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Will There Be An Onslaught Of ARS Litigation?

Law360, New York (July 30, 2009) -- The February 2008 meltdown in the market for auction rate securities left thousands of investors unable to sell their holdings. State and federal regulators moved quickly against underwriting banks and ARS market makers such as Goldman Sachs, UBS and JP Morgan Chase to secure liquidity and relief for some, but not all, investors.

On July 20, 2009, the SEC demonstrated a new front in its campaign against sellers of ARS, announcing its first major settlement with a “downstream” distributor of ARS, TD Ameritrade. The next day, the SEC filed a complaint against another downstream broker-dealer, Morgan Keegan & Co. Inc.

Generally, these claims have been predicated upon the assertion that broker-dealers misrepresented and sold ARS to investors as “cash-equivalent” or “liquid” investments without properly disclosing the risks of the auction system and their inside knowledge about the frailty of the system and the likelihood of auction failures.

The regulator’s recent actions — pursuing downstream investment advisors removed from underwriting — is significant for two reasons.

First, like prior settlements, the TD Ameritrade settlement will provide thousands of investors with liquidity and give them the right to seek consequential damages in special arbitration proceedings. Second, the pool of potential targets for government enforcement has expanded considerably.

The recent settlements are not good news for all investors. The settlements between the regulators and broker-dealers like Citigroup, Bank of America, Wachovia and TD Ameritrade typically require the defendants to buy ARS back from individual investors, nonprofits and small companies with less than $10 million in their accounts. Large investors are left out.

Settled broker-dealers are only obligated to use their “best efforts” or “work with” large investors to find a liquidity solution for them. Many companies who invested tens or hundreds of millions of dollars in supposedly cash equivalent ARS are left holding illiquid securities with potentially 30-year maturities that they cannot trade or redeem. According to one source, approximately $160 billion in ARS remain outstanding.

So what happens from here? Seventeen months after the auctions failed, litigation will likely increase. However, instead of class actions of small investors, many investors will likely wrangle over consequential damages in arbitration and over who is eligible for ARS buybacks under the settlements.

Downstream broker-dealers will face increased scrutiny from regulators expanding the pool of investors covered by settlements. Large investors (mostly companies and institutional investors), armed with the knowledge that government regulators are unlikely to directly assist them, likely will help themselves by filing lawsuits and/or arbitration proceedings against those who marketed the ARS to them.

What are Auction Rate Securities?

Auction rate securities were designed to give investors a vehicle to invest in the relative safety of long-term AAA-rated municipal bonds without sacrificing liquidity by using variable rate bonds and Dutch auctions typically held every 7, 14, 28 or 35 days at which the ARS interest rate was continuously reset.

The interest rate for the auction or “clearing rate” was set at the lowest rate at which the bids covered all of the securities up for sale. Issuers benefited because ARS had lower interest rates than typical 30-year fixed rate bonds.

For more than 20 years, the auctions appeared to function as a reliable and efficient market. By 2008, the total ARS market was estimated at $330 billion. Until mid-2007, auction failures were virtually unknown.

The Auction System Fails

In 2007, the auction system began to falter as supply outstripped demand. Demand was depressed as: (1) investors with less available cash to invest exited the market, and (2) insurance guaranteeing the securities in case of issuer defaults became more difficult and expensive to purchase.

According to the SEC’s complaints, auctions were evading failure only because large broker-dealers were propping up the auctions with their own bids. As the credit crisis deepened and the economy further soured, broker-dealers were less willing to prop up the auctions.

The broker-dealers realized the risk of ARS and began a hard push to sell the ARS they held for themselves. At the same time, broker-dealers continued to market ARS as cash-equivalent liquid investments without advising investors that the broker-dealers themselves were reducing their ARS positions because they knew that the auctions were not self-sustaining and had only worked due to the willingness of banks to bid themselves to prevent auction failures.

Finally, in February 2008, the broker-dealers stopped supporting ARS auctions and many failed. The failures left sellers with virtually no market for their supposedly “liquid” investments. The failures were a nightmare for most issuers because the penalty rates issuers had to pay when auctions failed were extremely high.

For example, on Feb. 12, 2008, the auction for ARS issued by the New York Port Authority failed. Due to the failure, the interest rate paid by the Port Authority rose from 4.3 percent to 20 percent.

Following the failed auctions, many issuers refinanced and converted ARS to variable-rate demand notes, replaced ARS with short-term debt funding or bought their own ARS.

By September 2008, public sector issuers had refinanced or planned to refinance approximately $104 billion of the originally outstanding $166 billion in municipal ARS debt.

Similarly, by September 2008, closed-end mutual funds, which held approximately 20 percent of the $330 billion ARS on the market, had redeemed or planned to redeem approximately $25 billion to investors.

Not all penalty rates, however, were high or even higher than the going market interest rate. After initially spiking, the penalty rates on many student loan auction rate securities (SLARS) reset at 0 percent because the issuing trusts were prohibited from paying more in interest than they made on the loans.

SLARS represented about 25 percent of the total ARS market or about $85 billion. Thus, SLARS issuers have no incentive to refinance or restructure, and only a small percentage of SLARS have been refinanced. Many companies currently have millions of dollars tied up in SLARS for decades with little promise of return.

Litigation and Government Enforcement Quickly Followed the Failed Auctions

In 2008, class action lawsuits were filed against more than 20 broker-dealers. State and federal regulators launched investigations and some investor companies have sought relief. The shape of future litigation has been formed by the settlements with state and federal regulators.

State and federal regulators and the Financial Industry Regulatory Authority (FINRA) have settled with different banks and broker-dealers for more than $67 billion. Citigroup, UBS, Wachovia, Merrill Lynch, RBC, Deutsche Bank, WaMu Investments, First Southwest Company, NatCity Investments and others have settled.

In the settlements, the broker-dealers agree to redeem investors' ARS at par value, but do not admit to any culpability. The regulators initially prioritized their investigations focusing on the biggest underwriters and market makers. Now regulators appear to have shifted their focus to downstream distributors and individuals.

Downstream broker-dealers were investment advisors and retail brokers who distributed or sold around $100 billion worth of ARS. They typically did not underwrite ARS or manage auctions. As of now, at least 10 downstream broker-dealers have settled, but three of the largest, Raymond James Financial Inc., Oppenheimer Holdings Inc. and E*Trade Financial Corp., have not.

Many downstream participants claim they cannot afford to buyback the ARS held by their customers. Others contest their liability. On July 20, 2009, Charles Schwab & Co. Inc. announced New York Attorney General's allegations of fraud and its threatened civil suit are "without merit" and blamed "large Wall Street firms" for the illiquid market.

Small ARS Investors Will Mostly Bring Future Disputes in Arbitrations

The regulatory settlements also bind the broker-dealers to special arbitration proceedings established by FINRA. The entire purpose of the special proceedings is to resolve claims for consequential damages.

In the special arbitrations, the settled broker-dealers cannot contest liability related to the illiquidity of the ARS holdings, or to the ARS sales, including any claims of misrepresentations or omissions. Broker-dealers also pay all the costs associated with the special arbitrations not including attorneys' fees.

Consequential damages can be very large. According to FINRA, consequential damages include "opportunity costs or losses that resulted from investor's inability to access their funds because their ARS assets were frozen." Some consequential damages are expected to top $1 million, but investors will face a challenge proving their damages are not speculative.

As of mid-December 2008, investors had filed 275 ARS claims under FINRA's special arbitration proceedings. With settlements continuing, including settlements worth over $7 billion in the last two months, small investors will likely file hundreds more FINRA arbitrations.

While investors are not bound to FINRA's special arbitration procedure, it is likely the best avenue for those who qualify. The regulatory settlements greatly diminish the viability of class actions.

In March 2009, a federal judge dismissed a class action suit in S.D.N.Y. against UBS because the class had availed themselves of their rescission rights afforded them from UBS's settlement with regulators.

Within two months, plaintiffs refiled their class action identifying the class of plaintiffs as those "stranded" by the regulatory settlements and alleging UBS traders manipulated the ARS market.

For customers of settled broker-dealers, class action plaintiffs' lawyers face an uphill battle to find a large and related class of investors who fell through the settlement cracks. The UBS decision provides a small incentive for broker-dealers to settle to cut off pending class actions.

Large Investors May Soon Turn to Self-Help

The elephant in the room, and the biggest potential group of "stranded" investors, is large companies who are not likely to join a class action. "Eligible customers" under the settlements only includes individual investors, nonprofits, and small to mid-size companies with small accounts. Settled broker-dealers, like Deutsche Bank Securities Inc. for example, are only obligated to "work with" institutional investors to "expeditiously provide liquidity solutions." That leaves larger companies out in the cold to fend for themselves. As time passes, large companies will begin to serve an ever-increasing number of complaints demanding broker-dealers redeem their ARS. This is especially true for companies holding some of the billions of dollars of SLARS still outstanding where interest rates are minimal if not 0 percent.

While its settlements have not directly assisted large investors, regulators' investigations and complaints do. The regulators' complaints provide roadmaps for large companies to follow.

After extensive investigations, the complaints set out specific details of what the broker-dealers knew about the risk of the auctions, when they knew about the risks, how they marketed ARS, and how the various divisions at the broker-dealers communicated with each other about the risk of ARS.

The greatest hurdle for large investors will likely be combing their communications with their broker-dealer to find the specific misrepresentations they received and relied upon that led them to believe that ARS are cash-equivalent investments.

Larger investors are also usually more sophisticated than individuals and would likely have had a better understanding of the risks of ARS, making reliance much harder to prove.

Litigation over ARS is not likely to end soon. Downstream broker-dealers are now squarely in the regulators' cross-hairs. Some will settle and shift litigation from class actions to arbitrations, but others seem perched to fight.

More large investors will join companies like Ashland Inc. ($194 million), Braintree Laboratories ($33 million) and Texas Instruments ($524 million) seeking millions from ARS buybacks.

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