A False Sense of Security

By John Churchill

"Are closed-end fund preferred-auction securities safe? We consider CFPs to be the conservative's conservative security."

"Defaults are even rarer than failed auctions."

"We are comfortable with the safety of auction securities from closed-end funds, municipals with an underlying credit rating of at least single-A and guaranteed student-loan issuers."

The foregoing quotations were lifted from a February 4 research report by Merrill Lynch fixed-income strategists Martin Mauro and Kevin J. Conery. The report — "Answering Your Questions About Auction Market Securities," a supplement to Merrill's *Fixed Income Digest* — noted that auction-market securities "do not provide the daily access to funds that money-market funds do," but, they wrote, "We think that the higher rates compensate for the slightly lesser degree of liquidity." Yes, Mauro and Conery noted that, "liquidity concerns have been a common theme in the money markets since last summer," but, "We view the unusually high present level of rates as an opportunity rather than a cause for alarm."

Famous last words. The report was issued roughly nine days before the entire auction-rate securities market seized up. That's right: The entire ARS market has been shut down for three months, a casualty of the popping of the credit bubble. Now Merrill advisors — and UBS, Smith Barney and other firms' reps — are sitting on millions in illiquid auction-rate securities. Their clients, who used the securities as a temporary parking space to grab some extra yield on their cash (sort of like a juiced-up money-market fund), are livid.

Perhaps you have a client like Stephen Joffe, a former professor of surgery and a laser-vision pioneer who lives in Cincinnati. Joffe invested $1.35 million of his charitable organization's cash in a now illiquid auction-rate security, specifically in preferred stock of the Eaton Vance Limited Duration Fund. Joffe, in a FINRA arbitration claim against UBS, alleges he did this upon the recommendation of his advisor, Michael Fitzgerald. All he wanted, Joffe says, was something safe, a vehicle that had no risk of loss of principal and was 100-percent liquid.

"On Thursday, February 14, I get a call out of the blue from my advisor," Joffe says. "He essentially says, 'Your charitable foundation is illiquid.' Friday, he apologizes profusely, and says, 'By the way, UBS is really going to help their clients with this by offering to borrow 50 percent of the value; interest rates will hopefully be a wash, etcetera."

Joffe was incensed by UBS' offer — a loan against his money (later determined to be at a rate of LIBOR, plus 25 basis points in fees to UBS): "I was absolutely horrified that it

occurred, but also that this was the way they were going to handle it." He told his advisor he was absolutely not going to borrow from the firm that was holding his money hostage.

"Weeks earlier I had been reading the papers with my son, and I was saying, 'Thank God, we're not in any of that stuff,'" he says. In fact, Joffe says he even put in a call to his advisor around that time. Fitzgerald told him his money was safe; the risk was nil.

Did he ever know that he was in an ARS? "No, no, no, never." UBS declined to comment on Joffe's case but a spokesperson said the firm is "committed to addressing our clients' concerns about … the breakdown of liquidity for auction-rate securities." He added that UBS is now offering as much as 100 percent margin loans and that it is working with the industry to restore liquidity.

As a result of Joffe's situation, The Joffe Foundation, a charity established by Joffe and his wife, has shut its doors to new funding requests, and hasn't been able to fulfill outstanding payments.

Joffe is, of course, not alone. There are individual arbitrations and lawsuits being brought against brokerages by clients who say the risks of the ARS market were never explained, that they were sold to them as "cash equivalents." Joffe's account statement clearly lists his Eaton Vance ARSs under a heading of "auction rate preferred," but the statement also has a line entry of "cash and cash alternatives" summing up his foundation's total assets in ARS.

Financial advisors are angry too. Many say they understood the ARS to be, well, cash like — a kind of money-market fund. The breakdown seemed impossible not long ago: "A breakdown of high-quality corporate and muni debt? Nah, it won't happen. Not a chance," is how advisors thought about the risk — if they even considered it. After all, the $330-billion auction-rate securities market, an obscure corner of the municipal-bond market, was too big, too important — a key source of liquidity for all kinds of businesses, institutions and high-new-worth investors — to fail.

And why should FAs think otherwise? In the ARS market's 24 years of existence, no more than a baker's dozen of individual auctions have ever failed, something that the Merrill fixed-income analysts noted in their February 4 report. And when an auction failed, it was an isolated incident. In fact, auction-rate securities really did act like cash equivalents. Risk seemed utterly remote, a Black Swan-type event. That's the track record research departments trotted out to advisors, who in turn used it on their clients when describing the liquidity and safety — and the relatively high yields — offered by the ARS market.

One former Merrill advisor (a veteran producer who now works for another large firm and caters to high-net-worth clients), when asked if he told clients that auction-rate securities were potentially risky, or could lose money, he replied, "No. Never. No." Why? "Because that's how the products were explained to us [as cash equivalents]." In fact, at Merrill, he says, he was taught — in a separate training session devoted to the

instruments — that they were to be considered as safe as money-market funds. “FAs were never given any reason to worry about this,” he says. “Ever. Ever. Ever.” Many used them — their access to them — as a “great prospecting tool,” the advisor says. This advisor, who spoke on the condition that his affiliation not be disclosed (he feared he would be fired because he is not authorized to speak to the press), said he had “millions” of client money in frozen ARS, but was able to get his clients out recently.

“This is the biggest deal to hit retail financial advice in my entire time in the industry. If there's something that could kick me out of the business, this is it,” says one livid UBS advisor with more than 20 years in the business, $1 billion-plus in assets under management and, as of April 1, more than $60 million of client money stuck in the ARS market. “Our firm, and the other broker/dealers, are having a complete crisis in confidence with investors that is going to hammer my profession and send people to the RIAs.”

The Black Swan

With names like MARS (for municipal auction-rate security) and ARPS (auction-rate preferred securities) the most commonly issued ARS sure don't sound risky. Indeed, it seems for the better part of 24 years, they weren't. Roughly half of the market pre-collapse consisted of bonds issued by municipalities and other public entities, like hospitals and universities. The rest was divided among closed-end fund shops — such as Nuveen and Eaton Vance, which sold ARPS — as well as student-loan issuers. And, at least for a while, the instruments appear to have been a good idea, a valuable innovation in fixed income. Issued as long-term debt, ARS pay interest rates that are periodically set through auctions, typically every seven, 28 or 35 days. Issuers get favorable short-term rates to fund long-term projects, and investors (often) get yields better than money-market funds or CDs — with the safety and liquidity provided by the ability to cash out at the next scheduled auction. Different disclosure documents viewed by *Registered Rep.* on wirehouse websites do note the risk of auction failure and issuer default; in fact, participant dealers facilitate the auctions, they say, but are not obligated to prevent them from failing — rare as that used to be. According to Moodys, between 1984 and 2006, only 13 individual auctions failed.

Now, with the great majority of auctions still failing each week, more municipalities are either buying back their bonds — which the SEC has temporarily given them the power to do — or refinancing. Closed-end funds like Nuveen and Eaton Vance that had used leveraged auction-rate securities to juice returns in their money-market funds have a stickier situation — taking care of the preferred shareholders without helping them too much, or hurting the common shareholders. Some fund firms, like Aberdeen Funds, have decided to buy back their funds. Nuveen and Eaton Vance, two of the largest sellers of ARPS, have been able to get financing from banks to redeem a portion of the funds from investors.

Retail clients are furious, putting their advisors in a bad — embarrassing even — predicament: Having to loan clients' their firm's own money — for a fee. Brokerage

clients are generally getting the same deal, more or less, at every major wirehouse firm: 50 percent margin loans (or more, depending on the situation) against the value of their ARS holdings at 30-day LIBOR, plus some nominal fee of 10 to 25 basis points. In the meantime, at least for investors in MARS, the penalty interest rates that have reached into the high teens have been some consolation for illiquidity, whereas penalty rates on ARPS are only slightly higher than the normal rates. But for anyone who needed the money immediately for taxes or a down payment on a house, the loan solution provided by the brokerage firms is probably little consolation, or even "insulting," as one Wachovia broker put it.

Forgotten Risk

The loans for a fee are especially disingenuous given how the securities were presented and sold to clients. The state of Massachusetts, SIFMA and the SEC are all investigating ARS sales procedures. Jonathan Levine, a class-action attorney with Girard & Gibbs in San Francisco, argues that not only did the disclosure system not work, but the firms he's suing on behalf of a class of ARS holders also improperly marketed these securities as safe and liquid. He's suing several firms — including Merrill Lynch, Morgan Stanley, Citi, UBS, Wachovia, TD Ameritrade, Deutsche Bank and JP Morgan — on behalf of an as-yet-unknown class size of ARS holders. "I've spoken with over 600 people now. All of them said 'shame on me' [for not doing more due diligence], but at the same time none of them — I mean none — received written documentation describing the nature of these securities," he says. Levine says he's spoken with investors who are former managing directors at investment banks, traders and yes, even brokers, who claim they didn't understand what they'd been invested in after asking their advisor for 100 percent safety and liquidity. (One Merrill advisor said that even if those people really did make such claims to Levine, it wasn't because they didn't know, it was because they're bitter their greed didn't pay off.) Levine adds that many of the potential class participants have since heard from their brokers who've told them they too were duped, that they trusted the company line on ARS. (More than a few Merrill advisors have mentioned they are holding onto the Mauro/Conery report just in case clients sue them.)

To some, there were warning signs. Whether the suits prove to have any merit, or it turns out the firms covered themselves sufficiently in disclosure documents, the ARS market appears to have been a troubled place for some time already. In early 2005, all "big five" accounting firms, including PriceWaterhouseCoopers and Ernst & Young, advised corporate treasurers who had ARS on company balance sheets not to classify them as "cash equivalents." They were more accurately "investments." They also hinted at the illiquidity inherent in the market.

In 2006, the SEC settled a case against 15 participating dealer firms, including all the major broker/dealers, for a total of $13 million for "industry-wide" violations between 2003 and the summer of 2004. Among the misdeeds: "Asking customers to make or change orders in order to prevent failed auctions," and "submitting or changing orders; allowing customers to submit or change orders after auction deadlines," and in certain

instances, bidding for proprietary accounts to prevent failed auctions without adequate disclosure. Per the settlement, the firms neither admitted nor denied the charges.

In a speech in September 2006 to a conference of women in public finance, Martha Mahan Haines, chief, Office of Municipal Securities of the SEC, warned that the ARS market wasn't what offering documents made it out to be. “The true liquidity risk, volatility and fragmented nature of this market was not made clear to issuers or investors.” In truth, Haines said, these auctions were fragile, and brokers intervened to, in effect, set interest rates. “It may not be accurate to call this an auction at all,” she said. She suggested calling it a “managed-auction process” or “bidding system” — or, as a handy acronym: “BS Securities.”

How right she was. When the sub-prime mess destroyed billions in capital, the hard-up brokerages all walked away from the ARS market, in effect abandoning their clients' securities. Some fear that these securities will be illiquid for the foreseeable future. At least one analyst, Citigroup's Prashant Bhatia, has said the market is doomed, that it will soon “cease to exist.” But the consequences of this failure may be bigger than any settlement, regulatory fine or lost marketplace — client trust may be the most significant victim.