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BF and Auction Rate Securities: A Case Study

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Auction rate securities ("ARS") are municipal bonds, corporate bonds and preferred stocks with interest rates or dividend yields that are periodically re-set through auctions, typically held until auction from daily to 35 days. Auction bonds were created in 1984 to allow municipalities, hospitals, student lenders and funds to borrow long-term at money-market costs by adjusting interest rates through bidding.

In any auction of ARS, holders will be able to sell all of their securities for which they submitted a sell order only if there are sufficient bids to purchase all those securities in the auction.

If sufficient bids have not been made, auction failure results, and holders that have submitted sell orders will not be able to sell in the auction all, and may not be able to sell any, of the securities subject to such submitted sell orders.

When an auction fails, the rate reverts to a set level specified in bond documents or one based on a formula pegged to money-market benchmarks. Holders of the bonds are stuck with the securities until a later time attracts enough demand.

In the past few months, auctions have failed because dealers stopped using their own capital to support the sales, due to the Sub-Prime Mortgage Crisis' effect on cash flow and corresponding financial industry crisis.

Unfortunately, when clients were solicited to purchase ARS, many firms failed to inform clients of the formula that would be used when an auction failed and how it would affect their liquidity and value. As a result, ARS interest rates were set at low percentages which were based on the commercial paper index plus a spread. The rate was too low to attract new buyers and clients were unable to get out.

That having been said, it has not been impossible to get out of all ARS, but now it is difficult for many holders. Positions that are being sold, if at all, are sold in smaller lots. There have been reports of some issuers failing, but also, may issuers have began re-financing their debt to respond to the negative outcry that will impact future funding efforts (bad publicity/investor relations), causing these securities to be redeemed and investors made whole. Securities industries sales practices in this regard are under investigation by regulators, self-regulators and state agencies.

CASE STUDY: Example Fact Pattern For Discussion Purposes

Brokerage Firm, Inc.:

Brokerage Firm, Inc. ("BF") is a well-known, full service brokerage firm and market maker. BF is registered with many exchanges and has been the subject of regulatory actions and customer complaints. BF, amongst other major financial institutions, consented to a settlement order with the SEC relating to the bidding process for auction rate securities and paid millions in penalties.

BF was the underwriter and received fees for the auction rate securities offering by issuer Z Development Corp. Sub series A-1 Bonds ("Z Bonds"). Additionally, BF was selected by Z Bonds to act as a broker-dealer through which investors must submit orders into auctions for the issuers' securities. As auction dealer, BF received auction dealer fees which generally are based on the amount of securities that BF places with investors. See example for discussion purposes only of a publicly posted *Description of BF's Auction Rate Securities Practices and Procedures*, Page 4, attached hereto as **Exhibit A**.

Additionally, BF wrote research reports relating to auction rate securities after the auctions were failing. See example for discussion purposes only of a publicly released annexed as **<u>Exhibit B</u>**.

<u>Typical Claimants:</u>

Typical claimants, although not all, are high net worth investors, often more sophisticated, who are looking for either a holding place for cash to be re-invested, ready or relatively liquid for emergencies and/or people seeking a conservative investments are also common. Many do not have prior experience with auction rate securities and/or ARS with these low re-set rates.

<u>Example ARS Investment:</u>

Z Development Corp. ("JDSC") Sub series A-1 Bonds ("Z Bonds") bought in 2007.

A typical recommendation includes a higher yield on the auction rate securities, indications of AA rated paper. Reliance is high, as who is going to research a "Cash or Cash Equivalent" investment for risk.

Z Bonds which were issued to finance a portion of the costs of the design, construction, and furnishing of a courthouse located at Z in New York and lease to the City. BF was one of many dealers signed up as an auction dealer for the various sub-series Z Bonds.

The Client usually does not gets a prospectus or other disclosure documents at the time of purchase (in these deals, they could be extremely large), only receiving confirmations after the purchase. The Client may or may not receive a copy of the Z prospectus, after already being placed in the illiquid positions. BF marketed auction rate securities to investors as short term cash equivalent investments and an alternative to money market funds.

The Broker is aware that The Client needed liquidity and was risk averse with this money and did not have time or intent to research these vehicles, which were in fact difficult to research without a prospectus in any event. The Broker was aware that The Client was relying on him and The CLIENT's reliance was justified, as his needs were simple: tax exempt liquidity and a cash equivalent with a decent interest rate. That may have been delivered with other ARS positions, but the significant differences between the other positions and the risks attendant with the Z Bonds were not disclosed.

There was no reason to believe that there would be great risk attendant to these investments or that great caution was warranted, as it seemed as an easy task for any broker to accomplish, but The Broker simply did not read the prospectus or any materials that would have helped him understand the actual features of this product and what the risks were that attended to that product, so that The Client could have made an informed decision.

The Client needed access to his money, so he/she told The Broker to sell Z Bonds at the auction one day, when The Client asked if the Z Bond order was completed, The Broker indicated that they were not. The Broker typically is initially unclear as to why the rate reset to the low interest rate and indicates that he/she needed to do some research, illustrating that he/she did not understand the product he/she solicited.

Next day, bothered by The Broker's lack of knowledge and expertise on a product they solicited and The Client's inability to get out and access his cash, The Client registered a formal complaint via electronic mail.

In response to this complaint, The Client had a conference call with The Broker and his Regional Managing Director, who also appeared ignorant as to the basis of the rate reset and deferred to The Broker, who by now had done the requisite research and explained the reset mechanism to his Regional Managing Director, who procedurally should have understood the position, so as to supervise the transaction and approve this exceptionally large transaction in a concentrated position.

Respondents never disclosed the true risk of holding a concentrated position in one security with the re-set feature. No rational investment advice would not have advocated maintaining over 50% of The CLIENT's assets in one position that could become illiquid.

The Broker failed to disclose that there were artificial and preset reset mechanisms that could render the position illiquid, as well as failed to inform The Client that Z carried much more risk than other ARS positions. Typically, only after the fact did The Client get an explanatory research report describing the features from BF, when it was too late. See for discussion purposes only a publicly available research report annexed as **Exhibit B**.

The Client justifiably relied upon all the representations made to him by Respondents as to their expertise and their ability to service the CLIENT's account given their safety and liquidity needs.

Now, Mr. and Ms. CLIENT do not have access to roughly half his net worth for an indeterminate amount of time and may be subjected to bond defaults and tremendous losses. It is untenable that Mr. and Ms. CLIENT has essentially "gifted" $5 million to the City of New York, as they have no way to reasonably access the CLIENT's money except through costly loans by BF to the CLIENT (a cost never desired, disclosed or contemplated in the decision to enter into this transaction), which margin-ability has been increased by FINRA because of the status of the instruments. See FINRA Regulatory 08-08 annexed as **Exhibit C**.

Respondents' Obligations When Selling Non-Conventional Investments:

NASD Notice to Members ("NTM") 03-71 Non-Conventional Investments reminds members of its obligations when selling non-conventional investments. It provides,

> Given the complex nature of non-conventional investments and the potential for customer harm or confusion, members are cautioned to ensure that their sales conduct procedures fully and accurately address any of the special circumstances presented by the sale of non-conventional investments. Additionally, NASD is concerned that investors, particularly retail investors, may not fully understand the risks associated with these products. According, NASD reminds member that the sales of non-conventional investments, like more traditional investments, requires them to:

1) conduct appropriate due diligence with respect to these products;
2) perform a reasonable-basis suitability analysis;
3) perform customer-specific suitability analysis for recommended transactions;
4) ensure that promotional materials used by the member are fair, accurate, and balanced;
5) implement appropriate internal controls; and
6) provide appropriate training to registered representatives that sell these products.

Given the complex and, at times, difficult-to-understand nature of non-conventional investments, members should take particular care to assure that they are fulfilling these obligations. See NASD NTM 03-71 attached hereto as **Exhibit D** pages 766 - 767. Further, NTM -3-71 goes on to say, in relevant part:

> The type of due diligence investigation that is appropriate will vary from product to product. However, there are some common features that members must understand about products before registered representatives can perform the appropriate suitability analysis. These features include, but are not limited to:
>
> - The liquidity of the product
> - The existence of a secondary market and the prospective transparency of pricing in any secondary market transactions
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> ***
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> - Principal, return, and/or interest rate risks and the factors that determine those risks.

See NTM 03-71 attached hereto as **Exhibit D** page 767.

Respondents Failures to Inform The Client of Material Information Regarding Re-pricing Mechanisms When Auctions Fail:

Respondents failed to inform The Client of material information regarding re-pricing mechanisms when if the auctions fail. The Client remembers no discussions relative to risk associated with the auction rate securities that were recommended. The Broker omitted material facts that would have been important to The Client in evaluating the investments in their account. In selling the Z Bond to The Client, Respondents made misleading material representations regarding the limitations of the product. Had The Client known this material information, he/she would have never placed a large portion of their assets in this one product.

TYPICAL CAUSES OF ACTION APPLY

Secs. 10(b) and 20(a), Securities Exchange Act of 1934, 15 U.S.C. 78j(b) & 78t(a)

Specifically, respondents violated Exchange Act, Section 10(b), 15 U.S.C. Section 78j(b), Securities Act, Section 17(a), 15 U.S.C. Section 78q(a), and Exchange Act, Section 20(a), 15 U.S.C. Section 78t(a), as well as Rule 10b-5, 17 C.F.R. Section 240.10b-5, Rule 15c1-7, 17 C.F.R. Section 240.15c1-7 and Rule 10b-16, 17 C.F.R. Section 240.10b-16 promulgated thereunder.

Respondents in selling the auction rate securities to Claimants (i) employed devices, schemes, and artifices to defraud Claimants; (ii) made untrue statements of material fact and/or omitted to state material facts necessary to make the statements not misleading; and (iii) engaged in acts, practices, and a course of business which operated as a fraud and deceit upon the Claimants in an effort to enrich themselves by recommending auction rate securities as risk free liquid investment, in violation Exchange Act and Securities Act. In committing the acts and omissions in violation of the Exchange Act and Securities Act, as alleged herein, Respondents used or employed, directly or indirectly, the use of a means or instrumentality of interstate commerce or of the mails, or of a facility of any national securities exchange. The investments purchased by Claimants are connected with the purchase and sale of a security.

The Respondents had actual knowledge of the misrepresentations and omissions of material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose such facts, even though such facts were available to them. See example for discussion purposes of Presentations and Reports prior to solicitation annexed as **Exhibit E.** [1]

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1 In November 2005, Merrill Lynch made a power point presentation at a Broker-Dealer Conference of the AICPA (American Institute of Certified Public Accountants). Merrill Lynch's topic: "FAS 140: QSPE Status of Certain Securitizations", found at http://conferences.aicpa.org/materials/downloads/05SECUR%2007.pdf. [Footnote: QSPE means a "Qualifying Special Purpose Entity", an accounting term of the FASB (Financial Accounting Standards Board)]. On page 4 of its power point, Merrill Lynch presented on the Classification of Auction Rate Securities. On page 5 of its power point,

Rescission is an available remedy in 10b-5 cases. Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970); Randall v. Loftsgaarden, 478 U.S. 647, 662, 106 S.Ct. 3143, 3153 (1986); Bruschi v. Brown, 876 F2d 1526, 1531 (11th Cir. 1989).

Breach of Contract

Claimants entered into various written and verbal contracts with BF and The Broker. These contracts provided that the Respondents would supply brokerage services in a legal, ethical and professional manner in accordance with applicable statutes, rules and regulations of the securities and insurance industries.

Failing to disclose the risks of a particular security or trading strategy is a violation of industry rules and a breach of the parties' agreement. A broker "cannot deliberately ignore that which he has a duty to know." SEC v. Hasho, 784 F.Supp. 1107; see In re Michael J. Fee, 50 S.E.C. 1124, 1125 (1992) cert. denied, 998 F.2d 1002 (3rd Cir. 1993).

Violation of Industry Rules

The respondents breached their respective contract by violating many industry rules they agreed to follow.

Unsuitability

Respondents recommended auction rate securities as short term liquid investments better than money market accounts which were suitable to Mr. and Ms. CLIENT'S needs.

Further, Respondents violated Municipal Securities Rule Board ("MSRB") Rule G-19 which provides that a dealer must consider the nature of the security as well as the customer's financial status, tax status and investment objectives, based upon the facts disclosed by or otherwise known about the customer when making recommendations to customers. The dealer then must have reasonable grounds for believing that the

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Merrill Lynch discussed the definition of Cash Equivalents under FAS 95 (Financial Accounting Standards). Merrill Lynch stated that "only investments with original maturities of 3-months or less qualify under this definition – US Treasuries, Fed Funds, etc." ARS did not qualify.

recommendations is suitable for that customer. Thus, among other factors, a dealer must consider both the liquidity characteristics of an auction rate security and the customer's need for liquid investment when making a suitability determination involving auction rate securities. See MSRB Notice 2008-09 attached hereto as **Exhibit F.**

Commercial Honor and Good Faith

FINRA's Conduct Rules, require that "[a] member, in conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." (FINRA Manual, Conduct Rule 2110, p. 4111). See also Bak-A-Lum and Seidenberg, supra.

"Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. . . ." (FINRA Manual, Conduct Rule IM-2310-2(a)(1), p. 4261). "[S]ales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed…." Id.

Respondeat Superior and Failure to Supervise

BF is required to "establish and maintain a system to supervise the activities of each registered representative . . . to achieve compliance with applicable securities laws and regulations and with the Rules of this Association. Final responsibility for proper supervision shall rest with the member. (FINRA Manual, Conduct Rule 3010, p. 4831).

Negligence and Negligent Supervision

By virtue of their contract, Respondent BF owed Mr. and Ms. CLIENT a duty to use reasonable care in the conduct of its affairs, especially in supervising The Broker breached those duties and those breaches were a proximate cause of Mr. and Ms. CLIENT'S damages.

Breach of Fiduciary Duty & Constructive Trust

By virtue of their contract, Respondents owed Mr. and Ms. CLIENT a fiduciary duty, and that duty was breached, for the reasons described above. Mr. and Ms. CLIENT placed complete confidence and trust in The Broker to handle his investments, and there has been a breach of that trust to the detriment of Mr. and Ms. CLIENT and for the benefit of Respondents. Respondents had an obligation to Mr. and Ms. CLIENT but instead operated for their own personal benefit to the detriment of Mr. and Ms. CLIENT.

Violation of Statutory Law: GBL Section 349

The above conduct violates General Business Law section 349(a) which declares unlawful "[d]eceptive acts or practices in the conduct of any business, trade or commerce or in the furnishing of any service." The statute provides for a private right of action to any person injured by the deceptive acts or practices committed by a business. Id. at Section 349(h).

Fraud & Misrepresentation: Common Law and Statutory

Respondents made material misrepresentations concerning facts and omitted other material facts, in conjunction with the purchase and sale of the securities discussed herein. These material misrepresentations and omissions concealed the level of risk associated with these securities, as well as concealed the conduct from the CLIENT. This fraud was conducted through and/or under the guidance of a supervisor and compliance department, who are liable to Mr. and Ms. CLIENT for conspiracy to defraud.

Further, Respondents violated MSRB Rule G-17 which requires dealers to deal fairly with all persons and prohibits deceptive, dishonest, or unfair practices. MSRB Notice 2008-09 provides,

> A longstanding interpretation of Rule G-17 is that a dealer transacting with a customer must ensure that the customer is informed of all material facts concerning the transaction, including a complete description of the security. Further, it states that disclosure of material facts to a customer under Rule G-17 may be made orally or in writing, but must be made at or prior to the time of trade. In general, a fact is considered "material" if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor.

See MSRB Notice 2008-09 attached hereto as **Exhibit F.**

Respondents' conduct in that regard violate FINAR Rules 2110 (just and equitable principles of trade) and 2120 (manipulative, deceptive, or other fraudulent device or contrivance), as well as, MSRB Rule G-17.