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Billions to Answer For

The auction-rate securities debacle stuck investors with a real need for representation.

BY DANIEL C. GIRARD

In their Aug. 18 analysis "Billions Not For the Plaintiffs' Bar" (Page 20), Michael Rivera and Erik Frias suggest that buy-back transactions will largely dispose of class actions against banks that sold auction-rate securities, denying plaintiffs lawyers what they had allegedly viewed as a "boon." As an attorney for auction-rate securities investors, I'd like to offer my perspective.

In case you're not familiar with this arcane corner of the bond market, auction-rate securities are long-term bonds or preferred stocks that pay interest or dividends at rates supposedly determined through periodic auctions. In February, the market for these securities collapsed, and investors discovered they could not liquidate their positions.

After the collapse, my firm filed class actions on behalf of auction-rate securities investors against most major brokerage firms. It all started when I got a phone call from an investor who had discovered that his broker had converted $15 million in cash in his account into auction-rate securities days before the market collapsed.

We investigated and heard the same story again and again: The brokerage firms had gone to extraordinary lengths to offload auction-rate securities on retail investors ahead of the market collapse.

PITCHED TO RETAIL

We also learned that while auction-rate securities had originally been placed with large institutional investors, beginning in 2005, the major brokerage firms had begun pitching auction-rate securities to their retail customers.

The change in marketing emphasis followed a 2005 Securities and Exchange Commission advisory clarifying the way companies were supposed to account for auction-rate securities. Rather than listing them as cash equivalents, these securities were to be classified based on their maturity date (in many cases, 20 or 30 years). According to experts in this market, the SEC order and accompanying position statements from major accounting firms led many corporations to start dumping their auction-rate securities.

You can guess what happened next, and the regulators' allegations and press coverage confirm it: The brokerage firms turned to retail investors, charities, and smaller companies as an outlet for the securities that their corporate clients no longer wanted.

Auction-rate securities were presented as an alternative to money-market funds. Despite accounting rules to the contrary, account statements often listed auction-rate securities as cash or cash equivalents. Some investors were issued checkbooks to draw on their auction-rate securities, "same as cash"; other firms had overnight liquidity policies, with the brokerage firm cashing out investors from its own funds, rather than having them await the periodic auctions.

NO PROSPECTUS

My colleagues and I have spoken to several thousand auction-rate securities investors regarding the circumstances of their auction-rate purchases, and not a single person we have spoken with received a prospectus at the time of sale. The clients who asked were told that the brokerage firms had no obligation to deliver a prospectus because their auction-rate securities sales were considered secondary market sales, and in any event, the bonds were highly rated and no auction had ever failed.

We also learned that the SEC had previously censured 14 of the major players in the auction-rate securities market for engaging in an exhaustive list of manipulative practices, such as intervening in auctions by bidding for their proprietary accounts or asking customers to change orders to prevent failed auctions, revising or submitting bids after the submission deadline, allocating securities among bidders in a manner other than what was disclosed in the prospectus, and providing higher rates of return than the clearing rate to certain investors.

The SEC had also issued a cease-and-desist order to three auction agents in January 2007, identifying as unlawful their practices of accepting bids after the submission deadline and allowing broker dealers to intervene in auctions to prevent failures.

The SEC's disposition of the problem was to fine the banks and order them to put a disclosure statement on their Web sites. Problem solved, however briefly.

As the market deteriorated in August 2007, an initial wave of auction failures occurred, involving primarily the more exotic collateralized debt obligations securities (which have come to be known as "toxic waste"). The brokerage firms stepped in to avert

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further failures, and the auction-rate securities market lurched on, sustained only by the continued willingness of the investment banks to buy up the securities that investors were increasingly reluctant to hold.

As the banks' inventory increased, they took increasingly desperate measures to reduce their auction-rate securities inventory. While the banks were pushing these securities on their retail customers, they were advising their largest customers to avoid the market, and in some cases bank executives were liquidating their own personal holdings.

In February, the banks stopped buying up excess auction-rate securities at the auctions, stranding thousands of investors in illiquid positions in the securities, despite having promised them days or weeks earlier that the securities were safe, liquid, and suitable for short-term investing.

INTO COURT

My firm filed a series of class actions on behalf of auction-rate securities investors beginning in March 2008. The past six months have been devoted to complying with the procedures mandated by the Private Securities Litigation Reform Act and our motion to coordinate the litigation in a single court. Under the act, discovery has been stayed while all this wheel-spinning takes place.

While our lawsuits have been getting off the ground, a task force of state regulators has been reviewing e-mails, interviewing witnesses, threatening license revocations, and negotiating settlements. Massachusetts Attorney General William Galvin filed complaints against UBS and Merrill Lynch, attaching some of the most incriminating e-mails to see the light of day since the golden age of Elliot Spitzer.

Several major banks have now agreed to repurchase auction-rate securities from individuals, charities, and small businesses that purchased the securities directly from the banks. These buybacks will take place over the next few months. Some banks also agreed to repurchase from institutional buyers over a longer time period, while others merely "undertake to expeditiously provide liquidity solutions to all other institutional investors," whatever that means. The banks have also agreed to implement a cleaned-up version of the usual industry-sponsored arbitration procedure for compensatory damage claims, and to pay penalties and fines to the regulators.

WHAT'S LEFT

This leads to the question of whether there is any further role for our private civil actions to play. The answer is yes. Here's what's left.

First, billions in auction-rate securities sales are not included in the buybacks. Someone has to make sure these sales are accounted for. These include sales of auction-rate securities to institutional holders who are excluded from most of the buybacks, and sales of auction-rate securities by "downstream" sellers (regional banks and brokerage firms that remarketed the auction-rate securities but did not serve as underwriters or auction managers).

Even those auction-rate securities holders who are included in the buybacks will not be made whole by the repurchase of their securities at par. Aside from having their money tied up for nine months or more when they were promised liquidity at periodic intervals of 28 days or less, many auction-rate securities holders received little or no interest on their bonds because of undisclosed interest rate "caps" concealed in the fine print of the prospectuses that were never delivered to any of the investors we've spoken with in the first place. These investors should be reimbursed for the interest they lost on their investments after the market failed.

BANK INTERVENTION

There are also troubling questions about how the auctions were administered before the failure of the market and the impact of the "interventions" by the auction manager-banks on the rates of interest paid on these securities.

Our preliminary investigation shows that interest rates on auction-rate securities were well below comparable instruments. The reason seems to be that, because the banks were buying the securities, the issuers didn't have to offer high-enough interest rates to attract sufficient nonbank investors. This let the issuers (the banks' clients) continue to issue securities and thus generate a continued flow of profitable business to the banks.

Of course, no one told our clients they would be paid less interest because of the banks' interventions.

There are many other unanswered questions, including who will represent investors who wish to make compensatory damage claims. The auction-rate securities debacle is the largest bond market failure in U.S. history. Although the buyback agreements represent real progress, any suggestion that auction-rate securities holders no longer have enough at stake to merit their continued representation by counsel would be misguided.

NO WINDFALLS

Finally, any suggestion that plaintiffs lawyers will be denied a windfall because of the regulatory settlements reflects a mistaken view of the facts and the law.

All told, about 30 securities cases have been filed against 15 different sellers following the collapse of a $300 billion market. By comparison, 30 price-fixing cases were filed against oil filter manufacturers involving a market that amounts to less than 1 percent of the auction-rate securities market. If anything, the legal response to this market's failure has been underwhelming, given the magnitude of the problem.

Plaintiffs lawyers get paid for bringing value to their clients by assuming risk in litigation on a contingency basis. Our clients, who saw their accounts used as a dumping ground by the biggest banks on Wall Street, could not possibly litigate these claims on their own. The law firms representing the banks account for most of the Am Law 25. If the courts overseeing the litigation are satisfied that plaintiffs' counsel have brought value to their clients, then —and only then—will the plaintiffs' lawyers be paid. Win, lose, or draw, there are no windfalls in our practice.

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