriCredit Corp. Form 10-K filed September 17, 2002, p. 16; CompuCredit Corp. Form 10-K filed April 1, 2002, p. 3; Metris Companies Inc. Form 10-K filed March 22, 2002, p. 3; Capital One Financial Form 10-K filed March 22, 2002, pp. 4, 15; "Credit Card Quarterly, Subprime Lending: Serving the Underserved," *Deutsche Bank*, May 25, 2001.

[64] D. S. Langdon, T. M. McMenamin and T. J. Krolik, "US Labor Market in 2001: Economy Enters a Recession," *Monthly Labor Review*, Vol. 125, No. 2 (2002), pp. 3–33. According to the National Bureau of Economic Research (NBER), the U.S. was in a recession from March 2001 to November 2001. It took the Business Cycle Dating

concerns about the speed of recovery and fears of a double-dip recession persisted throughout the leakage period. For example:

> However, if the fundamentals appear largely intact in the 2Q, the stocks seem to be worried about the future. The obvious risk is that of a "double dip" in the economy. Several issuers, particularly in the subprime space did not weather the "single dip" recession of last fall so well, and are hardly prepared for another scoop of bad credits, in our opinion.
>
> The worst price performance came from subprime issuers, with Metris down a whopping 58.4%, AmeriCredit off 26.0% and Providian down 21.9%. Stock in Amex and Capital One posted declines of 8.2% and 4.2%, respectively. Household's and MBNA's stock prices were off 12.1% and 12.0%, respectively.[65]
>
> The Federal Reserve is not yet convinced that America's economy is heading for a double-dip recession. At its policy meeting on August 13th, the central bank decided to keep its federal-funds rate unchanged, at a 40-year low of 1.75%. Still, it signaled a readiness to cut rates should the economy look like weakening further.
>
> Earlier this year most economists had expected the Fed to raise interest rates during 2002. Now many predict that rates will be cut before the year is out. In the past few weeks the recovery has started to look shaky. For a start, GDP growth in the second quarter slowed to only 1.1% at an annual rate. In July, the purchasing managers' indices of activity in both manufacturing and services fell sharply; total hours worked also declined. Retail sales rose by a robust 1.2% in July, yet this was due mainly to car firms offering interest-free loans. Not counting cars and petrol, retail sales were flat. Ominously, consumer confidence fell sharply.
>
> Most American economists weigh up America's prospects as if there were only two options: a double-dip recession, or a sustained recovery. A third and possibly more likely option is a protracted period of growth well below trend, until America had shed its excesses.[66]

Committee of the NBER until July 2003, a longer-than-normal period of time, to determine the U.S. recession ended in November 2001 due to "the divergent behavior of employment." Specifically, even though other indicators of macroeconomic health had improved, as of July 2003 "the most recent data indicate that employment has not begun to recover at all." *See* "Business Cycle Dating Committee," National Bureau of Economic Research, July 17, 2003, available at http://www.nber.org/cycles/july2003.html.

[65] "Fundamentals Steady, Stocks Not," *Deutsche Bank Securities Inc.*, July 1, 2002.

[66] "A double dip? – Monetary policy in the United States," *The Economist*, August 15, 2002.

> [W]e're now explicitly factor[ing] in the risk of a "double-dip" recession into our price target [for Household], which, as a result drops to $34 from $53. The principle reason for this decline is the possibility of higher credit losses.[67]

45. Moreover, in addition to concerns regarding a potential double-dip recession, market participants recognized that the lagged effects of the recession continued to impact companies like Household during 2002. For example:

> Credit quality remained in check [during Q2 2002], despite a modest uptick in the managed loss rate. Importantly, the increase was not unexpected, given the lagged effect of last year's recession and portfolio seasoning.[68]

> New business growth could remain under pressure for the next few quarters [after Q3 2002] as the lingering effects of the recession continue to weigh on the middle-market sector.[69]

46. As alluded to above, the recession was particularly hard on financial institutions, such as Household, serving primarily subprime customers. These individuals are more adversely impacted by economic downturn. For example:

> [G]iven that the non-prime customers targeted by [Household] are generally more economically sensitive and less interest rate driven, rising unemployment levels had a significant impact on the portfolio's credit performance.[70]

> Given the uncertainty of the current macro-economic picture, the risks that Household faces include: rising credit costs given its largely non-prime customer base in a slowing economy, slowing loan growth due to more cautious consumers and increasing prepayments, competitive end markets, and a slowing pace of help from interest rate reductions.[71]

47. Indeed, concerns regarding credit quality plagued Household throughout the leakage period. Household's auto lending business—which as noted above had been a recent source of

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[67] "Worth a Look," *Morgan Stanley*, October 10, 2002.
[68] "In-Line 2Q02 EPS Offer No Surprises; Maintain Buy," *CIBC World Markets*, July 17, 2002.
[69] "Specialty Finance-Third-Quarter 2002 Preview," *CIBC World Markets*, October 3, 2002.
[70] "Business Diversification And Efficiency Should Drive Steady Earnings Growth," *CIBC World Markets*, June 20, 2002.
[71] "2Q02 EPS A Mixed Bag; Trimming Ests, Target to Be Prudent," *Salomon Smith Barney*, July 18, 2002.

growth[72]— raised particular concern, but analysts also raised issues with respect to Household's home equity, other secured lending, and credit card portfolios. For example:

> Consumer credit quality is an issue of increasing significance in our sector. As the economy deteriorated in 2001, credit quality concerns heightened.…[73]

> *Credit deterioration in the auto finance portfolio stood out in the quarter*… We continue to monitor the results of the auto finance line of business, particularly as recovery rates at auction have been falling.…[74]

> Household credit quality, however, has remained reasonably strong, on balance, though there are some pockets of stress. Most measures of delinquency rates on standard consumer and mortgage debt were little changed early this year (latest data available), but delinquencies on pools of nonprime automobile loans rose sharply in March from an already high level and the delinquency rate on subprime mortgages remained very elevated in the first quarter. On the asset side, the decline in equity values has pulled the ratio of household assets to disposable income lower in the second quarter.[75]

> Household's credit losses increased in the quarter, with home equity, auto and other unsecured loans increasing meaningfully.[76]

> *Rising credit losses were driven by increases within the home equity and private label portfolios*…Credit quality erosion was evident as elevated bankruptcy filing activity and portfolio seasoning impacted results. The higher delinquency and loss rates, however, were expected and remained within management's targeted range.[77]

48. Analysts looked to macroeconomic data such as bankruptcy filings, unemployment data, consumer confidence, used car prices, and announcements regarding peers' credit performance to assess likely changes in Household's credit quality. For example:

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72 "The fastest growth segment at Household during the past few years has been Auto Finance." *See* "Household International: Strong First Quarter, up 20%; Raising Estimates," *William Blair*, April 17, 2002.

73 "Specialty Finance Quarterly: Fourth Quarter 2001," *A.G. Edwards*, January 2, 2002.

74 "HI: 4Q01 Results In Line and Solid," *Salomon Smith Barney*, January 16, 2002 (emphasis added).

75 "Current Economic and Financial Conditions: Recent Developments," Prepared for the Federal Open Market Committee by the staff of the Board of Governors of the Federal Reserve System, June 20, 2002.

76 "HI: Reports In Line Quarter: Trends Mixed," *Banc of America Securities*, July 17, 2002.

77 "3Q02 Operating EPS Upside Surprise; Upgrading To Sector Performer," *CIBC World Markets*, October 16, 2002 (emphasis added).

> We believe one of the more important indicators of consumer credit quality is the rate of bankruptcy filings. We monitor weekly personal bankruptcy filings collected by the Administration Office of the U.S. Courts.[78]

> A Diversified Consumer Franchise But Keep An Eye On Consumer Trends. … *investors need to be cognizant of individual consumer's balance sheet and trends affecting them such as higher unemployment, lower consumer confidence, and lower spending levels which can keep a lid on HI's shares in the near term.*[79]

> [I]nvestors irrationally fixated on the very notable increase in charge-offs and delinquencies in the company's sub-prime auto unit. …But in light of the recent news on subprime auto lender AmeriCredit, whose shares took a beating following higher-than-expected delinquencies, Household's downward move was not too surprising.[80]

> The sharply higher loss ratios [in auto lending] in the fourth quarter of 2001 are, in part, due to lower recoveries, which are, in turn, related to price weakness in the used-car market (see Exhibit 3 [year-over-year changes in the Manheim Used Vehicle Value Index]).[81]

> Credit results were mixed in April, with five issuers reporting [in their master trust data] higher losses and seven showing sequential improvement.[82]

49. Moreover, the funding environment was volatile during the leakage period. Concerns regarding Household's liquidity, access to capital markets, and widening bond spreads were discussed by analysts throughout the period. In addition, Household's debt rating was downgraded due in part to questions regarding its balance sheet flexibility in light of its subprime exposure. For example:

> Fitch Revises its Outlook on HI to Negative—In a review of the US consumer finance industry, Fitch revised its industry outlook to Negative from Stable. Although the challenging economic environment is part of the reason, the agency seems to be focusing on what it perceives to be the industry's "aggressive balance

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[78] "Credit Card Industry Review: Third-Quarter 2001," *A.G. Edwards*, November 28, 2001.
[79] "Margin Expansion Drives Quarter, While Credit Quality Only Slightly Deteriorates, But Something To Watch Closely; Headwinds Remain," *Piper Jaffray*, January 16, 2002 (emphasis added).
[80] "HI Gets Bum Rap For Decent 4Q01," *Fox-Pitt Kelton*, January 17, 2002.
[81] "Household International: Effect of Increasing Losses Overstated," *Bernstein Research*, February 1, 2002.
[82] "April Data Point to Impending Peak in Losses," *Fox-Pitt Kelton*, May 31, 2002.

> sheet management." Specific to HI, the agency cited the company's "growth of [its] real estate secured near-prime/subprime loans and the impact on balance sheet flexibility in times of stress." Fitch is concerned that HI has "securitized relatively less" of these portfolios, and it "has not engaged in whole loan sales." The implication here is that these assets would be only of limited value in terms of providing financial flexibility in times of stress.[83]
>
> In Household's case, the most recent unsubstantiated claim revolved around commercial paper and liquidity issues.[84]
>
> The company also took steps to enhance its liquidity position in the wake of the first quarter's volatile funding environment.[85]
>
> We are reducing this year's and next year's estimates by $0.20 each reflecting the accounting charge and some incremental uncertainty on the weak economic backdrop and the *persistency of relatively wide debt spreads*.[86]

50. In addition to pressure from the effect of economic slowing on its primary customers, companies such as Household felt increasing regulatory pressure directed at firms with subprime exposure. For example, regulatory scrutiny of and capital requirements for subprime lenders increased during the leakage period. Household explained in its 2001 Form 10-K:

> Our banking institutions are subject to capital requirements, regulations and guidelines imposed by the OTS [Office of Thrift Supervision], OCC [Office of the Comptroller of the Currency] and FDIC [Federal Deposit Insurance Corporation]. For example, these institutions are subject to federal regulations concerning their general investment authority as well as their ability to acquire financial institutions, enter into transactions with affiliates and pay dividends. Such regulations also govern the permissible activities and investments of any subsidiary of a bank. We have been advised by the OTS, OCC and FDIC that in accordance with their 2001 Guidance for Subprime Lending Programs, they will impose additional capital requirements on institutions which hold nonprime or subprime assets that will be greater than the historical levels we have maintained at our banking institutions. Household and [Household Finance Corp.] have

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[83] "Household International (Buy)—Headlines Hang Over Name," *Credit Suisse First Boston*, January 15, 2002.
[84] "Unsubstantiated Claims Continue to Haunt Stock," *Deutsche Bank*, February 7, 2002.
[85] "Tops Estimates On Way to 15th Consecutive Quarterly Record; Balance Sheet Significantly Strengthened," *Credit Suisse First Boston*, April 17, 2002.
[86] "HI – Reduce 02 and 03 by $0.20 each. Maintain RL," *Goldman, Sachs & Co. Investment Research*, August 14, 2002 (emphasis added).

> agreed with these regulators to maintain the regulatory capital of our institutions at these specified levels.[87]

51. Analysts also noted the increased capital requirements for and increased regulatory scrutiny of subprime lenders, and their adverse effect on Household's stock price, during the leakage period. For example:

> While the economy could move in fits and starts in 2002, we are more concerned about a hostile regulatory environment, particularly for subprime issuers. The OCC and FDIC, in our opinion, have an agenda, which is ultimately to limit the extent to which subprime card issuers fund themselves with FDIC-insured deposits. In addition, securitization structures and accounting are attracting more scrutiny in the wake of Enron (both use special purpose vehicles), as demonstrated by the OCC's closure of NextCard (caused, in part, by the breaking of the bank's securitizations as true sales).[88]

> HI shares appear to have suffered along with those of other financials in reaction to bank regulators imposing higher reserve and capital requirements on sub-prime lenders.[89]

> *New FFIEC Guidelines Could Have Far-Reaching Implications For The Credit Card Issuers*… Credit card issuer failures, such as Nextcard, and building consumer complaints and heightened credit risk on the heels of aggressive growth prompted the Federal Financial Institutions Examinations Council (FFIEC) to step up its oversight of the industry and impose more stringent lending and capital restrictions. The result of the heightened credit card issuer surveillance was sweeping industry changes in the absolute definition of sub-prime lending, accounting procedures, internal controls and corporate governance, and risk-based capital requirements.

> Following the groundswell of concerns surrounding the credit card issuers and capital adequacy levels, in July 2002 the FFIEC released draft guidelines to serve as the basis for prudent sub-prime credit card lending. …Overall, we believe

[87] Household 2001 Form 10-K, p. 9.
[88] "Consumer Finance 2002 Outlook," *Deutsche Banc Alex Brown*, March 28, 2002.
[89] "Solid Loan Growth, Increased Liquidity; Stock Weakness not reflective of Favorable Business Trends," *Bear Stearns*, July 17, 2002.

> many (if not all) monoline issuers will ultimately find some one-time charges unavoidable in light of the new guidance.[90]

52. Importantly, market observers saw announcements regarding Household's peers as providing incremental information regarding the regulatory environment that had implications for Household. For example:

> HI shares were under pressure yesterday in sympathy with its consumer finance peers…. Specifically, Capital One, the perennial leader in the card business, disclosed it is entering into a MOU [memorandum of understanding] with the national banking authorities. *We think this bombshell announcement signals an era of lower returns, increased capital intensity, and heightened regulatory oversight for consumer lenders of all types*.[91]

> Despite posting solid second quarter results, HI's bonds have widened on news that Capital One has agreed with banking regulators to bolster reserves and enhance systems controls at its two banking subsidiaries, as well as scale back its aggressive growth profile to maintain compliance with regulatory guidelines for subprime lending programs updated in 2001. This agreement has sparked fears that other subprime lenders will come under regulatory scrutiny and risk, becoming undercapitalized if they grow aggressively in an environment of rising losses.[92]

53. The rules with respect to what constituted predatory lending were changing as well, and there was speculation regarding future regulatory changes throughout the leakage period. Analysts expressed concern regarding potential changes in Household's business practices in light of the increasingly political nature of the issue and potentially tighter regulation going forward. Consistent with statements by Professor Fischel, I understand that, while information regarding past violations of predatory lending regulations could be corrective of the fraud, information about prospective changes in the laws (which could not have been disclosed at an

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[90] "Specialty Finance—Third Quarter 2002 Preview," *CIBC World Markets*, October 3, 2002 (emphasis added).
[91] "Makes Numbers but Focus Has Changed," *Fox-Pitt Kelton*, July 18, 2002 (emphasis added).
[92] "Solid Second Quarter Earnings," *Banc One Capital Markets*, July 18, 2002.

earlier time) is not corrective[93] as it is not information that Household could have provided to investors earlier. Household itself discussed the dynamic environment in its 2001 Form 10-K:

> There has been a significant amount of legislative activity, nationally, locally and at the state level, aimed at curbing lending abuses deemed to be "predatory." A predatory loan or lending practice is not a legally defined term and does not have a commonly recognized definition. Most legislative activity in this area targets certain abusive practices such as loan "flipping" (making a loan to refinance another loan where there is no tangible benefit to the borrower), fee "packing" (addition of unnecessary, unwanted and unknown fees to a borrower), "equity stripping" (lending without regard to the borrower's ability to repay or making it impossible for the borrower to refinance with another lender), and outright fraud. Household does not condone or endorse any of these practices. We are working with regulators and consumer groups to create appropriate safeguards to eliminate these abusive practices while allowing middle-market borrowers to continue to have unrestricted access to credit for personal purposes, such as the purchase of homes, automobiles, and consumer goods.[94]

54. Analyst comments also speak to the dynamic landscape with respect to predatory lending, and make clear this nonfraud component—changes in the law and political climate, and speculation regarding corresponding changes in Household's business practices—depressed Household's stock price during the leakage period. For example:

> Household is not acting in a vacuum but rather responding to the *changing legal climate around predatory lending* as consumer advocacy groups and state legislative bodies become more active.[95]

> *As states like North Carolina, California and Georgia pass progressively more restrictive state laws*, lenders face an increasing need for the protection of uniform standards in preemptive federal legislation….While negotiations around federal legislation continue, *we expect additional restrictive state laws to be enacted*. These will tend to reduce the profitability in subprime lending and make

[93] "Q. Hypothetically speaking, what are some examples of declines that would not be attributable to a claim of fraud in this matter? A…. Any negative event which causes a statistically significant price decline where there is no allegation that the negative event should have been disclosed at an earlier point in time." Fischel Deposition, 150:8–22.

[94] Household 2001 Form 10-K, p. 9.

[95] "HI: Downgrade to Market Perform: Legal Threats Increase Structural Risk to the Business Model and Near-Term Earnings Risk," *Bernstein Research*, March 5, 2002 (emphasis added).

> lending to some high-risk segments uneconomic (thereby reducing the size of the addressable market).[96]
>
> Our point is not that these sales practices are unethical or illegal…. Rather, we believe there is a risk they will become less sustainable, along with the earnings that arise from them, as Household reforms its practices either voluntarily or as a legal requirement given the shifting legislative environment.[97]

55. Particularly given the significant firm-specific, nonfraud concerns the market had throughout the leakage period concerning Household—such as subprime lending and its auto and credit card services business lines—Professor Fischel's attribution of the entire cumulative residual price decline over the entire leakage period to fraud-related information is unreliable.

IX. Professor Fischel Fails to Account for Significant Firm-Specific, Nonfraud-Related Information on the 27 Additional Statistically Significant Decline Days

56. As my previous discussion documents, Professor Fischel fails to address significant firm-specific, nonfraud information that could have contributed to declines in Household's stock price during the leakage period. Below, I will provide numerous examples of significant firm-specific, nonfraud information that could have affected Household's stock price on the 27 days discussed in the Second Supplemental Report but that, for the most part, Professor Fischel fails to even discuss, let alone take account of. Given this, Professor Fischel's leakage model fails to reliably isolate the effect of firm-specific, nonfraud information on Household's stock price during the leakage period, which renders the leakage model unreliable.

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[96] "Household International: Legal Risk to Business Model Increasing," *Bernstein Research*, May 10, 2002 (emphasis added).
[97] "HI | Joe Luna of Washington State," *Bernstein Research*, May 20, 2002.

A. January 11, 2002

1. Positive and Negative Firm-Specific Information Does Not "Cancel Out"

57. I agree with Professor Fischel's assessment that firm-specific, nonfraud information such as Fitch Ratings ("Fitch") revising its outlook on Household from Stable to Negative could reasonably explain Household's stock price decline on January 11, 2002. However, Professor Fischel has not demonstrated that his leakage model accounts for such information. He suggests that no adjustment is required to the leakage model because two trading days later, Credit Suisse analysts opined that Fitch's outlook change for Household was unwarranted, which he asserts "canceled out" the effect of Fitch's announcement.[98] Professor Fischel estimates a residual price decline of $1.66 on January 11, 2002 following Fitch's announcement and an increase of $1.39 on January 15, 2002 following Credit Suisse's report.[99] Even if Professor Fischel were correct that the information in Fitch's and Credit Suisse's reports should be netted, the stock price effect of these two events does not "cancel out" since the leakage model attributes a larger price decline on the date of Fitch's announcement than the price increase it attributes to Credit Suisse's announcement. Professor Fischel has not explained how the leakage model accounts for such a discrepancy.

2. Professor Fischel Does Not Account for Other Firm-Specific Information

58. In addition to discussing the Fitch report, the Credit Suisse report cited by Professor Fischel also identified that Household was "having a difficult run of things of late," including press reports that "indicated the company was taking a look at low-rated Providian Financial."[100] Credit Suisse discussed such a hypothetical investment in Providian by Household and concluded that, while it is possible that Household could buy a piece of Providian's business, "[s]uch an occurrence would not impact our view of the credit" and "[w]e see a *material*

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[98] Second Supplemental Report, ¶¶ 6–8.
[99] Fischel Initial Report, Exhibit 55.
[100] "Household International (Buy)—Headlines Hang Over Name," *Credit Suisse*, January 15, 2002.

investment in Providian by HI as highly unlikely."[101] Irrespective of whether the rumors turned out to be true, the Credit Suisse report provides contemporaneous evidence that a potential investment in Providian was weighing on market participants' minds and thus may have affected stock price. Professor Fischel has not addressed, let alone accounted for, other information reported by Credit Suisse and therefore has an insufficient basis to conclude that the Credit Suisse report "canceled out" the Fitch announcement.

59. Professor Fischel also fails to address an analyst report from Ventana Capital on January 15, 2002 that took a contradictory stance to Credit Suisse in evaluating the Fitch report. Ventana Capital did not believe that Fitch's outlook change was unwarranted, but rather commented that Household's response to Fitch's outlook change "should not allay concerns" about Household.[102] Professor Fischel has not explained how Credit Suisse's commentary "canceled out" Fitch's announcement in light of other analyst commentary that did not disagree with Fitch's outlook revision. Professor Fischel provides no basis for focusing only on commentary from a single analyst (from Credit Suisse) on this day.

3. Professor Fischel's Methodology for Assessing the Effect of Firm-Specific Information Underscores the Unreliability of the Leakage Model

60. More fundamentally, Professor Fischel utilizes the lack of statistical significance across January 11, 2002 and January 15, 2002 to conclude that "there is no reliable evidence that the net effect of this firm-specific, nonfraud related information had any significant impact on Household's stock price."[103] Such a conclusion is in tension with Professor Fischel's inclusion of 171 days in the leakage period—and its entire net residual decline of $6.75 as attributable to fraud-related information—as the stock price changes on these 171 days are not statistically significant. Assessing statistical significance is important in drawing causal inferences regarding stock price changes (as Professor Fischel acknowledges with respect to his purported analysis of

[101] "Household International (Buy)—Headlines Hang Over Name," *Credit Suisse*, January 15, 2002 (emphasis in original).
[102] "Our Take On The Fitch Downgrade, And More!" *Ventana Capital*, January 15, 2002.
[103] Second Supplemental Report, ¶ 8.

January 11, 2002), and accordingly Professor Fischel has no reliable basis to conclude that the stock price changes on these 171 days are attributable to fraud-related information. As I discuss throughout this report, the leakage model is flawed for including such days.

61. I note that Professor Fischel reaches the conclusion that the stock price return on January 15, 2002 "canceled out" the stock price return on January 11, 2002 by identifying a single piece of analyst commentary. Professor Fischel's willingness to attribute the stock price rebound on January 15, 2002 to a single piece of analyst commentary is inconsistent with his failure to address, let alone account for, substantial similar analyst commentary and other firm-specific, nonfraud information reaching the market throughout the leakage period. Given this, as discussed in Section X.B below, there is no reliable basis to attribute the firm-specific price decline to the leakage of fraud-related information.

B. January 28, 2002

62. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information on this date contained in the very *Barron's* article he relies upon. In discussing the basis for Mr. Chanos's then-current short positions in Household, Metris, and Capital One, the *Barron's* article stated that a "rotten economy has exposed their borrower base to hard times, says Chanos, and high lending rates and fat lending margins won't be enough to insulate the firms from rising credit losses."[104] The article further articulated Mr. Chanos's opinions regarding rising delinquency rates at Household and its peers, and that the "growing deterioration in sub-prime lending, it should be noted, has already laid low other former Chanos shorts, including AmeriCredit, Conseco and Providian."[105]

63. Moreover, Professor Fischel also fails to address, let alone account for, other firm-specific, nonfraud information on January 28, 2002 that may have contributed to Household's stock price decline. Specifically, a *Reuters* article titled "Credit card stocks fall on Metris, sub-prime worries" attributed Household's stock price decline on January 28, 2002 to concerns regarding subprime lenders' exposure to problem loans. The article stated that "[s]hares of credit

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[104] "Doubting Tyco," *Barron's*, January 28, 2002.
[105] "Doubting Tyco," *Barron's*, January 28, 2002.

card companies slid on Monday [January 28, 2002], as Metris Cos Inc. was downgraded by analysts amid worries that the subprime lender's growing exposure to bad loans may signal an industrywide trend."[106] *Reuters* further stated that "[c]oncerns about Metris spilled over into other credit card lenders," including MBNA, Household, and Capital One.[107]

C. February 6, 2002

64. Professor Fischel again fails to address, let alone account for, firm-specific, nonfraud information on this date including in the very analyst reports that he relies upon.[108] Although Professor Fischel cites to a quote from Deutsche Bank regarding "unsubstantiated claims, in our opinion, of issues with liquidity, accounting, and lawsuits," he fails to address that Deutsche Bank put particular emphasis on unsubstantiated claims regarding liquidity issues: "Many finance companies, and subprime issuers in particular, have been under pressure for all sorts of reasons. In Household's case, the most recent unsubstantiated claim revolved around commercial paper and liquidity issues."[109] Notwithstanding the fact that Deutsche Bank thought the claim unsubstantiated, its report makes clear that it was contemporaneously weighing on the minds of market participants and thus may have affected Household's stock price.

65. Professor Fischel also fails to address, let alone account for, other firm-specific, nonfraud information on February 6, 2002 that may have contributed to Household's stock price decline. For example, Bear Stearns issued an analyst report on February 6, 2002 stating that the stock price decline "appears to reflect a severe bout of accounting *and liquidity panic*" and that "[t]here was talk that Household was facing problems issuing commercial paper on Wednesday [February 6, 2002], which we believe is not true."[110] A.G. Edwards also issued a report on

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[106] "Credit card stocks fall on Metris, sub-prime worries," *Reuters News*, January 28, 2002.
[107] "Credit card stocks fall on Metris, sub-prime worries," *Reuters News*, January 28, 2002.
[108] Firm-specific, nonfraud information was also released on February 5, 2002—it is not clear whether the information was released after market hours, and as a result this information may have contributed to Household's stock price decline that occurred on February 6, 2002. An article from *American Banker* reported on a recent Fed survey, noting that "nearly half of the surveyed banks tightened standards on commercial and industrial loans, and one-fifth tightened standards on credit card and other consumer loans, primarily because of concern about the economy." A *Wall Street Journal* article similarly commented on the survey, stating that "Household credit generally was somewhat worse than would have been predicted." *See* "In Brief: Fed Survey Finds More Mortgage Demand," *American Banker,* February 5, 2002; "US Banks Report Tightened Lending Rules," *The Wall Street Journal*, February 5, 2002.
[109] "Unsubstantiated Claims Continue to Haunt Stock," *Deutsche Bank*, February 7, 2002.
[110] "More Bad Publicity…How Much Worse Can It Get?," *Bear Stearns*, February 6, 2002 (emphasis added).

February 6, 2002 stating that it "attribute[s] weakness in HI shares to *industry credit quality concerns* and accounting-related concerns," and that "[t]o be sure, investor sentiment on the consumer finance sector is poor today."[111]

D. February 21, 2002

1. Professor Fischel Fails to Address, Let Alone Account For, Firm-Specific, Nonfraud Information

66. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on February 21, 2002. Specifically, an *American Banker* article reported the opinion of Thomas Abruzzo, a senior director for Fitch, that the outlook for consumer finance firms was bleak, and cited to Fitch's recent downgrade of Household's senior debt. Mr. Abruzzo stated that "[p]rospects are still poor for consumer finance companies" and that "[c]ompetitive pressures have changed the economic landscape."[112] The article further noted that "[w]ith capital markets volatile, competition keen, and the economy slogging through its first recession in a decade, investors have turned against finance companies," and "[a]ccess to the capital markets could be hard for them to come by until the economy recovers and investors regain their confidence."[113] Finally, the article reported Mr. Abruzzo's opinion that although he did not consider the finance sector to be "fundamentally troubled," certain companies including Household were having problems.[114] Specifically, Mr. Abruzzo stated that "[t]o raise capital from worried investors, consumer finance companies must demonstrate short-term liquidity," and that Fitch's recent downgrade of Household indicated "it had not issued enough securities backed by subprime loans to demonstrate adequate access to the secondary markets in tough times."[115]

67. Moreover, on February 21, 2002, the *Wall Street Journal* published an article discussing rising credit card interest rates, particularly for subprime credit card issues. The *Wall Street*

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[111] "Upgrading to Strong Buy from Buy," *A.G. Edwards*, February 6, 2002 (emphasis added).
[112] "Consumer Finance Firms' Outlook Bleak, Fitch Says," *American Banker*, February 21, 2002.
[113] "Consumer Finance Firms' Outlook Bleak, Fitch Says," *American Banker*, February 21, 2002.
[114] "Consumer Finance Firms' Outlook Bleak, Fitch Says," *American Banker*, February 21, 2002.
[115] "Consumer Finance Firms' Outlook Bleak, Fitch Says," *American Banker*, February 21, 2002.

Journal noted that "losses have been greatest for issuers of subprime cards, which are targeted to borrowers with checkered credit records."[116] The article cited to a Fitch finding that charge-offs for subprime issuers "surged 54%" since September 2000.

2. Professor Fischel Relies Solely on an Article Published 20 Days Prior to February 21, 2002

68. Professor Fischel identifies a February 21, 2002 *Banking Wire* article as containing fraud-related information. However, the article identified by Professor Fischel on February 21, 2002 was actually published on February 1, 2002 by *US Banker* and *American Banker*. The *US Banker* and *American Banker* articles are identical to the *Banking Wire* article cited by Professor Fischel.[117] Professor Fischel fails to explain how the *Banking Wire* article, which was published 20 days earlier in *US Banker* and *American Banker*, may have caused Household's stock price to decline on February 21, 2002.

E. April 25, 2002

69. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on April 25, 2002. Analysts from Ventana Capital published a report on April 25, 2002 commenting on the increase in Household's stock price following its first quarter 2002 earnings announcement the week prior. Ventana Capital noted that, although Household announced better-than-expected earnings, earnings per share were basically in line with expectations when stripping out the year-over-year positive impact from securitization gain-on-sale revenues and lack of goodwill amortization, and further noted that Household implicitly gave downward earnings guidance to the next three quarters of earnings.[118]

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[116] "Credit-Card Companies Are Raising Rates," *The Wall Street Journal*, February 21, 2002.
[117] "Household Gets Rapped," *US Banker*, February 1, 2002; "Household Gets Rapped," *American Banker*, February 1, 2002. The articles are identical except that the *American Banker* article omits the first sentence contained in the *Banking Wire* and *US Banker* articles.
[118] "Looking For Quality Earnings? You Won't Find It Here!" *Ventana Capital, LLC*, April 25, 2002.

70. In addition to the Ventana Capital report, an article titled "Keeping the Lid on Subprime Exposure" was published on April 25, 2002 that discussed increasing challenges for subprime credit card issuers. The article noted that "[s]ecured cards, the original subprime cards, are presenting issuers with challenges in this difficult economy, as is the subprime sector in general," and that the "current economic slowdown seems to be proving that businesses that appeal to troubled consumers just might get into trouble themselves."[119] The article further noted that subprime credit card issuers who "seek out subprime consumers have been overwhelmed with problems," and highlighted the recent problems of two of Household's peers stemming from the "poor quality" of their credit card portfolios: NextCard Inc. and Providian Financial Corp.[120]

F. April 29, 2002

71. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on April 29, 2002. Specifically, articles published on April 29, 2002 address issues relevant for subprime credit issuers such as Household. A *Business Wire* article noted that Fitch completed its annual review of finance company risk-based capitalization, which is an assessment of the adequacy of a finance company's capitalization relative to the risk profile of its managed assets.[121] Fitch found that changes were "most prevalent in unsecured consumer assets, subprime real estate, and manufactured housing loans," and as a result, "many consumer finance companies' risk-adjusted capitalization[s] were negatively affected by the modifications that took place with this year's study."[122] In addition, *CNN* reported that late payments on credit card bills hit a five-year high in March 2002. *CNN* discussed that subprime "consumers are now struggling," and that the United States had "never been through a recession with the subprime market, and so we're beginning to see the effects of that."[123]

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[119] "Keeping the Lid on Subprime Exposure," *Credit Card Management*, April 25, 2002.
[120] "Keeping the Lid on Subprime Exposure," *Credit Card Management*, April 25, 2002.
[121] "Fitch Ratings Report: Finance Company Capital Standards – 2002," *Business Wire*, April 29, 2002.
[122] "Fitch Ratings Report: Finance Company Capital Standards – 2002," *Business Wire*, April 29, 2002.
[123] "Credit Card Delinquency Soars," *CNNfn: Markets Impact*, April 29, 2002.

G. May 10, 2002

72. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information on May 10, 2002 in the very analyst report that he cites.[124] Bernstein Research noted that changes in legislation "create legal risk for both predatory and legitimate subprime lenders," and that "the need to manage legal risk will lead to changes in subprime lending practices…[that] will, in turn, erode the profitability of business models because either returns are reduced or it simply becomes uneconomical to lend to higher-risk customers (and so the addressable market shrinks)."[125] In other words, there was risk that potential changes in state and federal lending laws would reduce Household's profitability because profitability of individual loans would be reduced or the size of the market for subprime loans would be reduced.

H. May 15, 2002[126]

73. On May 15, 2002, (1) Professor Fischel fails to provide a reliable basis for attributing the price decline to fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not accounted for in his leakage model. Professor

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[124] Second Supplemental Report, ¶ 24.

[125] "Household International: Legal Risk to Business Model Increasing," *Bernstein Research*, May 10, 2002.

[126] This day would not be statistically significant under generally accepted economic standards. On nine of the 27 days analyzed by Professor Fischel, including May 15, 2002, his regression model does not find statistical significance using a t-statistic cut-off of 1.96 (the nine days are 4/25/02, 5/10/02, 5/15/02, 7/1/02, 7/19/02, 8/9/02, 9/10/02, 10/7/02, and 10/8/02). Although none of my opinions hinge on Professor Fischel's determination of statistical significance, I note that Professor Fischel consistently uses a t-statistic of 1.65 as the cut-off for establishing whether a price movement meets the 5% statistical significance standard. This is important because, if a price movement is not statistically significant on a particular day, then one cannot reject firm-specific random noise as the reason for the price movement. The use of a t-statistic of 1.65 as the cut-off for a test of 5% significance, as Professor Fischel himself explains, necessarily entails the use of a one-tailed test, rather than a two-tailed test, as the latter test would imply a t-statistic cut-off of 1.96. However, in order to use a one-tailed test, one needs an *a priori* hypothesis or expectation as to the direction of the stock price reaction that one is testing, such as an expectation that the price reaction will be negative. Professor Fischel fails to provide let alone justify such an *a priori* expectation. Indeed, in Exhibit 1 to his Second Supplement Report, he reports for the days in his leakage period both positive and negative statistically significant price reactions all the while using a t-statistic of 1.65 as the cut-off. However, to appropriately use a one-tailed test in this way, one would need to have constantly shifting *a priori* expectations concerning the direction of the price reaction on these different days. As the literature recognizes, when there is no *a priori* expectation regarding the direction of the stock price movement, the appropriate test is a two-tailed test and the ability to discern abnormal performance is reduced markedly, with the use of a one-tailed test biasing the results in favor of finding statistical significance. *See*, *e.g.*, Stephen J. Brown and Jerold B. Warner, "Measuring Security Price Performance," *Journal of Financial Economics*, Vol. 8 (1980), pp. 205–258 at 227; Roman Weil, Daniel G. Lentz, and David P. Hoffman, eds., *Litigation Services Handbook: The Role of the Financial Expert*, 5th ed. (Hoboken, NJ: John Wiley and Sons, Inc., 2012), Section 8.9.

Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

I. July 1, 2002

74. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on July 1, 2002.[127] For example, a *Dow Jones News Service* article stated that, while credit card companies with healthy track records are expected to continue that course, "companies that issue cards to those with checkered credit histories – which have been operating under regulatory scrutiny given concern over rising losses from uncollectable loans – won't fare as well."[128] The article also quoted a Deutsche Bank analyst stating that "companies in the subprime space are operating under (regulatory) constraints.…"[129]

J. July 9, 2002

75. On July 9, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not accounted for in his leakage model. Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

K. July 10, 2002

76. On July 10, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not

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[127] Firm-specific, nonfraud information was also released on Friday, June 28, 2002, the trading day prior to July 1, 2002—it is not clear whether the information was released after market hours, and as a result this information may have contributed to Household's stock price decline that occurred on July 1, 2002. A report from JP Morgan commented on its below-consensus expectations for Household's EPS, noting that "[y]ear over year growth is expected to slow from the 20% posted in the first quarter owing to: (1) the lack of RAL; and (2) lower securitization benefits." *See* "Household International: 2Q02 Preview & Update," *JP Morgan*, June 28, 2002.
[128] "Card Cos 2Q EPS Produce Mixed Bag; Trends Mostly Stable," *Dow Jones News Service*, July 1, 2002.
[129] "Card Cos 2Q EPS Produce Mixed Bag; Trends Mostly Stable," *Dow Jones News Service*, July 1, 2002.

accounted for in his leakage model. Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

L. July 17, 2002

77. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information on July 17, 2002 in the very Fox-Pitt Kelton report he cites.[130] The Fox-Pitt Kelton report titled "Regulatory Uncertainty Causes Big Problems For Consumer Finance Group" discussed that Capital One's announcement "represents a profoundly significant development for the consumer credit industry, the ramifications of which could lead to lower returns, increased capital intensity and greater regulatory uncertainty in the future."[131] Fox-Pitt Kelton concluded that the Capital One announcement "throws into question the long-term sustainability of the business model."[132] Fox-Pitt Kelton further identified that the "potential spillover impact on sub-prime consumer creditworthiness could have a negative impact on the portfolio of Household International, due to its concentration of sub-prime borrowers…."[133]

78. Professor Fischel also ignores substantial other market commentary that also attributed Household's stock price decline on this date to Capital One's announcement, focusing on the implications of Capital One's announcement as it related to concerns about increasing capital requirements for subprime lenders and how rising consumer loan defaults would affect Household's profitability. For example, *Reuters News* stated that "[s]hares of credit card firms got hammered on Wednesday [July 17, 2002] after regulators asked issuer Capital One Financial Corp to increase its loan loss reserves, awakening fears of a rise in consumer loan defaults."[134] *Reuters News* further stated that the "stocks of credit card issuers and consumer finance companies are extremely sensitive to any news on the quality of credit, as widespread defaults by consumers would eat into profits and could lead to huge losses," and noted that the "credit quality fears also spilled over to affect the broader consumer finance sector," specifically

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[130] Second Supplemental Report, ¶ 36.
[131] "Regulatory Uncertainty Causes Big Problems For Consumer Finance Group," *Fox-Pitt Kelton*, July 17, 2002.
[132] "Regulatory Uncertainty Causes Big Problems For Consumer Finance Group," *Fox-Pitt Kelton*, July 17, 2002.
[133] "Regulatory Uncertainty Causes Big Problems For Consumer Finance Group," *Fox-Pitt Kelton*, July 17, 2002.
[134] "UPDATE 2-Credit card stocks dive on consumer default fears," *Reuters News*, July 17, 2002.

identifying Household.[135] Bear Stearns stated that "HI shares appear to have suffered along with those of other financials in reaction to bank regulators imposing higher reserve and capital requirements on sub-prime lenders."[136] Merrill Lynch similarly noted that "Household's shares were weak over investor concerns about possible regulatory scrutiny of its bank's capital adequacy, reserve adequacy, and operating practices a la Capital One, Metris, and Providian."[137] *American Banker* also stated that Household's shares declined "amid a credit card stock fallout" related to Capital One's announcement.[138] The *Wall Street Journal* noted that, following the Capital One announcement, credit card and lending stocks including Household fell "amid heightened scrutiny from federal regulators, who have become increasingly concerned that credit companies are too thinly capitalized to protect against customer defaults."[139]

79. In addition to fallout from Capital One's announcement, Professor Fischel also fails to account for other firm-specific, nonfraud information that may have impacted Household's stock price on July 17, 2002. For example, related to Household's own financial announcement on July 17, 2002, CIBC noted that "credit quality remained in check, although managed losses did rise modestly owing to portfolio seasoning and the challenging economic environment" and that a "potential economic double-dip could adversely impact credit quality and growth trends, which would represent a risk to our price target."[140]

M. July 19, 2002

80. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on July 19, 2002.[141] For example, a *Mortgage Servicing News* article titled "Subprime Forecast: Defaults Will Edge Up On Today's

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[135] "UPDATE 2-Credit card stocks dive on consumer default fears," *Reuters News*, July 17, 2002.
[136] "Household International (HI-$46.10) – Buy," *Bear Stearns*, July 17, 2002.
[137] "Nice Quarter, Wrong Day," *Merrill Lynch*, July 18, 2002.
[138] "2Q Earnings: Another Record at Household as 2Q Net Increases by 17%," *American Banker*, July 18, 2002.
[139] "Capital One Sees Shares Fall 40% On Fed Warning," *The Wall Street Journal*, July 18, 2002.
[140] "In-Line 2Q02 EPS Offer No Surprises; Maintain Buy," *CIBC World Markets*, July 17, 2002.
[141] Firm-specific, nonfraud information was also released on July 18, 2002—it is not clear whether the information was released after market hours, and as a result this information may have contributed to Household's stock price decline that occurred on July 19, 2002. A report from Deutsche Bank noted that it lowered its 2002 and 2003 EPS targets for Household, stating that "[g]iven the lower market valuations and cloud overhanding all subprime lenders, we took our target price down." *See* "Solid 2Q Performance," *Deutsche Bank*, July 18, 2002.

Loans" stated that "[t]he weak economy is causing the risk of default on newly originated, nonprime credit quality mortgages to rise again," citing data from University Financial Associates.[142] The article further stated that "[e]conomic conditions for the performance of subprime loans have been less favorable over the last two years than the prior two-year period" and that the "risk is rising because the accommodating interest rate policy of the Fed is not sufficient to offset the eroding prospects for both the consumer and the underlying housing collateral."[143]

N. July 25, 2002

81. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on July 25, 2002. For example, on July 26, 2002, Credit Suisse fixed income analysts issued a report titled "The Most Puzzling Bond of All: Household Finance Hits Historic Wides On No News—Look No Further Than Capital One," which related recent declines in Household's bond prices to spillover from recent announcements concerning Capital One. Specifically, Credit Suisse stated:

> This has been a tough couple of weeks for financials, with markets punishing investor perception of the brokers and regulators becoming more vigilant in their oversight of the banks. All of this has pushed spreads wider, although to be fair, financials have performed no worse than the broader market. But one name has been swept out to historic wides for no good reason in our opinion—Household Finance….
>
> We believe that Household paper has widened because short sellers can draw a line, however vague, between Capital One (Buy/Mid BBB) and Household. Both are full spectrum lenders and both have bank subsidiaries. We have long felt that Household's biggest vulnerability is a competitor's fall from grace. *Capital One's announcement a couple of weeks ago that it expects to be subject to greater regulatory scrutiny has spilled over into Household's story.*[144]

[142] "Subprime Forecast: Defaults Will Edge Up On Today's Loans," *Mortgage Servicing News*, July 19, 2002.
[143] "Subprime Forecast: Defaults Will Edge Up On Today's Loans," *Mortgage Servicing News*, July 19, 2002.
[144] "The Most Puzzling Bond of All: Household Finance Hits Historic Wides On No News—Look No Further Than Capital One," *Credit Suisse First Boston*, July 26, 2002 (emphasis added).

O. August 5, 2002

82. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on August 5, 2002 in the very Portales Partners report he cites. This report discussed Household's "willingness to extend…high loan-to-value ratios to subprime customers where there is significantly greater credit risk," and opined that Household "has been making loans at substantially higher loan-to-value ratios than most of its peers."[145] Portales Partners then discussed its review of the increasing risk profile of various Household equity securitizations and stated that "the changing risk profile could lead to substantially higher losses in the current weak economic environment."[146]

83. Professor Fischel also fails to account for other firm-specific, nonfraud information on August 5, 2002 that may have contributed to Household's stock price decline. For example, an article in the *Wall Street Journal* stated that Capital One fell 14% on August 5, 2002 after analysts at Salomon Smith Barney "warned of risks to [Capital One's] business model," and noted that stock of other consumer lenders, such as AmeriCredit and MBNA, "also retreated."[147]

P. August 7, 2002

84. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on August 7, 2002. Professor Fischel does not conclude that the information released on this date was "consistent with leakage" of fraud-related information. Instead, he appears to conclude that Household's stock price decline was caused by the revelation of the fraud because the buyback of zero-coupon bonds on August 7, 2002 resulted from Household's depressed stock price which "was in substantial part driven by the decline in Household's stock price due to the revelation of the fraud."[148] He identifies a *Reuters News* article reporting that Household was forced to buy back nearly all of its zero-coupon convertible bonds because the conversion value was substantially

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[145] "What is Wrong With This Picture," *Portales Partners*, August 5, 2002.
[146] "What is Wrong With This Picture," *Portales Partners*, August 5, 2002.
[147] "Cox Communications Falls 19%, Comcast 14% as Market Slides," *The Wall Street Journal*, August 6, 2002.
[148] Second Supplemental Report, ¶ 46.

lower than the repurchase value. Even assuming that Professor Fischel is correct that a substantial part of Household's stock price decline was attributable to the fraud, by stating that the stock price was driven "in part" by the revelation of the fraud, he has acknowledged that other information contributed to the decline in the conversion value—yet, he does not identify such information or attempt to account for it.

85. Professor Fischel also fails to account for other firm-specific, nonfraud information on August 7, 2002. For example, a *Reuters News* article reported that "AmeriCredit Corp. shares fell sharply on concerns about the Company's credit losses and its exposure to continuing weak, used car prices," and cited increasing delinquency and deferment rates.[149] As discussed throughout this report, analysts during the leakage period explicitly noted that announcements by Household peers such as AmeriCredit are relevant in assessing Household.[150]

Q. August 9, 2002

86. On August 9, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not accounted for in his leakage model. Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

R. August 13, 2002

87. On August 13, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not accounted for in his leakage model. Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

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[149] "AmeriCredit Corp. Shares Fall Sharply On Delinquency Concerns-DJ," *Reuters Significant Developments*, August 7, 2002.

[150] *See*, *e.g.*, "Household International: Reducing Price Target To $41," *UBS Warburg*, September 18, 2002.

S. August 23, 2002

88. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on August 23, 2002.[151] Specifically, an article in the *Australian Financial Review* discussed rising challenges for subprime lenders given the U.S. credit environment:

> Financial institutions in the US are tightening credit conditions, clamping the loose lending environment that has fueled the consumer spending binge keeping the world's biggest economy afloat. A credit crunch has not yet hit. But with household debt at record levels, many view federal government moves to more tightly regulate lenders as the first link in a chain that could restrain overall spending if the economy continues to falter….
>
> As consumers buy homes with bare minimum deposits, snap up cars under interest-free deals and spend excess cash from mortgage refinancing, delinquencies and bankruptcies are rising. Delinquencies on non-mortgage consumer debt jumped from 1.4 per cent of debts to 1.86 per cent in the past year, while total bankruptcy filings breached 1.5 million in the year to the end of June. Standard & Poor's believes US consumers are "tapped out", with household debt at a record 104 per cent of annual household income….
>
> In an effort to head off more significant default problems, the federal Government has begun pressuring lenders in the booming sub-prime market, which caters to consumers with low incomes or poor credit ratings and comprises about a third of the total credit card sector.[152]

T. September 10, 2002

89. On September 10, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business

[151] Firm-specific, nonfraud information was also released on August 22, 2002—it is not clear whether the information was released after market hours, and as a result this information may have contributed to Household's stock price decline that occurred on August 23, 2002. Fox-Pitt Kelton published a U.S. Specialty Finance industry report that discussed Household and its specialty finance peers and stated that its "recent cautious stance on the US Specialty Finance group reflects, in part, our concern that stock market volatility and loss of investor confidence in corporate America has damaged consumer confidence and, thus, the economy." *See* "The Card Game – Credit Card Monthly," *Fox-Pitt Kelton*, August 22, 2002.

[152] "US puts screws on consumer credit," *The Australian Financial Review*, August 23, 2002.

mix, which is not accounted for in his leakage model. Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

U. September 16, 2002

90. Professor Fischel fails to address, let alone account for, other firm-specific, nonfraud information that may have impacted Household's stock price on September 16, 2002. Specifically, after market hours on Friday, September 13, 2002, MGIC warned of lower-than-expected earnings and "attributed the lowered expectations to a continued increase in policy cancellations and higher expenses caused by heavy refinance activity and higher loan delinquencies."[153] An *American Banker* article discussed the implications of MGIC's announcement for the mortgage industry, stating that the "weak economy had led many industry insiders to the conclusion that mortgage insurers might be in for a rough spell," and that "MGIC Investment Corp.'s earnings warning late Friday showed just how rough it might get."[154] The *American Banker* article further noted that MGIC's announcement "reinforced a recent announcement by the Mortgage Bankers Association that the industry saw an uptick in both loan delinquency and foreclosure rates during the second quarter," and noted that the "MBA attributed these increases to continued weakness in the economy, especially in employment."[155]

91. Analysts at A.G. Edwards discussed the impact of MGIC's announcement on Household, noting that, with respect to MGIC's announcement, the "market is quick to discount shares related to sub-prime exposure following high profile sub-prime credit catastrophes at Providian Financial (PVN), Metris Cos. (MXT) and NextCard (NXCD)," and that while it distinguished Household from these lenders, it "believe[d] that the shares will likely remain compressed until an economic recovery materializes or one or more of the external issues are lifted."[156]

92. In addition, an *Asset Securitization Report* article published on September 16, 2002 discussed research updates on the auto loan sector of the asset-backed security ("ABS") market

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[153] "MGIC Warning Spurs an Industrywide Stock Drop," *American Banker*, September 17, 2002.
[154] "MGIC Warning Spurs an Industrywide Stock Drop," *American Banker*, September 17, 2002.
[155] "MGIC Warning Spurs an Industrywide Stock Drop," *American Banker*, September 17, 2002.
[156] "Lowering Rating on HI to Hold From Buy," *A.G. Edwards*, September 18, 2002.

from Credit Suisse and Fitch in light of "rising unemployment and weaker job creation combined with an anticipated rise in bankruptcy filings."[157] The article noted that both Credit Suisse and Fitch "concur that delinquency and loss performance - and therefore spreads - will remain under pressure until the economy turns around."[158]

V. September 17, 2002

93. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on September 17, 2002. Specifically, AmeriCredit announced poor financial results and market commentary attributed Household's stock price return on September 17, 2002 to this announcement, in addition to the MGIC announcement discussed above with respect to September 16, 2002. Specifically, AmeriCredit announced that it was changing its accounting method for auto securitizations, which required the company to hold a loan loss reserve against these loans and to recognize the income from these loans over their remaining life rather than upfront through the gain on sale, and AmeriCredit subsequently reduced its earnings guidance for the next six quarters.[159] Analysts attributed Household's stock price decline on September 17, 2002 to AmeriCredit's announcements and explained why the announcement was relevant for Household. A.G. Edwards reduced its rating on Household from Buy to Hold, stating that "with the announcement of additional negative press regarding the performance of sub-prime mortgages at MGIC and the credit related problems with the securitization portfolio at AmeriCredit (ACF) we believe that the uncertainty in the near term environment does not favor investors making additional investments in HI at this time."[160] With respect to AmeriCredit's announcement, A.G. Edwards explained that "the market is likely to continue to discount consumer securitization models until consumer trends are helped by an economic recovery," and therefore it "believe[s] this will likely dampen the near-term potential upside in HI shares."[161]

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[157] "Delinquencies rising, but auto ABS structures sound," *Asset Securitization Report*, September 16, 2002.
[158] "Delinquencies rising, but auto ABS structures sound," *Asset Securitization Report*, September 16, 2002.
[159] "Household International: Reducing Price Target To $41," *UBS Warburg*, September 18, 2002.
[160] "Lowering Rating on HI to Hold From Buy," *A.G. Edwards*, September 18, 2002.
[161] "Lowering Rating on HI to Hold From Buy," *A.G. Edwards*, September 18, 2002.

W. September 27, 2002

94. On September 27, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not accounted for in his leakage model. Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

X. October 1, 2002

95. On October 1, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not accounted for in his leakage model.[162] Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

Y. October 7, 2002

96. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information that may have impacted Household's stock price on October 7, 2002. Specifically, analysts downgraded Household and certain of its peers, citing a weaker economic backdrop, including a more pessimistic outlook on credit, housing, and growth. A *Reuters News* article stated that U.S. financial company stocks "dropped on Monday on growing concerns a weak economy would leave banks and credit card issuers with unpaid loans and also dent stock businesses at Wall Street firms."[163] *Reuters News* identified that Goldman Sachs cut the ratings of Household, Capital One, and AmeriCredit,[164] with Goldman Sachs stating that "[g]iven the

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[162] Firm-specific, nonfraud information was released on September 30, 2002—it is not clear whether the information was released after market hours, and as a result this information may have contributed to Household's stock price decline that occurred on October 1, 2002. A report from *Lehman Brothers* reported it was reducing EPS estimates for Household, and that the "lower esimates [*sic*]…are driven in part by [Lehman's] belief that [Household's] wider bond spreads could have an impact on margins." *See* "Household International: Change of Earnings Forecast: Revising Estimates; Updating model," *Lehman Brothers,* September 30, 2002.

[163] "UPDATE 1-U.S. financial stocks fall in weak economy," *Reuters News*, October 7, 2002.

[164] The Goldman Sachs report announcing the downgrade of Household is not available. An *Oster Dow Jones Select* article reported a similar summary of Goldman Sachs's downgrade rationale to the *Reuters News* article, stating that "Household International dropped 1.41, or 5.7%, to 23.25 after Goldman Sachs warned that the weak economy

weaker economic backdrop including a more pessimistic intermediate-term outlook on credit, housing and growth, we are adjusting estimates downward."[165] *Reuters News* also quoted analysts at U.S. Bancorp Piper Jaffray stating that "[u]ntil you see a clear improvement in the economy, it's going to be difficult for those consumer finance stocks to outperform."[166]

97. Also on October 7, 2002, CIBC downgraded Household to Sector Underperformer, stating that "the Specialty Finance sector is undergoing a secular revaluation" and that "HI could be at greater risk than its peers and may underperform."[167] Specifically, CIBC identified that the "combination of greater concern regarding prepayment speeds, credit quality trends within the auto finance and credit card portfolios, and the overhang of pending predatory lending lawsuits, has raised growing fundamental concerns regarding HI's ability to sustain earnings."[168] CIBC further discussed that prepayment speeds and credit quality trends continued to "plague" Household:

> [C]oncerns regarding prepayment speeds and credit quality trends continue to plague the company. Although the record low interest rates have sparked dramatic growth in origination volume, fears regarding prepayment speeds and the subsequent impact on consolidated results (particularly following investors' concerns regarding Fannie Mae's duration gap) have further depressed the stock price. In addition, the overhang of pending predatory lending lawsuits as it pertains to the company's home equity lending practices continue to represent an uncertainty.
>
> *In addition to concerns related to the home equity operation, credit quality trends within the credit card and auto finance portfolios continue to plague the company.* Although the bankcard and private label card portfolios have reported credit deterioration, the magnitude has been roughly as expected given the weak economy and consumer leverage. In general, we believe Household's steady addition to loan loss reserves through heavy provisioning should be adequate to manage future losses, but further reserve building is anticipated. Within the auto

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warrants 'an even more cautious stance' toward specialty-finance stocks." "DJ. US Late Market Comment -4 - American Express Falls 7%," *Oster Dow Jones Select*, October 7, 2002.

[165] "UPDATE 1-U.S. financial stocks fall in weak economy," *Reuters News*, October 7, 2002.

[166] "UPDATE 1-U.S. financial stocks fall in weak economy," *Reuters News*, October 7, 2002.

[167] "Downgrading To SU On Downside Risk Related To Fundamentals And Valuation," *CIBC World Markets*, October 7, 2002.

[168] "Downgrading To SU On Downside Risk Related To Fundamentals And Valuation," *CIBC World Markets*, October 7, 2002.

> finance portfolio, the company reported sharp credit quality deterioration earlier this year and at the end of 2001.[169]

98. In addition to the analyst downgrades and commentary on October 7, 2002, a *Dow Jones* article noted that certain subprime consumer finance companies "will continue to suffer" in light of "concern[s] about new regulations and the cloudy economic outlook."[170] The article quoted analysts at Prudential Securities Inc. acknowledging that "there's currently no clear light at the end of the economic tunnel and consumer lenders appear set to face some headwinds through at least the rest of 2002."[171] Finally, the article noted that investors focused on Household's compliance with potential regulatory changes and progress on the Company's plan to build its capital levels, and that additional concerns included an expected modest increase in credit losses, increased funding costs due to the increase in Household's bond spreads, and that it had bonds expiring in early 2003.[172]

Z. October 8, 2002

99. Professor Fischel fails to address, let alone account for, firm-specific, nonfraud information on October 8, 2002 in the very UBS report that he cites. For example, UBS stated that it was "also lowering [its] 2002 estimate to $4.44 from $4.56 to reflect slower receivable growth as a result of the company's capital constraints, wider spreads on the company's debt, higher credit losses and continued reserve building, and limited ability to further reduce costs."[173] UBS also noted that "there are a number of other concerns floating about in the market place," such as "surging charge-offs" in Household's mortgage and home equity portfolio, concerns about Household's auto portfolio "following announcements made by rival subprime auto lender Americredit that it is bringing all its auto loans back on balance sheet," and that "there continues to be concern about a surging charge-off scenario in the company's credit card portfolio."[174]

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[169] "Downgrading To SU On Downside Risk Related To Fundamentals And Valuation," *CIBC World Markets*, October 7, 2002 (emphasis in original).
[170] "Credit Cards 3Q Results Mixed; Focus On New Regulations," *Dow Jones News Service*, October 7, 2002.
[171] "Credit Cards 3Q Results Mixed; Focus On New Regulations," *Dow Jones News Service*, October 7, 2002.
[172] "Credit Cards 3Q Results Mixed; Focus On New Regulations," *Dow Jones News Service*, October 7, 2002.
[173] "Household: Lowering Target; Still Creating Value Despite Lower Growth," *UBS Warburg*, October 8, 2002.
[174] "Household: Lowering Target; Still Creating Value Despite Lower Growth," *UBS Warburg*, October 8, 2002.

100. Professor Fischel also fails to account for other firm-specific, nonfraud information on October 8, 2002 that may have contributed to Household's stock price decline. On October 8, 2002, the *Financial Times* reported that "[c]redit spreads for specialty US finance companies have widened sharply this week as concern grows over their ability to continue accessing the capital markets," noting that Household's credit spreads had reached their widest level to date.[175] The article noted that analysts attributed the widening in spreads to "negative sentiment in the corporate bond market as well as investor nervousness over the health of the financial sector."[176] The *Financial Times* also noted that "concern has begun to mount that consumer spending, and hence demand for credit, may be slowing."[177]

AA. October 9, 2002

101. On October 9, 2002, (1) Professor Fischel fails to identify any fraud-related information; and (2) as noted in Section VIII, throughout the leakage period there was firm-specific, nonfraud information such as market concerns regarding Household given its business mix, which is not accounted for in his leakage model. Professor Fischel therefore fails to provide a reliable basis for attributing the price decline to fraud-related information.

X. Professor Fischel Fails to Account for Significant Firm-Specific, Nonfraud-Related Information Throughout the Remainder of the Leakage Period

A. The 14 Specific Disclosure Days

102. The Seventh Circuit explained that Professor Fischel's specific disclosure model encounters the same problem as his leakage model—namely, it will overstate damages—to the extent that "there was some additional negative firm-specific, nonfraud related information on the same day as a specific disclosure."[178] In his Second Supplemental Report, Professor Fischel states that he "did not find significant firm-specific, nonfraud related information that could

[175] "Finance company spreads widen," *Financial Times*, October 8, 2002.
[176] "Finance company spreads widen," *Financial Times*, October 8, 2002.
[177] "Finance company spreads widen," *Financial Times*, October 8, 2002.
[178] Appellate Order, p. 24 and footnote 7.

reasonably explain the price movements on specific disclosure days."[179] Below I highlight several examples to illustrate that Professor Fischel has failed to account for significant firm-specific, nonfraud information that may have contributed to Household's stock price declines on his specific disclosure days, and as a result, both his specific disclosure model and his leakage model—both of which include declines on the 14 specific disclosure days as damages—are unreliable.

1. December 12, 2001

103. Professor Fischel fails to account for firm-specific, nonfraud information that may have impacted Household's stock price on December 12, 2001. Specifically, a *Business Wire* article discussed increasing credit card charge-off rates and noted that "the delinquency trends—combined with the recent increase in unemployment rates—point toward higher charge-off rates in the upcoming months."[180] *Business Wire* stated that "[s]ubprime lenders who have witnessed the most rapid growth over the past few years, and have yet to manage through a recession, will feel the increase in losses more directly," and that "[t]hese same lenders suffered the greatest absolute increase in losses this month."[181]

2. July 26, 2002

104. Professor Fischel fails to account for firm-specific, nonfraud information that may have impacted Household's stock price on July 26, 2002. For example, as discussed above with respect to July 25, 2002, Credit Suisse fixed income analysts issued a report on July 26, 2002 titled "The Most Puzzling Bond of All: Household Finance Hits Historic Wides On No News—Look No Further Than Capital One," which related recent declines in Household's bond prices to spillover from recent announcements concerning Capital One. Credit Suisse stated that it had "long felt that Household's biggest vulnerability is a competitor's fall from grace," and that "Capital One's announcement a couple of weeks ago that it expects to be subject to greater

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[179] Second Supplemental Report, footnote 4.
[180] "Credit Card Charge-Offs Increased in October," *Business Wire*, December 12, 2001.
[181] "Credit Card Charge-Offs Increased in October," *Business Wire*, December 12, 2001.

regulatory scrutiny has spilled over into Household's story."[182] Credit Suisse stated that "the facts become less meaningful when fear takes over the market," and that:

> [T]he catalyst forward seems to be a bit more in the future than what took place in the first quarter. We need to see the economy shake off all of the malaise that pervades markets today and post solid, if unspectacular levels of growth. We need to see unemployment stabilize. And the lifting of Capital One's MOU (which we would expect by mid-year 2003), would be the final piece of the puzzle.[183]

3. August 14, 2002

105. Professor Fischel fails to account for firm-specific, nonfraud information that may have impacted Household's stock price on August 14, 2002. While analysts did revise their price targets for Household on August 14, 2002 following the announced restatement, as noted by Professor Fischel,[184] analysts also attributed their price revisions to firm-specific, nonfraud factors. For example, JP Morgan lowered its estimates, citing "the earnings restatements, the temporary suspension of the company's share buyback program, *slower loan growth, and higher funding costs*."[185] JP Morgan also noted that "the bigger concern for the stock, in our view, is the broader economic picture, namely the U.S. economy."[186] William Blair reduced estimates, citing "*concerns of higher funding costs* and fewer share buybacks," and further noted that "the stock is likely to remain under pressure, as *management continues to face a difficult period, operating the business under difficult economic conditions, regulatory and political scrutiny*, and now heightened questions over the integrity of its accounting."[187] Bear Stearns indicated that it lowered estimates "to reflect the impact of the accounting changes, fewer share repurchases this year (we expect repurchases to resume in 2003), and *the whole loan sales we expect this year*."[188]

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[182] "The Most Puzzling Bond of All: Household Finance Hits Historic Wides On No News—Look No Further Than Capital One," *Credit Suisse First Boston*, July 26, 2002.
[183] "The Most Puzzling Bond of All: Household Finance Hits Historic Wides On No News—Look No Further Than Capital One," *Credit Suisse First Boston*, July 26, 2002.
[184] *See*, *e.g.*, Rebuttal Report of Daniel R. Fischel, February 1, 2008 ("Fischel Rebuttal Report"), ¶¶9–10.
[185] "Restating Financial Statements: Lowering Estimates," *JP Morgan*, August 14, 2002 (emphasis added).
[186] "Restating Financial Statements: Lowering Estimates," *JP Morgan*, August 14, 2002.
[187] "Household International Restates Financials for Credit Card Business," *William Blair*, August 14, 2002 (emphasis added).
[188] "Restatement Should Have Modest Impact On Household. New Capital Ratio Targets And Funding Challenges Likely to Impact EPS Next Year Though," *Bear Stearns*, August 15, 2002 (emphasis added).

Although Salomon Smith Barney revised its earnings for the restatement, it stated its opinion that "the biggest risk to the Household story is that jittery debt markets make the company's cost of funding prohibitive or mechanically difficult."[189]

106. In addition, Fitch affirmed its credit ratings for Household following the announced restatement and indicated that concerns centered on portfolio liquidity, particularly in times of economic stress:

> Concerns with Household continue to center on the company's ability to demonstrate effective portfolio liquidity, particularly in times of economic stress. More directly, given the non-conforming nature of Household's real estate secured near-prime/subprime and some of its other unsecured products, Fitch has been uncertain as to whether the company would be able to effectively monetize these assets as effectively as it has with other asset types, as such asset valuations could come under pressure in more stressful economic scenarios.[190]

4. August 16, 2002

107. Professor Fischel fails to account for firm-specific, nonfraud information that may have impacted Household's stock price on August 16, 2002. Specifically, A.G. Edwards reduced its price target and earnings estimates for Household on August 16, 2002 "to reflect the restatement and slightly lowered expectations based on a weaker than expected macro-economic environment."[191] A.G. Edwards noted that its revised estimates were "conservative…given the market[']s low appetite for consumer exposure and the uncertainty concerning the timing of an economic recovery," and stated that a "risk to HI reaching our $51 price objective is that the U.S. economy would sustain a downturn that would significantly weaken the credit quality of the U.S. consumer."[192]

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[189] "HI: Certifies Statements, But Restates $386 million Past Income - Maintain 2H," *Salomon Smith Barney*, August 14, 2002.
[190] "Fitch Affirms Household At 'A' Following Announcement," *Fitch Ratings*, August 14, 2002.
[191] "HI Restates Earnings Due to Accounting Issues - Estimates and PO Change," *A.G. Edwards*, August 16, 2002.
[192] "HI Restates Earnings Due to Accounting Issues - Estimates and PO Change," *A.G. Edwards*, August 16, 2002.

5. August 27, 2002

108. Professor Fischel fails to account for firm-specific, nonfraud information that may have impacted Household's stock price on August 27, 2002. Specifically, Keefe, Bruyette & Woods initiated coverage of Household on August 27, 2002 with a Market Perform rating and published a report titled "Yet Another Un-Investable Situation."[193] Professor Fischel cites this report as evidence that "[a]s information regarding Defendants' lending practices leaked out during the latter part of the Class Period, market participants reassessed the risks of investing in Household stock,"[194] and an *Oster Dow Jones Select* article indicating that Household's stock price declined on August 27, 2002 following the Keefe, Bruyette & Woods report.[195] However, Keefe, Bruyette & Woods identified five reasons that Household was an "un-investable situation," including that (a) "Right side of the balance sheet is a major issue. $19 billion of notes are maturing by year end 2003," (b) "Company has placed fixed income investors ahead of equity investors," and (c) "Credit costs remain a concern, particularly in auto and unsecured lending."[196] Regarding the "right side of the balance sheet," Keefe, Bruyette & Woods noted that Household "appears to be in a pickle" because its access to the commercial paper market had been reduced, access to deposits had been reduced as a result of regulatory scrutiny, its debt maturity schedule indicated $19 billion of term debt maturing in the next year and a half, and its bond spreads had increased, thereby increasing Household's cost of debt.[197] Also, with respect to Household's credit costs, Keefe, Bruyette & Woods noted that "credit costs for the industry are at or near peak levels," it "expect[s] charge-offs to increase," and it is "seeing negative trends in the company's static pool data."[198]

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[193] "Initiating Coverage of Household International With a Market Perform Rating Yet Another Un-Investable Situation," *Keefe, Bruyette & Woods*, August 27, 2002.
[194] Fischel Initial Report, ¶ 19.
[195] "DJ. WSJ(8/28) Abreast Of The Market - Stock Prices Struggle Tue," *Oster Dow Jones* Select, August 27, 2002. The article also noted that "[a] fresh update on consumer confidence put a dent in hopes for an emerging economic recovery, and left stock prices struggling…."
[196] "Initiating Coverage of Household International With a Market Perform Rating Yet Another Un-Investable Situation," *Keefe, Bruyette & Woods*, August 27, 2002.
[197] "Initiating Coverage of Household International With a Market Perform Rating Yet Another Un-Investable Situation," *Keefe, Bruyette & Woods*, August 27, 2002.
[198] "Initiating Coverage of Household International With a Market Perform Rating Yet Another Un-Investable Situation," *Keefe, Bruyette & Woods*, August 27, 2002.

6. September 23, 2002

109. Professor Fischel fails to account for firm-specific, nonfraud information on September 23, 2002. Specifically, CIBC published a report on Sunday, September 22, 2002 that noted it had "fine tuned our quarterly earnings progression for 2002 and trimmed our 2003 earnings estimates to $5.12 from $5.18 per share owing primarily to the likelihood of slower refinancing activity as interest rates begin to rise," and that "given the potential for higher interest rates and greater securitization activity, the net interest margin could come under modest pressure in 2003."[199] CIBC also noted that "there is reason for some concern given the uncertain economic outlook and recent troubles at the independent auto finance company Americredit (ACF)."[200] Finally, CIBC noted that "the ongoing skittish market and investor sentiment could continue to punish the stock," and "should the economic recovery reverse or interest rates rise sharply, production could slow and adversely impact earnings growth."[201]

110. I note that Professor Fischel has previously commented on the CIBC report, stating that "CIBC analysts reduced their price target by over thirty-five percent (from $57 to $36) due to concerns related to predatory lending."[202] However, Professor Fischel provides no basis for entirely ignoring CIBC's commentary unrelated to the fraud, summarized above, and thus his analysis fails to account for such firm-specific, nonfraud information.

111. In addition, a *Dow Jones Capital Markets* article reported that "[c]oncerns about companies with high levels of debt and exposure to sub-prime borrowers as well as general concerns about the health of the economy are overriding any enthusiasm over Treasury yields at their lowest levels in more than 40 years," and that "Spreads to comparable Treasurys on bonds issued by…Household International (HI) have widened around 30 basis points on the day."[203] The article further noted that:

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[199] "Lowering Price Target On Persistent Headline Risk, But Maintaining SP Rating," *CIBC World Markets*, September 22, 2002.
[200] "Lowering Price Target On Persistent Headline Risk, But Maintaining SP Rating," *CIBC World Markets*, September 22, 2002.
[201] "Lowering Price Target On Persistent Headline Risk, But Maintaining SP Rating," *CIBC World Markets*, September 22, 2002.
[202] Fischel Rebuttal Report, footnote 15.
[203] "Finance Co. Bonds Slide Despite 41-Yr Low In Tsy Yields," *Dow Jones Capital Markets Report*, September 23, 2002.

> "Household and Ford, because they are huge debt issuers, tend to be the first to go down on any bad news," said Vince Boberski, managing direct of fixed income research at RBC Dain Rauscher. "They also can be the first to go up on good news, but there's been a shortage of that lately," he added. Concerns about consumer lending spiked last week on news that AmeriCredit Corp. (ACF) had re-negotiated certain agreements on its subprime auto loan securitizations, which were expected to see a rise in delinquency rates.[204]

B. The Remaining 171 Days

112. Professor Fischel's leakage model includes 171 days during the leakage period for which his event study does not find a statistically significant stock price return. As discussed above, if a price movement is not statistically significant on a particular day, then firm-specific random noise could be the reason for the price movement. Professor Fischel has provided no reliable basis for including this stock price decline in his leakage model, let alone one consistent with accepted economic principles.

113. Moreover, Professor Fischel justifies his inclusion of the 171 days in his leakage model by citing to select analyst commentary regarding the general impact on Household's stock from fraud-related issues.[205] For example, Professor Fischel cites a Stephens Inc. statement "that Household's stock 'has been plagued by "headline" risk over predatory lending practices,'" and a Deutsche Bank statement that "Household's stock has been under pressure due to concern about accusations of unfair and predatory lending practices."[206] Professor Fischel then summarily concludes that "market participants attributed [Household's stock price decline] to concerns regarding Defendants' allegedly fraudulent practices."[207] Even assuming that Professor Fischel establishes that Household's non-statistically significant price movements are attributable to firm-specific information, which he has not, Professor Fischel fails to account for substantial similar analyst commentary and other firm-specific, nonfraud information reaching the market throughout the leakage period. In particular given this, there is no reliable basis to attribute the firm-specific price decline to the leakage of fraud-related information.

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[204] "Finance Co. Bonds Slide Despite 41-Yr Low In Tsy Yields," *Dow Jones Capital Markets Report*, September 23, 2002.
[205] *See, e.g.,* Fischel Initial Report, ¶¶ 28–29, 39.
[206] Fischel Initial Report, ¶ 28.
[207] Fischel Initial Report, ¶ 39.

114. As discussed in Section VIII above, there was significant firm-specific, nonfraud information released throughout the leakage period regarding credit quality issues at Household, subprime market factors that disproportionately affected Household-specifically or relevant narrower financial industry segments, uncertainty regarding potential future changes in regulations, and other firm-specific, nonfraud information. Below I provide additional examples of analysts discussing the types of firm-specific, nonfraud information released on the 171 days that Professor Fischel fails to address, which is illustrative of the types of firm-specific, nonfraud information released on the 171 days and is not an exhaustive list of such information.

115. On November 30, 2001, Ventana Capital issued a report stating that Household "is growing its sub-prime auto finance portfolio at the wrong time in the cycle," noting that "Macro Conditions Are Not In Anyone's Favor."[208] Ventana Capital stated that "[m]ost financial institutions engaged in either prime or sub-prime auto finance are finding the current environment particularly challenging," and identified "[w]aning consumer demand in light of the current economic downturn" as a contributing factor.[209]

116. On January 16, 2002, Piper Jaffray maintained its Outperform rating for Household but noted that "consumer finance trends remain key to stock performance and with rising unemployment we remain a little cautious near term."[210] Piper Jaffray further stated that "investors need to be cognizant of individual consumer's balance sheet and trends affecting them such as higher unemployment, lower consumer confidence, and lower spending levels which can keep a lid on HI's shares in the near term."[211]

117. On February 13, 2002, Bernstein Research noted that "Household's stock price was down 1.3% yesterday, as collateral damage from the sharp sell-off of 6.5% in AmeriCredit," although Bernstein Research noted that, in its opinion, "[t]he sale is over-done since the issues affecting

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[208] "Used Car Pile-Up," *Ventana Capital*, November 30, 2001.
[209] "Used Car Pile-Up," *Ventana Capital*, November 30, 2001.
[210] "Margin Expansion Drives Quarter, While Credit Quality Only Slightly Deteriorates, But Something To Watch Closely; Headwinds Remain," *Piper Jaffray*, January 16, 2002.
[211] "Margin Expansion Drives Quarter, While Credit Quality Only Slightly Deteriorates, But Something To Watch Closely; Headwinds Remain," *Piper Jaffray*, January 16, 2002.

AmeriCredit - capital adequacy, funding access, and sustainability of earnings growth - do not apply to the same degree at Household."[212]

118. On May 31, 2002, Wachovia initiated coverage on Household with a Buy rating but noted that "modestly rising credit losses and general uncertainty regarding the outlook for the U.S. economy is likely to limit valuation expansion in HI shares near-term.…"[213]

XI. The Leakage Model Cannot Be Cured by a "Canceling Out" of Positive and Negative Returns

119. Professor Fischel's testimony in this matter suggests that simply establishing that any positive and negative effects of firm-specific, nonfraud factors "cancel each other out" over the leakage period is sufficient to establish that his leakage model reliably estimates damages.[214] As discussed throughout this report, Professor Fischel ignores significant firm-specific, nonfraud information throughout the 228-day period and thus has not established that the net stock price effect of positive and negative firm-specific, nonfraud information over the leakage period was neutral (i.e., during the leakage period, the effect of positive information perfectly offset that of negative information). However, even assuming that Professor Fischel could establish that the net stock price effect was neutral, which he has not, it would still be insufficient to establish that his leakage model could be used to reliably measure damages.

120. Damages for a given share are determined primarily by the difference between the level of inflation at the time of its purchase and the level of inflation that remains at the time of its sale.[215] To a first approximation, a shareholder's damages are determined by estimating the losses attributable to the specific transaction of that shareholder, and damages for the class as a

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[212] "HI: Collateral Damage," *Bernstein Research*, February 13, 2002.
[213] "Initiating Research Coverage With A Buy Rating (Part 1 of 2)," *Wachovia*, May 31, 2002.
[214] Appellate Order (citing Professor Fischel's prior testimony), p. 18.
[215] Other caps on damages recoveries, such as the PSLRA rule that limits recoverable damages for shares retained through the end of the class period to the difference between the purchase price and mean trading price of the stock during the 90-day period following the class period end, may apply, but I understand that the out of pocket rule is the primary measure. The existence of these caps does not invalidate the overarching point here, which is that damages per share and per shareholder, and thus damages for the class as a whole, depend on the level of inflation on each day during the class period. Establishing that nonfraud price movements for which the model of inflation does not account cancel out over the class period such that inflation is calculated correctly *on average* is insufficient to establish that the model provides a reliable measure of damages.

whole are determined by aggregating the damages for all eligible shareholders. Professor Fischel himself identifies this in prior testimony:

> The aggregate economic losses of any class of investors is the sum of each class member's economic losses. Therefore, to determine the aggregate economic losses of such a class of investors, it would be necessary to know how much each class member invested, and when each class member purchased and (if applicable) sold.[216]

121. Similarly, in an article that he co-authored, Professor Fischel reiterates that reliably estimating individual and aggregate damages, given a per share damages estimate, depends on the timing of actual share trading, which can be determined from the claims administration process:

> For buyers who bought and sold shares during the class period, the amount of damages will generally depend on, among other things, the number of shares traded and the dates of the transactions…[with the] claims administration process to supply the remaining information to calculate an accurate, reliable total damage figure.[217]

122. Accurately estimating damages for individual shares, for each shareholder, and for the class as a whole requires accurately determining the level of inflation *on each day* during the class period. Thus, in order to establish that his leakage model reliably estimates damages, Professor Fischel would have to establish that the effect of firm-specific, nonfraud information was neutral *on each day* during the leakage period. Establishing that the level of estimated inflation is correct *on average* over the entire leakage period is insufficient to establish the leakage model's reliability. Differences in the timing of negative and positive firm-specific, nonfraud information can create wide variance in an individual plaintiff's damages, and thus potentially for the class as a whole.

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[216] Report of Daniel R. Fischel, *In re Royal Dutch/Shell Transport Securities Litigation*, November 3, 2006.

[217] Daniel R. Fischel, Davis J. Ross, and Michael A. Keable, "The Use of Trading Models to Estimate Aggregate Damages in Securities Fraud Litigation: An Update, Briefly…Perspectives on Legislation, Regulation, and Litigation," *National Legal Center for the Public Interest*, Vol. 10, No. 3 (2006).

123. Consider a very simple hypothetical situation where the true level of per share inflation is $10 throughout the class period, whereas the estimated level of inflation per share is $15 during the first half of the class period ("Period 1") and $5 during the second half ("Period 2") as a result of negative firm-specific, nonfraud information during the first half of the class period "canceled out" by positive firm-specific, nonfraud information in the second half. On average, inflation is correct because positive and negative factors for which the model does not account cancel each other out over the class period, but, because of the timing difference, the model overestimates inflation during the first half of the class period and underestimates it during the second half.

- Investor A purchases 1,000 shares in Period 1 and sells those shares in Period 2. According to the model, Investor A was damaged by $10,000, since inflation at purchase was $15 per share and inflation at sale was $5 per share. However, Investor A was actually not damaged since there was no change in the true level of per share inflation.

- Investor B purchases 1,000 shares in Period 1 and holds them through the end of the class period, when inflation drops to $0. According to the model, Investor B was damaged by $15,000. However, Investor B was actually damaged by $10,000.

- Investor C purchases 1,000 shares in Period 2 and holds them through the end of the class period, when inflation drops to $0. According to the model, Investor C was damaged by $5,000. However, Investor C was actually damaged by $10,000.

124. Although the level of inflation in this simple hypothetical is "correct" on average, damages are overstated by $10,000, $5,000, and ($5,000) for Investors A, B, and C, respectively. Moreover, if one assumes that these were the only class period purchases, damages for the class as a whole are overstated by 33% (estimated damages are $30,000 and actual damages are $20,000). Estimated individual and aggregate damages differ substantially from the actual amounts, notwithstanding the fact (in this hypothetical) that the level of inflation is correct on average. Reliably estimating damages requires a model that takes appropriate account of positive and negative firm-specific, nonfraud price movements on each day during the class period. Simply showing that these effects "cancel out" over the class period as a whole is not sufficient to reliably estimate damages.

Executed this 23rd day of October, 2015

Allen Ferrell

TAB 4

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, On Behalf of Itself and All Others Similarly Situated,	)	Case No. 02-C-5893
Plaintiff	)	
vs.	)	Honorable Jorge L. Alonso
HOUSEHOLD INTERNATIONAL, INC., et al.,	)	
Defendants.	)	

EXPERT REPORT OF PROFESSOR CHRISTOPHER M. JAMES

Table of Contents

I. Qualifications

1. I am the William H. Dial / SunTrust Eminent Scholar and Professor of Finance and Economics at the University of Florida and the Pembroke Visiting Scholar in International Finance at Cambridge University. Prior to joining the faculty of the University of Florida, I taught at the University of Oregon and the University of Michigan. I have been a visiting scholar at the Federal Reserve Bank of San Francisco on two occasions and have also held positions at the Federal Deposit Insurance Corporation ("FDIC") and the U.S. Department of the Treasury Office of the Comptroller of the Currency ("OCC"). My research while at the Federal Reserve Bank of San Francisco has included analysis on the effects of the financial crisis on the availability of bank credit and on the value of structured products. Additionally, I have served as the Securities and Exchange Commission ("SEC")-approved independent distribution consultant for the Janus Mutual Fund complex.

2. My academic research has been in the areas of securities pricing, corporate finance, mortgage markets, bank lending, private equity investments, and financial institutions. I have published numerous articles on issues related to corporate finance, bank lending, private equity, and the performance of mortgage-related securities. I have also published a number of articles on the effects of information disclosures on the common stock returns of financial institutions. My work in this area demonstrates that the stock price reaction of financial institutions to regulatory changes and macroeconomic factors is often heterogeneous, with the impact varying based on the business focus of the institution. See, for example, "An Analysis of Intra-Industry Differences in the Effect of Regulation: The Case of Deposit Rate Ceilings" *Journal of Monetary Economics* (1983), "The Effect of Interest Rate Changes on the Common Stock Returns of Financial

Institutions," *Journal of Finance* (1984), and "Heterogeneous Creditors and the Market Value of Bank LDC Loan Portfolios," *Journal of Monetary Economics* (1990).

3. I served on the Board of Directors and the Advisory Board to the SunTrust Bank of Florida (subsidiary of SunTrust Bank) between 1989 and 2006. As part of my Board duties, I served on the executive committee and the audit committee of the Bank. The executive committee approved all major investment activity (e.g., credit extensions, mortgages, and loan restructurings).

4. From 1990 to 2002, I also served on the academic board of the Turnaround Management Association. I currently serve on the board of directors of two private companies and as a senior advisor to Cornerstone Research.

5. I serve on the editorial boards of four scholarly journals, including the *Journal of Financial Economics*. I served as an associate editor of the *Journal of Finance* from 1988 through 2000, and as co-editor of the *Journal of Financial Intermediation* from 1988 through 1999. I have provided consulting services to a number of government agencies and corporate entities on issues concerning bank management, corporate finance, the valuation of corporate assets, and real estate-related issues. I have also provided expert witness testimony on issues concerning loss causation, financial institution performance, estimation of damages, and corporate restructurings. My curriculum vitae, which includes a list of publications I have authored, is included as Exhibit 1. A list of my deposition and trial testimony over the last four years is included as Exhibit 2.

6. In connection with my services, including the preparation of this report and any testimony I will render at trial, I am being compensated at my regular hourly rate of $950 per hour. I am also being reimbursed for reasonable expenses incurred in connection with such services. None

of my compensation is contingent upon the conclusions I reach or on the outcome of this matter. I have been assisted in this matter by staff of Cornerstone Research, who worked under my direction.

II. Background and Assignment

7. In the initial trial in this matter, Defendants were accused of inflating the stock price of Household International ("Household" or the "Company") throughout the period July 30, 1999, to October 11, 2012 ("Class Period"), making misrepresentations regarding predatory lending, re-aging delinquent loans, and revenue recognition.[1] Jurors ultimately found 17 actionable statements beginning on March 23, 2001, and determined the stock price inflation attributable to those actionable statements based on the "Leakage Model" of plaintiffs' expert, Professor Daniel Fischel ("Fischel"). This model effectively attributes the entirety of Household's residual price change (i.e., its price change after adjusting for market and broad industry effects, proxied by the S&P 500 Index and S&P Financials Index, respectively, as well as the risk-free rate) during the Observation Window to fraud-related information.[2]

8. Defendants appealed the verdict because, among other reasons, the Leakage Model did not account for firm-specific, nonfraud factors, and the Seventh Circuit agreed, granting a new trial.[3]

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[1] Decision by the U.S. Court of Appeals for the Seventh Circuit, May 21, 2015 ("Appellate Order"), pp. 11–12, 25.

[2] Appellate Order, p. 12. The Leakage Model measures inflation as the difference between actual price and Household's purported "true value" absent the misrepresentations. To estimate "true value," the model works backward from Household's actual stock price following the culmination of Fischel's "Observation Window," which spans November 15, 2001, to October 11, 2002. It estimates "true value" on earlier days during the Observation Window using the residual returns resulting from Fischel's regression model. See Report of Daniel R. Fischel, August 15, 2007 ("2007 Fischel Report"), ¶41-42.

[3] Specifically, the Seventh Circuit stated (Appellate Order, p. 24): "If the plaintiffs' expert testifies that no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explains in nonconclusory terms the basis for this opinion, then it's reasonable to expect the defendants to shoulder the burden of identifying some significant, firm-specific, nonfraud related information that could have affected the stock price. If they can't, then the leakage model can go to the jury; if they can, then the burden shifts back to the

On September 23, 2015, Fischel submitted a Second Supplemental Report in this matter (the "September 2015 Fischel Report"), in which he concludes, among other things, that "[n]o adjustment to the Quantification Including Leakage analysis of inflation [the Leakage Model] that I presented at trial due to significant, firm-specific, non-fraud related information is required."[4]

9. I have been asked by counsel for Defendants to address, based on my experience and expertise with respect to financial institutions and the financial industry, the types of factors important to the market's evaluation of institutions like Household. In particular, I have been asked to address the factors that were especially important with respect to Household as a consumer finance institution serving primarily nonconforming and subprime customers and that may have disproportionately affected Household relative to indices such as the S&P 500 Index or the S&P Financials Index during Fischel's Observation Window.

10. A complete list of the documents that I have relied upon in forming my opinions is attached as Exhibit 3. My work in this matter is ongoing. The opinions presented in this report are the result of the information available to me as of the report date. I reserve the right to supplement or modify my opinions if new information comes to light and to respond to any additional report(s) or opinions offered by other experts.

III. Summary of Opinions

11. Below is a summary of my opinions regarding non-fraud factors negatively affecting Household's stock price during the Observation Window. The bases for these opinions are detailed in the sections that follow.

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plaintiffs to account for that specific information or provide a loss-causation model that doesn't suffer from the same problem…."

[4] September 2015 Fischel Report, p. 1.

a) Household was a diversified consumer finance company serving largely nonconforming and subprime customers. Its managed receivables comprised primarily home equity loans (44%), unsecured loans (18%), auto loans (6%), and credit cards—both bank card (17%) and private label (14%). Consumer finance companies, particularly those like Household serving largely subprime customers, are generally considered riskier than many other financial institutions like commercial banks.

b) The S&P Financials Index, which Fischel uses to control for the effect of macroeconomic and regulatory changes on Household's industry, is a broad index that is heavily weighted towards companies with businesses that differ substantially from Household's—banks, insurers, investment services companies, and asset managers.

c) Given the economic downturn and regulatory changes affecting financial institutions with subprime customers that occurred during the Observation Window, I would expect companies like Household, with a subprime customer base, to be disproportionately negatively affected.

d) During the Observation Window, financial markets realized that the United States was in a recession. Recovery was slow, and fears of a double-dip recession persisted throughout the period. Given their economic vulnerability, subprime customers, who comprised Household's primary customer base, were disproportionately affected.

e) Changes in the regulatory landscape, in particular higher capital requirements and changing rules regarding "predatory lending," also disproportionately affected financial institutions with a subprime customer base during the Observation Window.

IV. Household Was a Diversified Consumer Finance Company Focused on Subprime Customers

12. Household was a diversified consumer finance company, with businesses centered on "mortgages, home-equity loans, auto financing, and credit-card loans."[5] Household had market leading positions in each of these segments.[6] Its managed receivable portfolio as of December 31,

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[5] Appellate Order, p. 3.

[6] "Household International, Inc. (HI), is one of the nation's leading branch-based consumer finance companies, with managed assets of $100 billion, more than 45 million customers, and 1,400 branches. The company serves primarily the nonprime (or working-class) consumer market and is a leading provider of home equity loans (43% of its total

2001, near the beginning of the Observation Window, comprised the following segments: home equity loans (44% of the portfolio), credit cards (31%)—both bank card (17%) and private label (14%), other unsecured loans (18%), and auto loans (6%).[7] Although a relatively small fraction of Household's portfolio, its auto loans segment had been particularly important for recent growth.[8]

13. Household served "primarily the nonprime (or working-class) consumer market."[9] Indeed, Fischel notes that Household was focused on subprime customers:

> Across these segments, Household generally served nonconforming and nonprime ("subprime") customers,[10] *i.e.*, those who have limited credit histories, modest income, high debt-to-income ratios, high loan-to-value ratios (for real estate secured portfolios) or have experienced credit problems caused by occasional delinquencies, prior chargeoffs, or credit-related actions.[11]

14. A Federal Reserve publication discusses subprime consumer lending, and associated risks:

> The term "subprime" as it relates to lending is broadly defined as extending loans to borrowers with tarnished or imperfect credit histories. This type of consumer

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managed receivables) as well as complementary products that round out its offering and support successful cross-sell, including unsecured loans (19% of the portfolio), auto loans (5%), and credit cards – both bank card (19%) and private label (13%). Household has built industry-leading franchises in several large markets. While home equity is its largest business line with #2 market share (behind CitiGroup), Household also holds the #2 position in private label (behind GECC), #3 in indirect auto finance, and #10 in general purpose credit cards. International operations, largely in the U.K., represent about 15% of owned receivables. The company has grown internally and through acquisitions, the latter serving to expand product lines (ACC Finance in auto finance and Renaissance Holdings in subprime credit cards) and add scale (Beneficial acquisition)" (Legg Mason, December 11, 2001).

[7] Household International, Inc. Form 10-K for the year ended December 31, 2001, filed on March 13, 2002 ("2001 10-K"), Exhibit 13, p. 2.

[8] For example, one analyst noted in late 2001 that "[w]hile Household's sub-prime auto finance business remains small relative to the overall size of the managed portfolio…it has once again become a significant driver of growth in recent quarters" (Ventana Capital, November 30, 2001).

[9] Legg Mason, December 11, 2001.

[10] "Subprime lending provides a credit source to borrowers that may not otherwise be available due to concerns with borrowers' credit history or repayment capacity" ("The Division of Supervision and Consumer Protection's Examination Assessment of Subprime Lending," FDIC Office of Inspector General, Audit Report No. 03-019, March 18, 2003 ("2003 OIG Report")), p. 1. Like Fischel, I use the term "subprime" throughout this report to refer to such borrowers.

[11] 2007 Fischel Report, ¶5.

> lending encompasses auto, home equity, mortgage, and credit card loans. Characteristics of a subprime borrower may include a history of paying debts late, bankruptcy filings, or an insufficient credit record.
>
> …Inherent operational risks associated with subprime lending include more frequent and earlier delinquencies and defaults, potential strains on underwriting and collection resources, and difficulties in estimating recovery values on repossessed collateral.[12]

15. Companies like Household that serve primarily subprime customers are considered riskier than many other financial institutions like traditional commercial banks.[13] For example, one introductory financial institutions management textbook highlights key differences between finance companies and other lenders:

> The primary function of finance companies is to make loans to both individuals and corporations. The services provided by finance companies include consumer lending, business lending, and mortgage financing. Some of their loans are similar to commercial bank loans, such as consumer and auto loans, but others are more specialized. Finance companies differ from banks in that they do not accept deposits but instead rely on short-and long-term debt as the source of funds.[14]

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[12] Randolph D. Brown, "Dispelling Misconceptions about Consumer Subprime Lending," Federal Reserve Bank of Philadelphia *SRC Insights* 3, no. 2 (1998) ("FRB Philadelphia 1998"), pp. 4–5.

[13] "Historically, banking organizations did not venture into this segment of the credit quality spectrum…" (FRB Philadelphia 1998, p. 4). The FDIC estimated that, during the Observation Window, relatively few banks held significant subprime assets. Specifically, it estimated that "as of June 30, 2002, 128 FDIC-insured institutions (1.35 percent of all insured institutions) had significant holdings of subprime assets" (2003 OIG Report, p. 3).

[14] Household did, through its banking subsidiary, have access to some deposits. However, the magnitude of those deposits was small relative to the remainder of its funding base, and decreased dramatically during the Observation Window due in part to new capitalization rules. In 2000, 2001, and 2002, deposits comprised approximately 11% ($8,676.9 million divided by $76,309.2 million), 7% ($6,562.3 million divided by $88,910.9 million), and less than 1% ($821.2 million divided by $97,860.6 million) of Household's total liabilities and shareholders' equity at year end. Household International, Inc. Form 10-K for the year ended December 31, 2002, filed on March 25, 2003, pp. 18, 112.

As noted below, beginning on January 1, 2002, new capitalization rules went into effect. Household stated in its 2001 10-K (p. 7):

> We have funded our operations globally and domestically, using a combination of capital market debt and equity, deposits and securitizations. Although we have in the past utilized our banking subsidiaries as a means to provide deposit funding to support some of our operations, due to recent regulatory requirements for additional capital to support nonprime and subprime lending activities, we do not believe that such sources will be actively utilized in the near term. We do not anticipate that the reduction in the use of our banking subsidiaries as a funding vehicle for our businesses will have any material effect on our operations or our ability to timely fund our operations, or will materially increase the costs associated with our funding. We will continue to fund our operations in the global capital markets, primarily through the use of securitizations, commercial paper, bank lines, medium-term notes and long-term debt.

> Additionally finance companies often lend to customers commercial banks find too risky. This difference can lead to losses and even failure if the high risk does not pay off….
>
> Personal credit institutions (e.g., HSBC Finance and AIG American General) specialize in making installment and other loans to consumers. Personal credit institutions will make loans to customers that depository institutions find too risky to lend to (due to low income or a bad credit history). These institutions compensate for the additional risk by charging higher interest rates than depository institutions and/or accepting collateral (e.g., used cars) that depository institutions do not find acceptable….
>
> The higher rates finance companies charge for consumer loans are mostly due to the fact that finance companies attract riskier customers than commercial banks. Customers who seek individual (or business) loans from finance companies are often those judged too risky to obtain loans from commercial banks or thrifts. It is, in fact, possible for individuals to get a loan from a subprime lender finance company (a finance company that lends to high-risk customers) even with a bankruptcy on their records.[15]

16. Companies such as Household also face different financing risks than do other lenders such as banks and savings and loans, which rely primarily on customer deposits for funding. For example, the same financial institutions management textbook states:

> To finance asset growth, finance companies have relied primarily on short-term commercial paper and other debt (longer-term notes and bonds). Thus, management of liquidity risk is quite different from that in commercial banks that mostly rely on deposits….[16]

17. Another notes that:

> Finance companies typically fund themselves by selling commercial paper.

[15] Anthony Saunders and Marcia Millon Cornett, *Financial Institutions Management: A Risk Management Approach*, 7th ed. (New York: McGraw-Hill, 2011) ("Saunders and Cornett"), pp. 164, 167, 170–171 (internal citations omitted).
[16] Saunders and Cornett, p. 173.

> The commercial paper market is notoriously fragile. Macroeconomic shocks have been known to paralyze commercial paper issuance. In addition, the fortunes of a particular borrower may preclude use of the commercial paper market.[17]

18. The profits of companies like Household are driven by the magnitude of credit losses (higher losses decrease profit); the spread between the interest the company earns and its cost of funds (a lower spread decreases profit);[18] and fees and other income (e.g., late payment fees, prepayment penalties) that it earns from customers.[19]

19. Profits and losses associated with subprime credits are riskier, or more volatile, than those associated with prime credits. For example, in 2001 the federal bank regulatory agencies issued expanded guidance for subprime lenders, noting that "responsible subprime lending can expand credit access for consumers and offer attractive returns. However, we expect institutions to recognize that the elevated levels of credit and other risks arising from these activities require more intensive risk management and, often, additional capital."[20] The guidelines go on to note that, "[b]ecause of the elevated risk levels, the quality of subprime loan pools may be prone to rapid deterioration, especially in the early stages of an economic downturn."[21]

20. As discussed in more detail in the sections that follow, during the Observation Window, companies such as Household with a subprime customer focus were adversely affected by realization of these risks. The macroeconomic downturn had a negative effect on subprime asset

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[17] Stuart Greenbaum and Anjan Thakor, *Contemporary Financial Intermediation* (Fort Worth, TX: The Dryden Press, 1995), p. 71.

[18] "Finance companies, like depository institutions, are financial intermediaries that borrow funds for relending, making a profit on the difference between the interest rate on borrowed funds and the rate charges on loans" (Saunders and Cornett, p. 176). See also Household's 2001 10-K, which states (p. 7): "As a financial services organization, we must have access to funds at competitive rates, terms and conditions to be successful."

[19] Deutsche Bank, May 25, 2001, p. 22; Morgan Stanley, July 31, 2002, pp. 8-9.

[20] "Expanded Guidance for Subprime Lending Programs," FDIC Press Release, January 31, 2001, https://www.fdic.gov/news/news/press/2001/pr0901a.html ("FDIC Expanded Guidance").

[21] FDIC Expanded Guidance.

quality, which adversely affected credit losses and cost of funds. Moreover, regulatory concern increased as well, leading to increased scrutiny of and tighter regulation for subprime lenders.

V. Given Its Business and Portfolio Mix, Household's Underperformance of the S&P 500 and S&P Financials Indices Is Not Surprising

21. In his regression analysis, Fischel attempts to control for the effect of macroeconomic and regulatory changes on Household's industry using the S&P Financials Index. Analysis of that index reveals it to be quite broad, including a handful of companies similar to Household as well as many others with different characteristics. As shown in Exhibit 4, during Fischel's "Control Period" (November 15, 2000, to November 14, 2001) and Observation Window (November 15, 2001, to October 11, 2002), the S&P Financials Index included approximately 70 to 80 companies—81 at the end of the Observation Window.[22] The index is heavily weighted towards banks, with 30 of the 81 companies in the index on October 11, 2002 (37%) falling into that subsector classification. Other heavily weighted subsectors include property and casualty insurance (12 of 81 companies as of October 11, 2002), life insurance (9 companies as of October 11, 2002), investment services (6 companies as of October 11, 2002), and asset managers (6 companies as of October 11, 2002).[23]

22. As Fischel points out, during the Observation Window, Household suffered declines in excess of those suffered by the S&P 500 Index and the S&P Financials Index.[24] Based on my experience with and research regarding financial institutions, I do not find Household's underperformance during the Observation Window surprising. My own published research is part

[22] This is consistent with Fischel's count (August 2007 Fischel Report, FN 10).
[23] See Exhibit 4.
[24] August 2007 Fischel Report, ¶29.

of a wide body of academic literature that demonstrates clearly that the stock price reaction of financial institutions to macroeconomic factors and regulatory changes is often heterogeneous, with the impact varying based on the business mix and portfolio composition of the institution. For example, my own research includes the following findings:

- "An Analysis of Intra-Industry Differences in the Effect of Regulation" notes that "certain firms in the regulated industry may earn subsidies while others are taxed by regulation" and "[e]mpirical studies which examine the average impact of regulation on firms in an industry may therefore mask important differences among firms." In the paper, I study the impact of deposit rate regulation on the market value of commercial banks by examining the effect of deposit rate ceilings changes on the common stock price performance of actively traded commercial banks. I find differential responses, even among commercial banks, to regulatory changes depending on their customer base (retail versus wholesale).[25]

- "The Effect of Interest Rate Changes on the Common Stock Returns of Financial Institutions" examines the relationship between "the interest rate sensitivity of common stock returns and the maturity composition of nominal contracts…for a set of actively traded commercial banks and stock savings and loan associations (S&Ls)." The paper finds evidence that "the effect of nominal interest rate changes on common stock prices is related to the maturity composition of a firm's net nominal asset holding" and that "for commercial bank and S&L stocks, changes in interest rates [are] significantly related to stock price movements." The paper also finds a differential response among commercial banks and S&Ls related to their portfolio composition—specifically, "the maturity mismatch of the bank assets and liabilities."[26]

- "Heterogeneous Creditors and the Market Value of Bank LDC Loan Portfolios" studies the relationship between bank stock returns and the return on bank lesser developed countries ("LDC") loan portfolios. I find "significant cross-sectional

[25] Specifically, I find (1) for the sample of commercial banks as a whole, "statistically significant increases in value were experienced at the announcement of the removal of ceilings on certificates of deposits of over $100,000" whereas "no statistically significant change in value was observed at the announcement of the removal of ceilings on consumer certificate accounts and the introduction of Money Market Certificates"; (2) for the subset of the entire sample comprising retail-oriented commercial banks, "statistically significant declines in value were experienced on the announcement of ceiling changes on consumer accounts"; and (3) "for all events analyzed significant differences in the response of wholesale and retail banks to ceiling changes were found." In sum, "[t]he evidence suggests that significant intra-industry wealth transfers have resulted from ceilings" (Christopher James, "An Analysis of Intra-Industry Differences in the Effect of Regulation: The Case of Deposit Rate Ceilings" *Journal of Monetary Economics* 12 (1983): 417–432, at 418).

[26] Christopher James and Mark J. Flannery, "The Effect of Interest Rate Changes on the Common Stock Returns of Financial Institutions," *Journal of Finance* 39, no. 4 (1984): 1141–1153, at 1141, 1152.

> differences in the sensitivity of bank stocks to changes in the price of LDC loans," with "[d]ifferences in sensitivity…related to changes in bank exposure to LDCs."[27]

23. Given the difference in business and portfolio mix between Household and many of the companies in the S&P 500 and S&P Financials Indices, I would expect Household's stock price to be affected more negatively than those indices by the macroeconomic downturn and regulatory changes affecting the subprime sector that occurred during the Observation Window (which I describe in more detail in Section VI that follows).

VI. Macroeconomic Changes Adversely Affected Companies like Household during the Observation Window

24. Below I first discuss generally changes in the macroeconomic environment during the Observation Window and their disproportionate effect on subprime consumers (Section A). I would expect such changes in the regulatory landscape to have a greater impact on Household's value than on the value of the broad peer set used by Fischel in his analysis, given the nature of the changes and Household's business focus. Consistent with my expectation, I find negative trends in customer credit quality and cost of funds at Household, as well as contemporaneous analyst comments discussing the negative implications of those trends on their assessments of Household's prospects (Section B).

A. As Would Be Expected, the Economic Downturn Beginning in 2001 Was Particularly Hard on Subprime Borrowers

25. While it was ultimately determined with hindsight that the recession began earlier, based on real-time data available, financial markets were just beginning to understand at the start of the

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[27] Christopher James, "Heterogeneous Creditors and the Market Value of Bank LDC Loan Portfolios," *Journal of Monetary Economics* 25 (1990): 325–346, at 325.

Observation Window that the U.S. economy was in recession.[28] Economists explained that, while retail sales and the housing market remained stable throughout most of 2001, "[c]onsumers' steadfastness did waver in the fourth quarter, as rising unemployment coupled with the psychological and economic effects of the tragic events of September 11 depressed consumer confidence."[29]

26. Ongoing concerns about the economy weighed on investors' minds throughout the Observation Window.[30,31] In particular, toward the end of the Observation Window, economists expressed concerns regarding the possibility of a double-dip recession. For example, Morgan Stanley's chief U.S. economist noted that, by August 2002, "economic growth [had] weakened to the point where a shock could send [the economy] into a double dip."[32] An economist at Northern Trust went so far as to say that "economists who still believe the economy will continue to recover have got it wrong" and that those economists "will change their views once a renewed recession is clear to just about everyone else."[33]

27. Regulators too commented on the economy and, in particular, on its effects on subprime lenders. For example, a 2003 Office of Inspector General audit report regarding subprime lending found:

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[28] Kevin L. Kliesen, "The 2001 Recession: How Was It Different and What Developments May Have Caused It?," Federal Reserve Bank of St. Louis *Review* 85, no. 1 (2003): 23–38 at 27.

[29] David S. Langdon, Terence M. McMenamin, and Thomas J. Krolik, "U.S. Labor Market in 2011: Economy Enters a Recession," *Monthly Labor Review* (2002), p. 3.

[30] A.G. Edwards, January 2, 2002.

[31] Ta-Win Lin and Jim Schimidt, "Economic Conditions during the 2001 Recession (Part I*)," *Washington Economic Trends*, Research Brief No. 15, July 2002.

[32] "Watch Out for the Double-Dip: The Economy Has Hit an Air Pocket and Some Fear the Worst," *CNNMoney*, August 2, 2002.

[33] "Watch Out for the Double-Dip: The Economy Has Hit an Air Pocket and Some Fear the Worst," *CNNMoney*, August 2, 2002.

> According to the DIR September 2002 Briefing Notes on Subprime Lending, the financial condition of the nation's 128 insured subprime lenders deteriorated through mid-year 2002 as losses escalated….
>
> …DIR reported that performance measures have deteriorated among insured institutions that have subprime consumer loans…. As of September 30, 2002, the nation's 20 subprime credit card lenders reported especially high consumer loan delinquencies and charge-offs.[34]

28. The expectation of regulators that economic downturns would be particularly difficult for subprime lenders is consistent with the performance of and contemporaneous commentary regarding that sector during the Observation Window.[35,36] Indeed, financial institutions such as Household, whose customers were comprised primarily of subprime borrowers, were more negatively affected than others.

29. Not surprisingly, as discussed in more detail in the section that follows, stresses on subprime borrowers were noted by analysts following Household. One stated, for example, that "the non-prime customers" targeted by Household were "generally more economically sensitive

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[34] 2003 OIG Report, pp. 4–5.

[35] The 2002 Monetary Policy Report to the Congress by the Federal Reserve points out the disparity between prime and subprime loan performance. Although it noted that, for the market as a whole, "[m]easures of household credit quality deteriorated noticeably last year," it also noted that subprime borrowers were particularly hard hit. Specifically, "[t]he economic slowdown and the rise in unemployment significantly eroded the quality of loans to subprime borrowers, and delinquency rates for both mortgages and consumer credit in that segment of the market moved sharply higher." Indeed, Exhibit 15 taken from that report highlights the differential performance of subprime loans ("Monetary Policy Report to the Congress," Board of Governors of the Federal Reserve System, February 27, 2002, p. 9).

[36] In its February 2003 Monetary Policy Report to the Congress, the Federal Reserve again highlighted the differential performance of subprime loans, stating that "broad measures of household credit quality deteriorated very little last year" and that "signs of financial stress were confined mainly to the subprime segment of the market" ("Monetary Policy Report to the Congress," Board of Governors of the Federal Reserve System, February 11, 2003, p. 8). Indeed, the Mortgage Bankers Association of America reported that "subprime loans in the third quarter of 2002 had a delinquency rate 5½ times higher than that for prime loans (14.28 versus 2.54 percent)…" (Souphala Chomsisengphet and Anthony Pennington-Cross, "The Evolution of the Subprime Mortgage Market," Federal Bank of St. Louis *Review* 88, no. 1 (2006): 31–56 at 32).

and less interest rate driven."[37] Thus, "rising unemployment levels had a significant impact on the portfolio's credit performance."[38] Similarly, another analyst stated:

> Given the uncertainty of the current macro-economic picture, the risks that Household faces include: rising credit costs given its largely non-prime customer base in a slowing economy, slowing loan growth due to more cautious consumers and increasing prepayments, competitive end markets, and a slowing pace of help from interest rate reductions.[39]

B. Negative Macroeconomic Developments during the Observation Window Adversely Impacted the Market's Assessment of Household's Prospects

30. As discussed in Section IV above, profitability for a finance company like Household is driven by factors such as credit losses and the spread between interest earned from customers and an institution's cost of funds. Changing macroeconomic conditions affected both credit quality and spread, and were the subject of concern in market participants' assessments of Household's prospects during the Observation Window. Concerns regarded not only financial results disclosed during the Observation Window (e.g., a realized increase in delinquencies), but also the potential implications of Observation Window conditions for Household's future financial results (e.g., the potential for rising delinquencies in the future).

1. Deteriorating Credit Quality

31. Not surprisingly given Household's consumer finance focus, Household's delinquencies and charge-offs increased throughout the Observation Window, as shown in Exhibits 5–6. Analysis of contemporaneous market commentary indicates that deteriorating consumer credit quality was of primary concern throughout the Observation Window. For example, a January

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[37] CIBC World Markets, June 20, 2002.
[38] CIBC World Markets, June 20, 2002.
[39] Salomon Smith Barney, July 18, 2002.

2002 A.G. Edwards report stated that "[c]onsumer credit quality is an issue of increasing significance in our sector. As the economy deteriorated in 2001, credit quality concerns heightened."[40] A William Blair analyst noted in April 2002 that "[c]redit quality…deteriorated during the most recent fourth quarter…."[41] An early October 2002 CIBC report stated that "[c]redit losses should continue to rise, particularly within the bankcard portfolio, as the managed portfolio seasons and the economy remains weak. Heightened concern also exists regarding the auto finance portfolio…."[42]

32. Financial industry experts understand that, among other things, delinquencies and defaults are influenced by borrowers' inability to repay. Inability to repay may result from many factors, including a change in a borrower's economic circumstances, such as job loss. For example, Foote et al. (2009) notes that a "1-percentage-point increase in the unemployment rate raises this probability [the probability of a 90-day delinquency] by 10-20 percent…."[43]

33. Given the importance of assessing ability to repay, it is not surprising that market analysts look to data such as unemployment and consumer bankruptcies to estimate future credit losses. Indeed, my review of analyst reports reveals that market participants were looking to such factors, as well as credit-related announcements by peers, to assess Household's prospects during the Observation Window. For example, an October 2001 Legg Mason report stated that "[i]t finally appears that the weakening economic environment (with rising layoffs and consumer bankruptcies) is beginning to show up in HI's asset quality stats.…"[44] A January 2002 A.G.

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[40] A.G. Edwards, January 2, 2002.
[41] William Blair, April 17, 2002.
[42] CIBC World Markets, October 3, 2002.
[43] Christopher L. Foote et al., "Reducing Foreclosures," Federal Reserve Bank of Boston, Public Policy Discussion Papers, No. 09-2, April 8, 2009, p. 1.
[44] Legg Mason, October 18, 2001.

Edwards report stated that it "believe[s] one of the more important indicators of consumer credit quality is the rate of bankruptcy filings."[45] Indeed, it "monitor[ed] weekly personal bankruptcy filings collected by the Administration Office of the U.S. Courts."[46]

34. As shown in Exhibit 7, throughout the Observation Window, unemployment remained high relative to its pre-recession level at the beginning of 2001. Exhibit 8 shows that bankruptcy filings increased throughout the Observation Window, ending at approximately the peak level seen during the recession.

35. Household's auto lending segment, which had been a source of recent growth, was particularly hard hit during the Observation Window. As shown in Exhibit 9, credit losses for that segment increased meaningfully during the period. Not surprisingly, analyst concern regarding the auto segment was apparent throughout the Observation Window. For example, in January 2002, A.G. Edwards noted that "[i]n auto finance, delinquency and loss rates were higher than we had modeled due to seasonal issues and the impact from the recession."[47] Following the announcement of Household's second quarter 2002 results, a Bank of America analyst noted that "Household's credit losses increased in the quarter, with home equity, auto and other unsecured loans increasing meaningfully."[48] Toward the end of the Observation Window, a CIBC analyst remarked that "[h]eightened concern also exists regarding the auto finance portfolio…."[49]

36. Notably, the market looked to information regarding auto finance peers, in particular AmeriCredit, to assess Household's prospects. For example, an analyst noted that "Household's

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[45] A.G. Edwards, January 2, 2002.
[46] A.G. Edwards, January 2, 2002.
[47] A.G. Edwards, January 16, 2002.
[48] Bank of America, July 17, 2002.
[49] CIBC World Markets, October 3, 2002.

stock price was down 1.3% yesterday [February 12, 2002], as collateral damage from the sharp sell-off of 6.5% in AmeriCredit."[50] In September of 2002, A.G. Edwards stated:

> [W]ith the announcement of additional negative press regarding…credit related problems with the securitization portfolio at AmeriCredit (ACF) we believe that the uncertainty in the near term environment does not favor investors making additional investments in HI at this time….
>
> Consumer Credit Securitization Model – ACF released information yesterday that its sub-prime auto finance securitization pools are performing worse than expectations….[51]

37. In addition to factors affecting customers' ability to pay (discussed above), credit losses are also affected by collateral value. Given this, it is not surprising that financial economists look to data regarding collateral value to estimate future credit losses. Indeed, my review of analyst reports during the Observation Window indicates that market participants looked to indicators such as the Manheim Used Vehicle Value Index.[52] As shown in Exhibit 10, used car prices declined precipitously at the end of the Observation Window.

2. Increased Cost of Funds

38. As noted above, financial institutions like Household make money in large part by "borrow[ing] funds for relending, making a profit on the difference between the interest rate on borrowed funds and the rate charges on loans."[53] Given this, it is not surprising that Household's value was negatively impacted during the Observation Window by factors that increased its cost of funds. For example, Fitch's downgrade of Household's debt rating in early 2002, due in part to

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[50] Bernstein Research, February 13, 2002.

[51] A.G. Edwards, September 18, 2002.

[52] Bernstein Research, January 17, 2001; Fox-Pitt Kelton, January 17, 2002; Bernstein Research, January 25, 2002; Bernstein Research, February 1, 2002; Ventana Capital, February 8, 2002; Salomon Smith Barney, April 9, 2002; Bernstein Research, April 15, 2002; JP Morgan, October 4, 2002.

[53] Saunders and Cornett, p. 173.

a more pessimistic view of the consumer finance sector and concerns regarding its near/subprime lending portfolio,[54] had negative implications for Household's cost of funds.[55]

39. Indeed, Household was plagued by concerns regarding liquidity and cost of funds throughout the remainder of the Observation Window as well. For example, in early February 2002, market participants expressed concerns regarding the Company's access to the commercial paper market and liquidity issues, noting stock price declines and widening bond spreads. For example, analyst comments include:

- "The recent decline appears to reflect a severe bout of accounting and liquidity panic. …
  Unfortunately, fixed income investors have been panicking a bit about the company's longer term debt, as spreads on the company's 5.75% coupon bonds maturing in 2007 have widened from 200 basis points over 5 year Treasuries on February 4 (before S&P's downgrade of CIT) to 270 basis points over 5 year Treasuries on February 6."[56]
- "In Household's case, the most recent unsubstantiated claim revolved around commercial paper and liquidity issues."[57]

40. In April 2002, analysts noted the volatile funding environment and discussed implications of longer debt maturities and decreased reliance on commercial paper on Household's net interest margin. Selected analyst comments include:

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[54] "And Friday, word came out that Fitch had changed the outlook on its HI rating to Negative from Stable, as part, it seems, of its Negative outlook for the broader consumer finance business.… Fitch Revises its Outlook on HI to Negative — In a review of the US consumer finance industry, Fitch revised its industry outlook to Negative from Stable. Although the challenging economic environment is part of the reason, the agency seems to be focusing on what it perceives to be the industry's 'aggressive balance sheet management.' Specific to HI, the agency cited the company's 'growth of [its] real estate secured near-prime/subprime loans and the impact on balance sheet flexibility in times of stress.' Fitch is concerned that HI has 'securitized relatively less' of these portfolios, and it 'has not engaged in whole loan sales.' The implication here is that these assets would be only of limited value in terms of providing financial flexibility in times of stress" (Credit Suisse First Boston, January 15, 2002, paragraph breaks removed).

[55] I note that Fischel found this downgrade to be firm-specific in the September 2015 Fischel Report (¶6).

[56] Bear Stearns, February 7, 2002.

[57] Deutsche Bank, February 7, 2002.

- "The company also took steps to enhance its liquidity position in the wake of the first quarter's volatile funding environment."[58]

- "There was some net interest margin compression as the company lengthened its debt maturities to reduce its commercial paper issuance. The company appears to have ample liquidity and is well positioned to weather a change in interest rates should one occur."[59]

41. Concerns regarding the cost of debt persisted throughout the remainder of the Observation Window.[60,61]

42. As shown in Exhibits 11–13, materials prepared for Household's Finance Committee in November 2002[62] document the Company's decreased reliance on commercial paper during 2002, as well as increasing five- and ten-year spreads.

VII. Regulatory and Legislative Changes Adversely Affecting Household Were Also Implemented and Discussed during the Observation Window

43. Below I first discuss generally certain regulatory changes such as increased capital requirements for and scrutiny of subprime lenders' portfolios and changes in "predatory lending" rules that had implications for Household and its close peers (Section A). I would expect such changes in the regulatory landscape to have a greater impact on Household's value than on the value of the broad peer set used by Fischel in his analysis, given the nature of the changes and Household's business focus. Consistent with my expectation, I find contemporaneous comments from analysts raising concerns about the implications of the changing regulatory landscape for Household specifically (Section B).

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58 Credit Suisse First Boston, April 17, 2002.
59 Bear Stearns, April 18, 2002.
60 Goldman Sachs, August 14, 2002.
61 Deutsche Bank, October 9, 2002.
62 HHS 03181288–356

A. The Regulatory and Legislative Changes Pertained to Stricter Requirements for Subprime Lenders

44. During the Observation Window, the regulatory environment was changing in ways relevant to Household and its close peers. New regulations and regulatory discussions covered areas such as increased capital requirements for and scrutiny of subprime lenders' portfolios, as well as changes in "predatory lending" rules, which as described more fully in Section B below, were not corrective of the fraud since they did not reveal information regarding past infractions but rather had to do with actual and prospective changes during the Observation Window.

45. Increased capital requirements for subprime lenders like Household entered the regulatory environment in late 2001. At that time, regulators issued examiner guidance that "tightened standards for subprime portfolios and for asset securitizations."[63] Specifically, on November 29, 2001, the Federal Financial Institutions Examination Council ("FFIEC")—which comprises representatives of the FDIC, the OCC, the Federal Reserve Board ("FRB"), and the Office of Thrift Supervision ("OTS")— "announced the publication of a final rule that change[d] their regulatory capital standards to address the treatment of recourse obligations, residual interests, and direct credit substitutes that expose banks, bank holding companies, and thrifts (collectively, banking organizations) to credit risk."[64] Subprime lenders were "likely to be more significantly affected by [the rule]," which became effective on January 1, 2002.[65]

[63] W.A. Lee, "Are None Immune in Card Crackdown?," *American Banker,* July 18, 2002.
[64] "Agencies Adopt Recourse, Direct Credit Substitutes and Residual Interests Final Rule," Board of Governors of the Federal Reserve System and FDIC Joint Press Release, November 29, 2001, p. 1, http://www federalreserve.gov/boarddocs/press/boardacts/2001/20011129/default htm
[65] Linda Punch, "Shape Up, Issuers!," *Credit Card Management*, April 2002, p. 46.

46. A few months later, in early 2002, federal regulators "formed two task forces to determine how susceptible subprime credit card banks [were] to an economic downturn."[66] Those task forces were expected to come out with rule changes during 2002, which David Gibbons, the OCC's deputy comptroller for credit risk, stated were intended "to make sure that the institutions out there are (operating) in a safe and sound way."[67]

47. Indications of a tougher regulatory stance were reinforced by Capital One's announcement in July 2002 that it would increase its loan-loss reserves to meet regulators' demands. *American Banker* noted that regulators showed a "determination to crack down on card issuers" at the time.[68] In the following days, the FFIEC issued a draft of additional examiner guidance on "Credit Card Lending," laying out stricter account management standards which they intended to issue on August 16, 2002.[69] It described the agencies' expectations for prudent risk management practices for credit card activities, particularly with regard to credit line management, over-limit accounts, and workouts. The draft guidance also addressed income recognition and loss allowance practices for credit card lending. Among other things, the guidance discussed calling for card banks to carry higher reserves by requiring that they reserve against uncollectible fee and finance charge income.[70] The guidance also singled out subprime credit card lenders in particular: "[r]egulatory scrutiny and risk management expectations… will be greater for higher risk portfolios and portfolio segments, including those that are subprime."[71] Consistent with this, the

[66] Linda Punch, "Shape Up, Issuers!," *Credit Card Management*, April 2002, p. 46.
[67] Linda Punch, "Shape Up, Issuers!," *Credit Card Management*, April 2002, p. 48.
[68] W.A. Lee, "Are None Immune in Card Crackdown?," *American Banker*, July 18, 2002.
[69] "Federal Financial Institution Regulators Draft Guidance on Credit Card Lending," Board of Governors of the Federal Reserve System Joint Press Release, July 22, 2002, p. 1, http://www federalreserve.gov/boarddocs/press/bcreg/2002/20020722/default.htm
[70] "Subprime Loans Will Be Covered," *The Wall Street* Journal, July 23, 2002.
[71] "Credit Card Lending," *Federal Financial Institutions Examination Council*, July 22, 2002, p. 1.

guidance outlined specific recommendations for subprime credit card lenders' over-limit practices:

> While prudent over-limit practices are important for all institutions, they are especially important for subprime lenders, where liberal over-limit tolerances, inadequate repayment requirements, and deficient reporting and loss allowance methodologies can magnify the high credit risk exposure of those institutions.[72]

48. Thus, the regulatory environment for card issuers, particularly those with subprime customers, was shifting and issuers were facing potential increased scrutiny and oversight in 2001 and 2002.

49. Other regulatory developments affecting subprime lenders during the Observation Window included changes to subprime lending practices resulting from what was perceived to constitute "predatory lending" practices. A March 2002 research paper prepared for the U.S. Department of Housing and Urban Development's Office of Policy Development and Research stated:

> As the subprime market continues to develop, it is attracting more scrutiny from consumer groups and government regulators. These organizations are concerned that some lenders in the subprime market take advantage of borrowers by engaging in questionable marketing techniques and borderline or outright fraudulent business practices. Companies that employ these techniques have been accused of practicing *predatory lending*. While there is no common definition of predatory lending, government agencies and consumer groups are working to develop an applicable definition.[73]

50. Consumer groups and politicians became increasingly interested in the subject of predatory lending around this same time. One of the panelists in a *Wall Street Week* discussion in

[72] "Credit Card Lending," *Federal Financial Institutions Examination Council*, July 22, 2002, p. 2.

[73] Kenneth Temkin, Jennifer E. H. Johnson, and Diane Levy, "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," U.S. Department of Housing and Urban Development, March 2002, p. 12 (emphasis in original).

May 2002 noted that "[y]ou have consumer groups and local politicians out in the states who have begun to try to almost redefine all sub-prime loans as predatory loans, and the industry really needs a bill to define that in a way that won't throw the baby out with the bath water and to get a federal preemption in law."[74] Indeed, a number of states and cities passed anti-predatory lending laws in 2001 and 2002. For example, in February 2002, Washington, D.C., approved a new anti-predatory lending law.[75] New York State followed shortly thereafter with debate on an anti-predatory lending law that "industry experts believed had the potential to drive subprime lending out of the state."[76] As shown in Exhibit 14, an analyst following Household summarized a number of state and local laws addressing predatory lending practices.

51. At the federal level, legislators were also debating new predatory lending laws. For example, the Predatory Lending Consumer Protection Act of 2002 was introduced to the Senate Banking Committee in early May 2002.[77] One analyst noted that "[a]s states like North Carolina, California and Georgia pass progressively more restrictive state laws, lenders face an increasing need for the protection of uniform standards in preemptive federal legislation."[78] There was hope that a federal law would generate nationwide consistency.

52. Analysts commented on the changing state and federal subprime regulation proposals and laws, remarking that, "[w]hile negotiations around federal legislation continue, we expect additional restrictive state laws to be enacted. These will tend to reduce profitability in subprime

[74] "Panelist Discussion - Michael Farr, Charles Gabriel, Greg Valliere," *Wall Street Week*, May 10, 2002.
[75] "DC Council Approves New Predatory Law," *National Mortgage News*, February 25, 2002.
[76] "NY Bill to Drive Subprime Out of State?," *Origination News*, June 28, 2002.
[77] Credit Suisse First Boston, May 3, 2002.
[78] Bernstein Research, May 10, 2002.

lending and make lending to some high-risk segments uneconomic (thereby reducing the size of the addressable market)."[79]

B. Changes in the Regulatory Landscape Negatively Impacted the Market's Assessment of Household's Prospects during the Observation Window

1. Concerns Regarding Increased Capital Requirements

53. Subprime lenders were particularly hard hit as regulatory scrutiny increased and new regulations called for higher capital requirements. One analyst noted in March 2002 that, "[c]onsistent with increased regulatory [scrutiny] seen across the industry for subprime lenders, Household indicated it had agreed with regulators to raise the capital levels at its bank subsidiaries." The report further stated that although Household "indicated that this requirement should not have any material impact on its financial results," it did "not yet have an accurate estimate as to the incremental capital requirement."[80]

54. Analysts inferred additional regulatory scrutiny from competitor announcements regarding regulatory actions. For example, concern regarding the regulatory environment and its implication for Household increased following Capital One's July 17, 2002, announcement regarding a Memorandum of Understanding with national banking authorities. A Bear Stearns analyst noted that "HI shares appear to have suffered along with those of other financials in reaction to bank regulators imposing higher reserve and capital requirements on sub-prime lenders."[81] Similarly, Fox-Pitt Kelton stated that "HI shares were under pressure yesterday in sympathy with its consumer finance peers," noting its belief that the "bombshell announcement

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[79] Bernstein Research, May 10, 2002.
[80] Salomon Smith Barney, March 15, 2002.
[81] Bear Stearns, July 17, 2002.

signals an era of lower returns, increased capital intensity, and heightened regulatory oversight for consumer lenders of all types."[82]

55. Concerns regarding new FFIEC guidelines affected credit card issuers like Household toward the end of the Observation Window as well. For example, an October 2002 CIBC World Markets report stated:

> *New FFIEC Guidelines Could Have Far-Reaching Implications For The Credit Card Issuers.* …Credit card issuer failures, such as Nextcard, and building consumer complaints and heightened credit risk on the heels of aggressive growth prompted the Federal Financial Institutions Examinations Council (FFIEC) to step up its oversight of the industry and impose more stringent lending and capital restrictions. The result of the heightened credit card issuer surveillance was sweeping industry changes in the absolute definition of sub-prime lending, accounting procedures, internal controls and corporate governance, and risk-based capital requirements.
>
> Following the groundswell of concerns surrounding the credit card issuers and capital adequacy levels, in July 2002 the FFIEC released draft guidelines to serve as the basis for prudent sub-prime credit card lending.… Overall, we believe many (if not all) monoline issuers will ultimately find some one-time charges unavoidable in light of the new guidance.[83]

2. Concerns Regarding Changes in Predatory Lending Rules

56. Apart from concerns about potentially inappropriate past lending practices, there was concern that Household's practices would have to change in the future as a result of regulatory changes—both actual and potential—including changes to the definition of what comprises "predatory lending." It is important to differentiate the impact of news related to past infractions (which is fraud-related) from the impact of news related to regulatory changes (which is not). The latter, news regarding regulatory changes, is not information that could and should have been

[82] Fox-Pitt, Kelton, July 18, 2002 (emphasis removed).
[83] CIBC World Markets, October 3, 2002 (emphasis added).

disclosed earlier by the Company. Hence, any stock price declines attributable to such news are not due to correction of the fraud.[84]

57. Analysts commented that Household's vulnerability irrespective of past wrongdoing and the difficulty defining "predatory lending," the increasingly politicized nature of the issue, and the changing legal/regulatory landscape had negative implications for the Company's future prospects. For example, reports from Bernstein Research noted that "Household is not acting in a vacuum but rather responding to the changing legal climate around predatory lending as consumer advocacy groups and state legislative bodies become more active."[85] Another report stated that "[o]ur point is not that these sales practices are unethical or illegal…. Rather, we believe there is a risk they will become less sustainable, along with the earnings that arise from them, as Household reforms its practices either voluntarily or as a legal requirement given the shifting legislative environment."[86]

VIII. Conclusion

58. In sum, I have found numerous types of nonfraud information were released during Fischel's Observation Window that could have affected, and based on my industry experience, likely did affect, the stock price of Household and similar subprime lenders more negatively than such information would have affected the stock prices of the broader set of financial institutions represented by the S&P Financials Index.

[84] Note that Fischel's deposition testimony is consistent with my understanding that changes in regulations, which is not something that could have been disclosed earlier by Household, are not corrective of the fraud: "Q:…what are some examples of declines that would not be attributable to a claim of fraud in this matter? A: Any negative event which causes a statistically significant price decline where there is no claim that the negative event should have been disclosed at an earlier point in time…" (Deposition of Daniel R. Fischel, March 21, 2008, p. 150).

[85] Bernstein Research, March 5, 2002.

[86] Bernstein Research, May 20, 2002 (emphasis removed).

Executed this 23rd day of October in 2015,

Christopher M. James