

Auction Rate Securities = Auction Risky Securities

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While the financial world was obsessed with the sub-prime mortgage crisis that resulted in a staggering loss of at least \$380² billion dollars, a related and equally potent occurrence in the auction rate securities market did not catch the attention of the American public. The reason for the public's non-interest in auction rate securities may be because it is not well known to the general public outside of financial and legal institutions, or because it was intentionally advertised as something else--cash equivalents. The market failure of auction rate securities has affected the liquidity of approximately \$330 billion dollars.

This article will describe auction rate securities, the players--issuers, investors, and regulatory agencies, as well as the reasons for financial illiquidity and the decrease in valuation of auction rate securities. This article will also discuss the legal implications for brokers and dealers who marketed these products as something other than what they are, before finally concluding that auction rate securities are not cash equivalents and that they should be properly marketed as long-term bonds with potentially serious liquidity risks.

I. AUCTION RATE SECURITIES

A. BACKGROUND

The auction rate securities ("ARS") market is estimated to be valued at \$330 billion.³ ARS is not commonly known in the world outside of finance, possibly because it is marketed as "cash equivalent,"⁴ "cash alternatives,"⁵ "cash management,"⁶ "highly liquid securities," and "money market funds."

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2. Kathleen M. Howley, *U.S. Mortgage Delinquencies, Foreclosures at Record (Update 1)*, BLOOMBERG, June 5, 2008, available at <http://www.bloomberg.com>.

3. Stephanie Lee, *Auction-Rate Securities: Bidders Remorse? A Primer*, NERA Economic Consulting (2008), available at http://www.mmc.com/knowledgecenter/NERA_PUB_Auction_Rate_Securities.pdf.

4. John Carney, *Auction Rate Securities: Were they Sold as 'Highly Liquid'?* (March 27, 2008), http://dealbreaker.com/auction_rate_securities.

5. John Carney, *Auction Rate Securities: Still Stuck After All this Time* (May 23, 2008), http://dealbreaker.com/auction_rate_securities.

6. John Carney, *Tim Flynn: UBS's \$37 Million Auction-Rate Securities Man* (May 19, 2008), http://dealbreaker.com/auction_rate_securities.

Some brokers have called ARS “floaters,” “seven-day papers,” “weekly money market investments,” “seven day CDs,” and “short-term rolls.”⁷ In financial terminology, ARS is a “long-term variable-rate instrument with interest rates being reset at periodic and frequent auctions.”⁹ In other words, ARS are long-term bonds whose interest rates are based on short-term market interest rates.¹⁰ The interest rates for ARS are typically set at a dutch auction,¹¹ which are held at seven, twenty-eight, thirty-five, and forty-nine day intervals. For some ARS, the interest rate reset occurs daily and for others, at six months or even only once over a multi-year period.¹² ARS are issued as either bonds¹³ or preferred stock¹⁴ and are designed to serve as money market-type instruments.¹⁵ Also, it is important to note that ARS

7. Julia Browne, *State Regulators & Attorney General Probe Banks and Brokers in Auction-Rate Securities Debacle* (May 5, 2008), <http://www.lawyersandsettlements.com/articles/10561/ars-banks-brkoers-probed.html>.

8. Katie Benner, *Investors Desperate for Cash Turn to Courts*, (updated April 1, 2008), http://money.cnn.com/2008/03/31/news/companies/benners_ars_lawsuits.fortune/index.htm. A well known player in this market also suggests that ARS are called “auction market preferred stock,” and “variable rate preferred.” Merrill Lynch also notes that ARS are also called “auction market preferred stock,” “variable rate preferred securities,” “money market preferred securities,” and “periodic auction rate securities.” See DESCRIPTION OF MERRILL LYNCH AUCTION RATE SECURITIES PRACTICES AND PROCEDURES (2008), <http://www.ml.com/media/70501.pdf> (hereinafter “ML”).

9. See Lee, *supra* note 3, at 1.

10. Douglas Skarr, *Auction Rate Securities*, CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION, (2004), *available at* <http://www.treasurer.ca.gov/cdiac/issuebriefs/aug04.pdf>.

11. Usually the issuer signs an agreement with a firm for a fee as the auction agent for auctions of ARS. Issuers also sign agreements with auction dealers who participate on their behalf at auctions. Auction dealers are also broker-dealers for the issuer. The auction dealer submits orders for the issuers in the auction through the auction agent. The auction dealer may also place auction orders for its own account. See generally ML, *supra* note 8.

12. *Id.* at 2.

13. Bonds are issued by corporations or state, local or federal government entities and their agencies. The issuer promises to pay to a specified interest based on a benchmark interest rate, i.e., LIBOR. LIBOR stands for London Interbank Offered Rate at which banks lend to each other. On designated dates, the issuer promises to pay a specified percentage of par value and at maturity, the principal value of the bond. See Frank J. Fabozzi & Franco Modigliani, *CAPITAL MARKETS INSTITUTIONS AND INSTRUMENTS*, (3rd ed. 2002).

14. Preferred stock is similar to common stock for payment purposes, except that preferred stock holders are entitled to receive fixed dividends prior to common stock holders. See Fabozzi, *supra* note 13, at 228-29.

15. There are numerous instruments that fall under the money market-type funds umbrella. Most importantly for discussions in this article, money market instruments are generally short-term and highly liquid. In addition to certain U.S. government securities, the following instruments are commonly traded in the money market:

Bankers Acceptance (BA): a draft or bill of exchange, most commonly generated in import or export transactions, representing moneys due at a future date in connection with the transaction, the payment of which is guaranteed by the “accepting” bank. BAs are typically sold on a discounted basis in a wide variety of denominations. Many BAs are eligible for discounting at the Federal Reserve.

Certificate of Deposit (CD)--a negotiable instrument representing a large time deposit at a commercial bank. Most CDs are interest bearing (typically paying interest at maturity), but some discounted CDs are issued. CDs are typically sold in denominations of \$100,000 to \$1,000,000. Eurodollar Deposit--a time deposit of eurodollars. Eurodollars are U. S. dollars on deposit at a branch of a U.S. bank or a foreign bank located outside of the United States. Repurchase Agreement (RP)(Repo)--an agreement consisting of two simultaneous transactions

have long-term maturity¹⁶ or no maturity at all.¹⁷ They have been marketed to rich individuals (for tax exemption purposes) and corporate treasuries (for liquid cash on corporate balance sheets, however taxable) as an alternative to money market funds.¹⁸ The issuers of ARS are typically municipalities, non-profit hospitals, utilities, housing finance agencies, student loan finance authorities and universities¹⁹ interested in alternative forms of financing. Closed-end mutual fund²⁰ companies also issue ARS. Issuers prefer ARS because it allows them to vary their "credit spread" over time and possibly provide lower cost financing.²¹

The minimum investment amount is \$25,000 with a \$25 million minimum issue size.²² The typical participants in this industry are issuers, underwriters, investors, broker-dealers and credit rating providers. Risks associated with ARS include, possible default on payment of interest,²³ illiquidity and

whereby one party purchases securities from a second party, and the second party agrees to repurchase the securities on a certain future date at a price which produces an agreed-upon rate of return (the "repo rate").

Reverse Repurchase Agreement (Reverse Repo)(Reverse)--an agreement consisting of two simultaneous transactions whereby one party purchases securities from a second party and agrees to resell them to the second party on a certain future date at a price that produces an agreed-upon rate of return. See Glossary of Municipal Terms, available at <http://www.municipalbonds.com>, (last visited June 5, 2008).

16. The typical maturity for ARS is 20 to 30 years. See Skarr, *supra* note 10, at 1.

17. See ML, *supra* note 8, at 3 (noting that the exact dates of auction and the payment interest or dividends is provided in the offering documents).

18. See Lee, *supra* note 3, at 2; Skarr, *supra* note 10, at 2.

19. See Skarr, *supra* note 10, at 2. (noting that the money market funds are ineligible to hold ARS in their portfolios because of SEC Rule 2a-7, which restricts them to securities with maturities of 297 days or less).

20. Closed-end mutual funds are investment companies that issue a fixed number of shares that are traded on exchanges. Lee, *supra* note 3, at 3. These shares are traded on the open market and not with the closed-end funds. Open-end mutual funds are prohibited from using most types of leverage; closed-end funds use leverage (borrowed money) to enhance returns for their shareholders. *Id.* Since closed-end funds are required to have three times as much assets as compared to debt and only two times as much assets when using preferred stock, the closed-end funds prefer ARS preferred stock. See *Id.* (citing the Investment Company Act of 1940, sections 18a 1A and 2A - Capital Structure of Investment Companies, published by the University of Cincinnati College of Law, available at <http://www.law.uc.edu/CCL/InvCoAct/sec18.html> (last visited June 30, 2008)). While the total ARS market is estimated to be \$330 billion, of the total ARS market, closed-end fund share is 38%, municipal is 50%, student loans is 26% and others are 5%. See *Id.*

21. Credit Spread is the difference between the issuer's borrowing rate and a credit risk-free benchmark rate (U.S. Treasury Rate). While a traditional variable rate instrument fixes in advance the credit spread for the issuer, giving the advantage of certainty, the ARS allows the issuer to take advantage of current situation, in terms of supply and demand and favorable economic conditions, where the short-term rates are lower than long-term rates. See Lee, *supra* note 3, at 4. (citing the lower interest rate cost of borrowing for Dallas-Forth Worth International Airport).

22. Lee, *supra* note 3, at 4.

23. Default risk occurs when the issuer is unable to make interest and or principal payment when due. Traditional municipal ARS have very low to non-existent default risk. However, there have been some notorious instances of public defaults. New York City defaulted on its notes in the 1970's and Washington Power Supply System defaulted on its notes in 1983. See Michael Quint, *SEC Assails Brokerages in '83 Default*, NEW YORK TIMES, Sept. 13, 1988, available at <http://query.nytimes.com/gst/fullpage.html?res=940DE5D7153CF930A1575AC0A96E948260> (last visited on September 26, 2008). There have been other cities which have faced crisis of this type. See, Axel Koester, *Today, Orange County . . .*, BUSINESSWEEK, December 19, 1994, available at

the possible loss of value²⁴. While default risk is usually minimized by getting bond insurance, the illiquidity risk,²⁵ which was thought to be a non-issue in the past, has turned out to be an unforeseen but real risk that was borne out of the sub-prime mortgage meltdown and the ensuing credit crunch in the financial markets.

B. DUTCH AUCTION

Throughout 2007 and early 2008, the ARS market has been characterized by failed auctions²⁶ and myriad investigations by federal and state agencies and officials.²⁷ The nuts and bolts of the ARS auction procedures are generally found in the offering documents²⁸ and are more popularly known as dutch auctions.²⁹ The auction procedures may also be found in "Broker-Dealer Agreements" and "Auction Agency Agreements."³⁰ An entity, except for the investor, may be an underwriter, dealer for auctions ("auction dealers"), agent for investor, and principal for its account.³¹ More disturbingly for an investor, the auction dealer wears many hats and in the process creates conflicts of interest, which an investor may not be aware of.³² In essence,

<http://www.businessweek.com/archives/1994/b340434.arc.htm>. For example, in 1994, Orange County in California defaulted on its payments to creditors in the amount of \$2.6 billion in reverse repurchase agreements. *Id.*

24. Loss of value means the security being sold at less than its par amount.

25. Liquidity risk is defined as "how much the sellers stand to lose if they wish to sell immediately against engaging in a costly and time consuming search." *See* Fabozzi, *supra* note 13, at 7. In other words, liquidity risk is the cost of not being able to sell a product.

26. Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-rate Securities*, THE NEW YORK TIMES, Feb. 15, 2008, <http://www.nytimes.com/2008/02/15/business>; Megan Johnston, *Auction-Rate Securities Suffer Total Insecurity*, FINANCIAL WEEK, Feb. 18, 2008, <http://www.financialweek.com/apps/pbcs.dll/article>; Christopher Condon & Michael McDonald, *Wall Street Draws Investor Ire over Auction-Rate Debt (update 1)*, Feb. 29, 2008, <http://www.bloomberg.com/apps/news?pid>; *Fund Manager is to Refinance Stalled Auction-Rate Notes*, May 22, 2008, <http://www.nytimes.com>, available at <http://www.lexisnexis.com/us/lnacademic/delivery>; John Carney, *Auction Failures Continue*, Feb. 15, 2008, http://dealbreaker.com/auction_rate_securities.

27. Lynn Hume, *Auction Agent Pay SEC 1.6m: Firms Violated Securities Laws*, THE BOND BUYER, Jan. 10, 2007, <http://www.lexisnexis.com/us>; *Auction-Rate Securities - the Latest Legal Rage?*, available at <http://blgs.wsj.com/law/2008/04/18/> (last visited Apr. 18, 2008); *Auction-rate Securities Markets Probed*, LOS ANGELES TIMES, Apr. 18, 2008, <http://www.latimes.com/business/>; *Oregon Investigating Auction-rate Securities*, PORTLAND BUSINESS JOURNAL, Apr. 24, 2008, available at <http://www.bizjournals.com/Portland/stories/2008/04/21>. *See* Browne, *supra* note 7; *SEC*, *supra* note 24.

28. *See* ML, *supra* note 8, at 5-7.

29. *See* *Dutch Auction*, <http://www.streetauthority.com/terms/d/dutch-auction.asp> (last visited on June 5, 2008); Michael Steinberg, *Mechanics of Auction-Rate Securities* (Feb. 21, 2008), <http://seekingalpha.com/article/65539-mechanics-of-auction-rate-securities>.

30. *See* ML, *supra* note 8, at 5-6.

31. *Id.* at 4.

32. There are many areas in which the auction agent's role and participation is problematic. Merrill Lynch, in its practices and procedures brochure, outlines many risks for the investors. It states that Merrill Lynch submits orders for its own account and encourages bidding by others, Merrill Lynch is appointed and paid by the issuer of the ARS as an auction dealer in the auction, it places bids to prevent an auction failure, and it shares portion of the auction dealers' fees with other brokers-dealers. *See* *Id.* at 15-17.

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the auction dealer submits the purchase orders to an auction agent,³³ which includes the purchase orders from the auction dealer's customers who are interested in purchasing the ARS of certain amount at a certain price. There is a submission deadline for an auction after which the auction agent submits all orders received and determines the clearing rate. The clearing rate is also known as the "auction rate" and understood to be the "lowest bid sufficient to cover all the securities that are exposed for sale in the auction."³⁴

Merrill Lynch, in its *Description of ARS Practices and Procedures*, provides an example for 1,000 shares of security (outstanding) and the following orders received by an auction agent and the determination of clearing rate:

Roll-at-Rate Orders ³⁵ (holders)	Sell Orders ³⁶ (holders)	Buy Orders ³⁷ (prospective holders)
20 shares at 2.90%	100 shares	40 shares at 2.95%
60 shares at 3.02%	100 shares	60 shares at 3.00%
120 shares at 3.05%	200 shares	100 shares at 3.05%
200 shares at 3.10%	Total = 400 shares	100 shares at 3.10%
200 shares at 3.12%		100 shares at 3.11%
Total = 600 shares		100 shares at 3.14%
		200 shares at 3.15%
		Total = 700 shares

In the above example, there are 600 shares for roll-at-rate orders and 400 shares of sell orders, thereby exposing all 1,000 shares. There are no hold orders³⁸ in the above example. The chart below shows how the clearing rate is determined:

33. The auction agent is usually a bank that serves an issuer through the auction dealer. Mainly, the auction agent takes buy and sell orders from buyers and sellers of ARS and informs the auction dealers of the result of the auction. *Id.* at 6.

34. *Id.* at 9.

35. A securities holder indicates to a dealer the amount of security he desires to hold, or a prospective holder indicates the amount of securities he desires to acquire at a desired interest or dividend rate. This is known as a "bid," and the person placing the bid is a "bidder." If the clearing rate is below the interest or dividend rate specified by a holder or a prospective holder, then the holder is required to sell his securities and the prospective holder does not acquire the securities. *See ML, supra* note 8, at 6-7.

36. An order by the holder of ARS to sell his securities regardless of the clearing rate at the auction. *Id.* at 7.

37. A bid in an auction by a prospective holder. *Id.*

38. A holder of securities indicates to the auction agent how many shares he desires to hold regardless of the clearing rate. *Id.* at 6.

<u>Number of Shares in Order</u>	<u>Rate Bid</u>	<u>Cumulative Shares</u>	<u>Winning/Losing Bids</u>
20	2.90%	20	Winning
40	2.95%	60	Winning
60	3.00%	120	Winning
60	3.02%	180	Winning
100	3.05%	280	Winning
120	3.05%	400	Winning
200	3.10%	600	Winning
100	3.10%	700	Winning
100	3.11%	800	Winning
<u>200(clearing rate)</u>	<u>3.12%</u>	<u>1000</u>	<u>Winning</u>
100	3.14%		<i>Losing</i>
200	3.15%		<i>Losing</i>

In the above scenario, the clearing rate is 3.12% (at 200 shares) because the rate of 3.12% clears the auction of all 1,000 shares (600 shares of roll-at-rate orders and 400 shares of sell orders) that are exposed for sale. Thus, the new (and the existing) holders of the ARS will receive 3.12% interest until the next auction. Also, the bidders who bid above 3.12% (100 shares at 3.14% and 200 shares at 3.15%) will be unable to purchase any shares in the auction (losing bids) and the bidders who bid 3.12% or lower will retain their shares or purchase new shares as indicated in their bids.

Also, auction procedures require that if a bid exceeds a "maximum rate,"³⁹ then the bid is a sell order for existing holders and the bid by prospective holder is not considered. Alternatively, if the bid is below a "minimum rate,"⁴⁰ then the bid is treated as though the bid specified the minimum rate.⁴¹ Then, the minimum rate is applied to all shares.

After determining the clearing rate, the auction agent allocates the securities first to (i) hold orders,⁴² then (ii) roll-at-rate⁴³ with buy orders that indicate a rate below the clearing rate, followed by (iii) roll-at-rate at the clearing rate, and finally (iv) buy orders⁴⁴ at the clearing rate. If there are more

39. Maximum rate is usually a rate above the LIBOR and stated in offering documents. The offering documents also may specify a different rate than the LIBOR. *See Id.* at 10.

40. Minimum rate is usually a fixed rate below the LIBOR or the applicable U.S. Treasury index rate. ML, *supra* note 8, at 10-11.

41. *Id.* at 10.

42. Hold orders are orders in which the shareholders specify that they wish to hold their shares regardless of the clearing rate. *Id.* at 22.

43. A roll-at-rate order is one in which the holder of ARS is required to sell his shares if the clearing rate sets below the rate that the holder specifies in his bid. *Id.* at 7.

44. A holder indicates the amount of security that he desires to continue to hold, or a prospective holder wishes to acquire a specified amount of security at or above a desired interest or dividend rate that the prospective holder specifies. *Id.* at 6.

bids for securities at the clearing rate than available for allocation, then the auction agent allocates the securities on a pro-rata basis.⁴⁵

C. AUCTION FAILURE

ARS markets have functioned without any serious complications since 1976.⁴⁶ However, recently the ARS markets have been characterized by market failures.⁴⁷ When the amount of securities available for sale exceeds the demand for purchase, then there is market failure.⁴⁸ In essence, there is a market failure "when seller supply outstrips buyer demand" or alternatively, "buys must equal or exceed sells"⁴⁹ and thus resulting in no setting of a clearing rate.⁵⁰ After ARS market failure, a maximum rate (instead of clearing rate) is applied to all securities until the next successful auction.⁵¹

The following example describes a market failure. There are 1,000 shares of ARS outstanding, of which 500 shares are hold orders, 350 shares are subject to roll-at-rates (at rates equal to or less than the maximum rate), 150 shares are subject to sell orders (one holder places an order to sell 30 shares and the other places an order to sell 120 shares), and 100 shares are subject to buy orders. Since the buy orders exceed the shares of sell orders by fifty, there is a market failure.⁵² In this hypothetical scenario, the buyer's order will be filled on a pro-rata basis of making available twenty shares of one holder ($100/150=0.67$, multiplying 0.67 to 30 shares) and eighty shares of another holder (again 0.67 times 120 shares) for sale.

Under another scenario,⁵³ there are 4,000 shares outstanding, out of which 1,000 units have holds (hold at any rate), thus making 3,000 units available

45. First to roll-at-rate buyers that require a rate at *clearing* rate and then buy *orders* that require a rate at the clearing rate. ML, *supra*, note 8, at 11.

46. The U.S. Treasury has used the dutch auction process to reset the dividend or interest rates on T-Bills and Treasury Notes since 1976. See W. Bartley Hildreth & C. Kurt Zorn, *THE EVOLUTION OF THE STATE AND LOCAL GOVERNMENT MUNICIPAL DEBT MARKET OVER THE PAST CENTURY* (2005). The present form of ARS resetting of dividend and interest rates has become more prominent around 2001. See Skarr, *supra* note 10. American Express registered the first ARS in 1984. See Lee, *supra* note 3, at 10.

47. John Carney, *ARS Lockdown: Banks Making It Even Worse*, http://dealbreaker.com/auction_rate_securities, (June 11, 2008).

48. See ML, *supra* note 8, at 11.

49. See Lee, *supra* note 3, at 6.

50. See *Id.* at 9. Another outcome is the "all hold" auction. This occurs when there is no bidder with roll-at-rate or sell order, thus for the next period a below-market rate is applied to all securities. The below-market rate is also known as the "minimum" or "all hold rate" and found in the offering documents. See ML, *supra* note 8, at 12.

51. Maximum rate is also a penalty rate. In ARS issued by the Port Authority of NY/NJ, the penalty rate for auction failure was 20% which equaled to \$300,000 in extra payments; however, for closed end funds the rate was lower. These maximum rates vary and may be also capped. See Lee, *supra* note 3, at 9. Municipal ARS penalty rates are approximately 10%. See Aaron Pressman, *Auction-Rate Securities: How to Get Unstuck*, BUSINESSWEEK, May 22, 2008, available at http://www.businessweek.com/print/magazine/content/08_22/b4086076696407.htm.

52. See ML, *supra* note 8, at 12. The first auction rate failure was in 1987 for MCorp preferred stock. See Lee, *supra* note 3, at 11.

53. See Lee, *supra* note 3, at 6.

for change of ownership. The bids received are 1,000 shares for sell, 500 shares for hold at 3%, 1,500 shares for hold at 4%, 700 shares for buy at 3.5% and 400 shares for buy at 4.5%. This auction succeeds because there are 1,000 shares available for sale and 1,100 shares bid for purchase--demand exceeds supply. Here, there is demand for 3,100 shares (500 shares at 3% plus 1,500 shares at 4% plus 700 shares bought at 3% and 400 shares at 4.5%) and supply of 3,000 shares for sale.

In the past, auction dealers would step into the market and buy shares that were not bought and avert any mismatch in the ARS auction.⁵⁴ The banks and brokerage houses would "stabilize" the market by buying excess inventory of the ARS shares.⁵⁵ While this activity has continued for some time, the question arises as to what occurrences in the last year and half have led banks and brokers to change their practice of purchasing excess ARS?⁵⁶ Commentators and experts in the field allude to many possible explanations. The most commonly discussed reason is the sub-prime mortgage crisis.⁵⁷ Since many of the banks had a considerable amount of sub-prime loans in the form of mortgage-backed securities bonds, with rising defaults, many banks had considerable losses on their balance sheets.⁵⁸ Consequently, the

54. See Johnston, *supra* note 26.

55. John Carney, *Auction-Rate Market Winners and Losers*, http://dealbreaker.com/auction_rate_securities, (Feb. 21, 2008).

56. The ARS market experienced many auction failures in the second half of 2007 and the trend continued well into first part of 2008. See Lee, *supra* note 3, at 13.

57. See Johnston, *supra* note 26. For an excellent discussion of sub-prime loans and the related crisis, See Faten Sabry & Thomas Schopflocher, *The Sub-prime Meltdown: A Primer* (June 21, 2007), available at

http://www.nera.com/image/SEC_Subprimeseries_Part1_June2007_Final.PDF. The sub-prime mortgage crisis originated when borrowers with poor credit or a high credit risk received loans with adjustable interest rates that they could not make payments on. These loans are usually for home purchases, or refinancing of existing loans and simultaneous borrowing of cash against the home equity of the borrowers. Seed of payment default occurred when the Federal Reserve Bank started to increase the interest rate in 2004 to reduce inflation. Since most of the borrowers had very low interest payments initially and when higher interest rate resulted due to the adjustable rate mortgages, the borrowers were unable to make the resulting payments. Additionally, the expectations of many borrowers was that if they were unable to make their monthly payments, they would be able to sell their homes at a higher price or refinance them with the increased value of their homes. Due to the decreasing market value of these homes, the expectation of increased home values never came to fruition, resulting in a severe crisis in the sub-prime market. Moreover, many lenders either misrepresented the information on the loan application and or never told the borrowers the exact terms of the loans. Since this crisis began, many sub-prime lenders have declared bankruptcy, are looking to sell, or closed. Some of the famous victims of the sub-prime crisis are Merrill Lynch, Bear-Stearns, Washington Mutual, and American Insurance Group.

58. As of January 2008, U.S. banks had to write-off almost \$50 billion in losses. Bank of America had the largest holding of mortgage backed securities portfolio, followed by Wachovia. See Julie Havis, *Mortgage Bonds Vulnerable to Bank Selling*, REUTERS, Jan. 31, 2008, available at <http://www.reuters.com/article/businessNews/idUSN3028793820080131?sp=true>. These losses, related to sub-prime mortgages, led to changes in senior management at many hedge funds and at Citigroup Inc., Merrill Lynch & Co. and UBS AG. See Kathleen Howley, *US Mortgage Delinquencies, Foreclosure at Record*, BLOOMBERG (July 1, 2008), www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=aQp.Msi3g.AA; See also Mary Gordon, *Citigroup Returning Billions to Investors*, ASSOCIATED PRESS, (Sept 08, 2008), available at [www://news.yahoo.com](http://www.news.yahoo.com).

lack of funds led to very little cash on hand to keep the ARS auction market afloat.

Another possible cause of ARS market failure is the downgrading or review of ARS⁵⁹ credit ratings. Mainly, as the sub-prime mortgage crisis spread, the credit agencies started questioning Monolines⁶⁰ ability to support their obligations. In prior years, as a result of various bankruptcies, the local and state governments turned to bond insurance as credit enhancement to provide added protection for municipal ARS.⁶¹ With the downgrading of the value of Monolines' insurance, the value of the ARS declined, and thus, potential holders of ARS demanded a higher rate than the maximum rate outlined in offering documents, leading to market failure.⁶²

Another expert speculated that “[g]uidance from the Securities and Exchange Commission and from the ‘big four’ audit firms told investors they couldn’t view ARS as equivalent to cash, so they [ARS] became less popular as a cash management vehicle for corporate treasuries.”⁶³ The ‘big four’ accounting firms advised many of their clients that ARS should be classified as short term investments rather than cash equivalents.⁶⁴ Also, the Financial Standards and Accounting Board determined that “cash equivalent” was too confusing, and that the term should be eliminated from cash flow statements.⁶⁵ Many experts believe that the reclassification was one of the main reasons the ARS sell-off started and led to the weakening of ARS demand. Moreover, Deloitte—one of the big four audit firms—even went to the extent of warning auditors that “many issuances of auction rate securities have been adversely affected by the turmoil in the credit markets; thus, their current fair value is at discount, sometimes substantial, from par value.”⁶⁶ Obviously, a warning of such nature would have a chilling effect on demand for ARS and even more so with the banks facing their own credit crunch for loans related to collateralized debt obligations. Eventually, the corporate owners decided to unload these securities causing ARS market failures. Unfortunately, some of these corporations could not unload these securities fast enough because of the sudden and unexpected illiquidity in the ARS mar-

59. See Lee, *supra* note 3, at 13.

60. Monolines are insurers which only write financial guarantee insurance contracts. Ambac, MBIA, FGIC, and XL Capital are major Monolines.

61. See Hildreth, *supra* note 46, at 149.

62. See Lee, *supra* note 3, at 13.

63. Tammy Whitehouse, *Cos. Face Auction-Rate Insecurities*, COMPLIANCE WEEK, (May 13, 2008), <http://www.complianceweek.com/index.cfm?printable=1&fuseaction=article.view.article>.

64. The reasoning is that ARS have long term maturities and there is risk of auction failure. See John Rieger, *Auction Rate Securities, Surprise for Treasurers!*, May 25, 2005, (.pdf copy on file with author).

65. See John Carney, *Did the Auditors Trigger the Sell-Off of the Auction-Rate Securities?*, (Feb. 22, 2008), http://dealbreaker.com/auction_rate_securities. See also, Marie Leone, *FASB Moves to Nix "Cash Equivalents"* (Mar. 22, 2007), <http://www.cfo.com>.

66. See Carney, *supra* note 65.

ket.⁶⁷ Individuals⁶⁸ and many government entities assumed that these securities were cash-like investments. When they could not liquidate their ARS holdings, these investors became very angry and brought lawsuits against banks and brokers for “unfair practices, inadequate disclosures, and securities law violations.”⁶⁹ Moreover, with the threat of actual lawsuits from ARS holders, the brokers/banks have refused to sell the ARS in the secondary market, thereby creating a catch-22 situation. If these brokers/banks allow the ARS holders to liquidate their securities at a loss, then that may lead the plaintiff ARS holders to establish liability against the banks⁷⁰ and provides an explanation for the banks’ refusal to let ARS holders redeem their holdings even if there is demand for ARS.

II. DISCLOSURE REQUIREMENTS FOR MUNICIPAL SECURITIES

Prior to determining liability, there is a need to provide background information regarding disclosure requirements for municipal securities, and precisely whether a broker must provide: (i) the offering/disclosure (prospectuses) documents, and (ii) the content of the disclosure documents.

The Securities Act of 1933 (“1933 Act”) generally requires that investors receive adequate information about securities being offered for public sale and prohibits misrepresentation and fraud in connection with the sale of these securities.⁷¹ In achieving these goals, the securities laws require that these securities shall be registered with the Securities and Exchange Commission (“SEC”). Therefore, auction-rate preferred securities must be accompanied by a prospectus when made available for public sale by closed-

67. *Id.*

68. Many individuals--young homeowners, retirees, small business owners, and small investors--with different types of ARS instruments have found their ARS frozen. They include a Wall Street Journal reporter, retiree from Google, a real estate investor, a lawyer, and persons who sold their businesses and invested funds in the ARS market. See Condon, *supra* note 26, at 67. Also, many states have sued or are determining whether they should bring lawsuits against many of the banks. Massachusetts and New York have brought lawsuits against many banks and brokers. See Liz Rappaport, *Cuomo Readies UBS Civil Lawsuit*, WALL STREET JOURNAL, July 23, 2008, page c3; Browne, *supra* note 7. Florida, Georgia, Illinois, Missouri, New Hampshire, New Jersey, Texas and Washington have formed an ARS task force which is being led by Massachusetts. North Dakota and Oregon had also started their investigation of ARS meltdown. See *Oregon Investigating Auction-Rate Securities*, PORTLAND BUSINESS JOURNAL (Apr. 24, 2008), available at <http://www.bizjournals.com/Portland/stories/2008/04/21/daily38.html?t=printable>.

69. See Pressman, *supra* note 51.

70. See Brown, *supra* note 7 (quoting statement of Bryan Lantagne, Securities Division Director for State of Massachusetts, Secretary of State). Bank of America, UBS, Wachovia, and many others that sold ARS were blocking attempts to create a secondary market for the securities. See Carney, *supra* note 47.

71. Section 17, paragraph (a) (2) of the 1933 Act states that:

“It is unlawful for any person in the offer or sale of any securities or any security-based swap agreement . . . by the use of any means or instructions of transportation or communication in interstate commerce or by use of the mails, directly or indirectly . . .

2. to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading;”

end funds.⁷² However, the securities offered by a federal, state, or municipality are exempted from the registration requirement.⁷³ Due to past problems in the municipal bond industry,⁷⁴ the SEC promulgated Rule 15c2-12 in 1989 under the anti-fraud provisions of the securities laws.⁷⁵ More specifically, the SEC based its decision under its authority in section 15(c) of the 1933 Act "to prevent such acts and practices as are fraudulent, deceptive or manipulative."⁷⁶ The Rule 15c2-12 release ("SEC Release") states that the rule is "designed to establish standards for the procurement and dissemination by underwriters of disclosure documents as means of enhancing the accuracy and timeliness of disclosure to investors in municipal securities."⁷⁷

Since the registration requirements of the securities laws are generally inapplicable to municipal securities, there is no formal administrative framework for the content of a primary offering disclosure.⁷⁸ However, industry groups such as National Federation of Municipal Analysts ("NFMA"), the Government Finance Officers Association ("GFOA"), and the Securities Industry and Financial Markets Association ("SIFMA") have issued guidelines and content for appropriate disclosures to help the investors⁷⁹ in accor-

72. <http://www.sec.gov/answers/mfinfo.htm#prospectus>, (last visited July 31, 2008).

73. See Government Finance Officers Association, *15TH ANNIVERSARY OF THE DISCLOSURE GUIDELINES FOR STATE AND LOCAL GOVERNMENT SECURITIES*, (1990). The first *Guidelines for Offerings of Securities by State and Local Government* was written in 1975 following the New York City general obligation bond default in 1975.

74. The largest default in history of bond market was the default of Washington Public Power Supply System ("WPPSS") bonds for \$2.25 billion. WPPSS wanted to build five nuclear power plants to supply electricity but built only one. See *Municipal Bonds and Defaults*, http://www.publicbonds.org/public_fin/default.htm, (last visited on Aug. 1, 2008). An SEC investigation revealed that there were serious problems in the disclosure practice observed by the professionals participating in WPPSS bond offering. There have been other municipal bond defaults; however, the collapse of WPPSS bonds was the primary reason for the adoption of Rule 15c2-12.

75. See 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (hereinafter "Section 10b of the 1934 Act"). Thus, defendants can be sued by the SEC, federal prosecutors, and plaintiffs in private lawsuits. See National Federation of Municipal Analysts White paper on Federal Securities Law Relating to Municipal Securities, Mar. 2008, at 6. In essence, while the registration and reporting requirement is not applicable to municipal securities, the antifraud provisions of section 17(a) of 1933 Act and section 10(b) of 1934 Act are still applicable. See 15 U.S.C. § 77u(a); Interpretive Guidance on the Antifraud Provisions, SEC Release No. 33-7049; 34-33741 (Mar. 9, 1994).

76. Adoption of Rule 15c2-12, SEC Release No. 34-26985 (June 28, 1989) (hereinafter "Rule 15c2-12").

77. *Id.* However, this rule is not applicable to underwriters participating in primary offering of municipal securities in aggregate of less than \$1 million. The rule also exempts underwriters participating in primary offering to no more than 35 sophisticated investors in large denominations, or have short-term maturities (nine months or less), or have short term tender of put features. A put or tender feature allows the bondholder to require the purchase of the bond by the issuer or a third party at a certain time, or prior to maturity or upon satisfaction of certain events or conditions. See Glossary of Municipal Terms, *supra* note 15. Municipal securities do not have a put option. See Skarr, *supra* note 10, at 4.

78. See National Federation of Municipal Analysts, *White Paper on Federal Securities Law Relating to Municipal Securities*, Mar. 2008, at 11 (hereinafter "NFMA White Paper").

79. *Id.* There are other organizations that provide guidelines for their members such the Healthcare Financial Management Association ("HFMA"), National Association of State Auditors, Comptrollers and Treasurers ("NASACT"), National Council of State Housing Agencies ("NCSHA"), and the National Association of Local Housing Finance Agencies ("NALHFA"). Also, in different industries the disclo-

dance with the requirements of SEC Rule 15c2-12.⁸⁰ NFMA, in its white paper on federal law regarding securities, states that the disclosure statements must have material information and no material omissions.⁸¹ This is essentially the language of section 17 (a)(2) of the 1933 Act. The SEC Release goes on to state that municipalities "are subject to prohibition against false and misleading disclosures"⁸² and emphasizes the need for timely and material information concerning municipal issuers and securities. In addition to these rules, the SEC recommends that the market participants continue to provide information via voluntary disclosure guidelines such as those provided by the GFOA.⁸³ The GFOA municipal securities disclosure guideline calls for (i) a description of the securities, (ii) information about credit enhancement and the financial and business information about the issuer of the enhancement, (iii) a description of the issuer, (iv) the obligations and business information of the private profit making and non-profit conduit issuers, (v) a description of the issuer's outstanding debt, and the prospective debt burden and the rate of its retirement, (vi) and a description of basic documents such as the indentures, trust agreements, other financial documents such financial practices, legal matters, tax considerations and other miscellaneous matters such as credit ratings, underwriting and agreements with experts and financial advisors.⁸⁴ The anti-fraud provisions prevent any persons (municipal issuers, brokers, dealers and municipal securities dealers) from making false or misleading statements of a material fact, or omitting any material facts necessary to make statements made by the above persons not misleading.⁸⁵ Additionally, the above persons are subject to regulations adopted by the SEC and related to fraud under section 15(c) (1) and (2) of

ures vary depending on their needs, i.e., the student loan, housing and healthcare industry provide quarterly financial statements. *Id.* at 12.

80. Rule 15c2-12 requires that in primary offerings (i) underwriters obtain and review "Near Final" Official Statements, (ii) distribute copies of Primary Official Statements in Non-Competitive Offerings, (iii) receive copies of Final Official Statements, and (iv) provide copies of the Final Official Statements to potential customers. Furthermore, in 1994, the SEC amended Rule 15c2-12 to include continuing disclosure requirement. The continuing disclosure requires the broker-dealer and indirectly the issuer to "include both periodic reporting of financial and operating information and disclosure of the occurrence of any of a specified list of 11 events if material." SEC Rule 15c2-12. *See* NFMA White Paper, *supra* note 78, at 16-17. The eleven material events are (a) principal and interest rate delinquencies, (b) non-payment related defaults, (c) unscheduled draws on debt service reserves reflecting financial difficulties, (d) unscheduled draws on credit enhancements reflecting financial difficulties, (e) substitution of credit or liquidity providers, or their failure to perform, (f) adverse tax opinion or events affecting the tax-exempt statutes of the security, (g) modifications to rights of security holders, (h) bond calls, (i) defeasances, (j) release, substitution, or sale of property securing repayment of the securities, and (k) rating changes. *See Id.* at 17; Municipal Securities Disclosure, SEC Release no. 34-34961, *available at* <http://www.sec.gov/rules/final/adpt6.txt>, (Nov. 10, 1994), at 53.

81. *See* NFMA White Paper, *supra* note 78, at 12.

82. *See generally* SEC Release No. 33-7049, *supra* note 75.

83. Municipal Bond Disclosure--The Story You are Required to Tell, <http://www.munibondadvisor.com/Disclosure.htm>, (last visited Aug. 7, 2008).

84. *See* SEC Release No. 33-7049, *supra* note 75, at 130.

85. *Id.* at 128.

the Securities Exchange Act of 1934 ("1934 Act").⁸⁶ The municipal securities dealers (banks and securities firms only) are also subjected to the rules of the Municipal Securities Rule Making Board.⁸⁷

III. BASIS OF LIABILITY

A. ALLEGATIONS IN BURTON⁸⁸

Due to ARS market auction failures and the subsequent illiquidity in this market, brokers/bankers such as Merrill Lynch, UBS, Deutsche Bank, TD Ameritrade, Citibank, and Wachovia have been sued by irate ARS holders.⁸⁹ This article will discuss two specific lawsuits: *SEC v. Tzolov*, and *Burton v. Merrill Lynch & Co., Inc.* On May 31, 2006, fifteen well-known broker-dealer firms settled SEC charges involving violations of section 17 (a)(2) of the 1933 Act in the ARS market.⁹⁰ In *Burton*, the plaintiff's claims arose from alleged violations of sections 10(b)⁹¹ and 20(a)⁹² of the 1934 Act and Rule 10b-5⁹³ promulgated by the SEC against defendants Merrill Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith Inc. (hereinafter "Merrill").⁹⁴ In Count I, the plaintiff alleged that Merrill violated section 10(b) of

86. *Id.* See also 15 U.S.C. § 78(c)(1)(2).

87. The Municipal Securities Rulemaking Board was established by Congress via the Securities Acts Amendments of 1975 to develop rules regulating securities firms and banks involved in underwriting, trading, and selling municipal securities, bonds and notes issued by states, cities, and counties or their agencies to help finance public projects. The Board is a self-regulatory organization that is subject to oversight by the SEC. It does not have authority over municipal issuers or investors. See About the MSRB, <http://www.msrb.org/msrb1/whatsnew/default.asp>, (last visited Sept. 28, 2008).

88. *Burton v. Merrill Lynch & Co., Inc.*, No. 08-03037 (S.D.N.Y. filed Mar. 25, 2008).

89. Katie Benner, *Investors Desperate for Cash Turn to Courts*, <http://cnmoney.printhis.clickability.com> (Apr. 1, 2008). See also Mary Gordon, *Citibank Returning Billion to Investors*, ASSOCIATED PRESS (Aug. 7, 2008), available at <http://news.yahoo.com>.

90. The firms were ordered to cease & desist and agreed to pay over \$13 million in penalties. The SEC had brought the following charges: (i) allowing customers to place open or market order auctions, (ii) intervening in auctions by bidding for a firm's proprietary account or asking customers to make change orders in order to prevent failed auctions, to set a "market" rate, or to prevent all-hold auctions, (iii) submitting or changing orders, or allowing customers to submit or change orders, after auction deadlines, (iv) not requiring certain customers to purchase partially-filled orders even though the orders were supposed to be irrevocable, (v) having an express or tacit understanding to provide certain customers with higher returns than the auction clearing rate, and (vi) providing certain customers with information that gave them an advantage over other customers in determining what rate to bid. The violators were Bear, Stearns & Co., Inc., (acquired by JP Morgan & Chase Co., unrelated to ARS violations in May 2008), Citigroup Global Markets, Inc., Goldman Sachs & Co., J.P. Morgan Securities Inc., Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner & Smith Inc., Morgan Stanley & Co. Inc./Morgan Stanley DW Inc., RBC Dain Rauscher Inc., A.G. Edwards & Sons, Inc., Morgan Keegan & Company, Inc., Piper Jaffray & Co., SunTrust Capital Markets Inc., Wachovia Capital Markets, LLC, and Banc of America Securities LLC. These violations occurred during January 2003 to June 2004. Under the settlement, the broker-dealers agreed to cease & desist orders providing for censures in addition to the monetary fines. See 15 Broker-Dealer Firms settle SEC Charges Involving Violative Practices in the Auction Rate Securities Market, SEC Release No. 2006-83 (May 31, 2006).

91. 15 U.S.C. § 78j(b).

92. 15 U.S.C. § 78(t)(a).

93. 17 C.F.R. 240.10b-5.

94. See *Burton*, No. 08-03037 at 2.

the 1934 Act and Rule 10b-5. Rule 10b-5, which implements section 10(b) of the Securities 1934 Act states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.⁹⁵

Moreover, section 15B(c)(1) of the 1934 Act states that: “No broker, dealer, or *municipal securities dealer* shall make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any *municipal security* in contravention of any rule of the Board.”⁹⁶ (emphasis added). Finally, section 12(2) of the 1933 Act⁹⁷ states that

§ 771. Civil liabilities arising in connection with prospectuses and communications

Any person who . . . (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or *oral* communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, . . . shall be liable . . . to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon,

95. 17 C.F.R. § 240.10b-5.

96. 15 U.S.C. § 78-4(c)(1).

97. 15 U.S.C. § 771.

upon the tender of such security, or for damages if he no longer owns the security. (emphasis added).⁹⁸

The above statutes are applicable to municipal ARS. In *Burton*, the plaintiff alleges that the defendant “represented to investors in its written materials and uniform sales presentations by financial advisors that auction rate securities were the same as cash and were highly liquid, safe investments for short-term investing.”⁹⁹ Similar allegations made by other plaintiffs stated that “clients were assured that investments were risk-free and completely liquid. The misrepresentation and omissions occurred at the broker level.”¹⁰⁰ The misrepresentations occurred orally in addition to broker-dealer written materials, making section 12(2) of the 1933 Act applicable.

In order to sustain a misrepresentation claim under Rule 10b-5, the plaintiff must plead and prove that “(1) in connection with the purchase or sale of a security; (2) defendant, acting with scienter; (3) made a material misrepresentation or . . . a material omission.”¹⁰¹ There is no question that ARS is a security, and the misrepresentation is in connection with the purchase or sale of a security.

The first inquiry is the presence of scienter. “[A] plaintiff must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁰² (internal quotations omitted). The allegations by the plaintiff clearly indicate that the defendants had the requisite scienter because the written materials stated that ARS were cash-like and the financial advisors repeated the same during their presentations.¹⁰³ The intent must have been to deceive or manipulate the investors in purchasing the ARS, which the investors otherwise may have hesitated in purchasing if they knew that these instruments were not liquid and or may lose value. “The scienter needed with securities fraud is intent to deceive, manipulate or defraud, or knowing misconduct.”¹⁰⁴

The main inquiry, however, is whether there was a material misrepresentation. The first step is to determine the meaning of material. A material fact is simply “the facts investors would find important in making an investment decision.”¹⁰⁵ The district court in *Gridley v. Sayre & Fisher Co.* stated that under the 1933 Act, a material fact “must concern information

98. *Id.*

99. *Burton*, No. 08-03037 at 8.

100. *See Benner*, *supra* note 89.

101. *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 189 (2d Cir. 1998).

102. *Press v. Quick & Reilly*, 218 F.3d 121, 130 (2d Cir. 2000).

103. *See Burton*, No. 08-03037 at 8.

104. *Press v. Chemical Ins. Serv. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999); *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 620 (4th Cir. 1999) (stating that “[t]o establish scienter, a plaintiff must still prove that the defendant acted intentionally, which may perhaps be shown by recklessness”); *Maclean v. Huddleston*, 459 U.S. 375, 390, n. 30 (1983) (the proof of scienter may be inferred from circumstantial evidence).

105. Q&A Small Business, <http://www.sec.gov/info/smallbus/qasbsec.htm> (last visited Aug. 04, 2008).

about which an average prudent investor ought reasonably be informed of before purchasing a security."¹⁰⁶ A commonly used and accepted definition is that something is a material fact if "its disclosure would have been viewed by a reasonable investor as having significantly altered the total mix of information made available."¹⁰⁷ The SEC states that what is material is measured by an objective standard.¹⁰⁸ An omitted fact is considered material "if there is a substantial likelihood that, under all circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable (investor)."¹⁰⁹ Finally, the inquiry of materiality is a mixed question of law and fact and requires application of a legal standard to a particular set of facts.¹¹⁰ Thus, the question that arises in *Burton* is whether the defendants omitted material fact or misrepresented a material fact. In *Burton*, in addition to the allegation of misstating the true nature of ARS- that it is cash equivalent and liquid-the plaintiff also alleged that the defendants "omitted material facts about its role and the auction market."¹¹¹ The defendants failed to disclose that the ARS the defendants were selling was only liquid because the defendants and other brokers-dealers were artificially supporting and maintaining the ARS market to maintain the appearance of liquidity and stability; that the defendants were acting on behalf of the issuer; for defendants own account; and the defendants and other brokers-dealers routinely intervened to set rates and prevent all-hold auctions and failed auctions.¹¹²

At the heart of the lawsuits is whether the banks and brokerage houses misrepresented the true nature of ARS, and failed to properly disclose the liquidity risk and the defendants' material role in the auction market to the investors.¹¹³ In *Burton*, the plaintiff alleged that:

- (i) defendants represented to investors that ARS were equivalent to cash or money markets; were highly liquid, safe investments for short-term investing; and were suitable to any investor with at least \$25,000 of available cash and as little as one week to invest; and
- (ii) defendants knew, but failed to disclose to investors, material facts about auction rate securities.¹¹⁴

106. 409 F. Supp. 1266, 1270 (D.S.D. 1976).

107. SEC v. Paro, 468 F.Supp. 635, 646, (N.D.N.Y. 1979).

108. See SEC Release No. 33-7049, *supra* note 74, at 129.

109. *Id.* at 129-30. See also *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

110. See *TSC Industries* at 450. SEC has determined that (i) failure to disclose intended use of proceeds; (ii) failure to accurately disclose financial condition; (iii) failure to disclose financial interest in a transaction; and (iv) failure to disclose potential taxability of bonds as material. See NFMA White Paper, *supra* note 77, at 12.

111. See *Burton*, No. 08-03037 at 7.

112. *Id.* at 9.

113. See *Whitehouse*, *supra* note 62.

114. See *Burton*, No. 08-03037 at 8.

The plaintiff further alleged that the defendants knew, but failed to disclose that these auction rate securities were not cash alternatives, but instead, complex, long-term financial instruments.¹¹⁵ The other material fact alleged was that "[d]efendants knew, but failed to disclose that auction rate securities were only liquid at the time of sale, and that the defendants were artificially supporting and manipulating the auction to maintain the appearance of liquidity and stability."¹¹⁶ Moreover, the defendants knew but failed to disclose that auction rate securities would become illiquid when the defendants stopped supporting the ARS auction market.¹¹⁷

In order to determine whether the defendants in *Burton* misrepresented the true nature of ARS, one must determine what is cash equivalent. *The Lawyers Journal*,¹¹⁸ in discussing an asset allocation of investments states that "cash equivalents" are cash and money market accounts.¹¹⁹ This definition of "cash equivalent" does not raise the issue of illiquidity, since a depositor can easily withdraw up to \$100,000 with reasonable notice.¹²⁰ In *Great Adventure, Inc. v. Div. of Taxation*,¹²¹ the Tax Court of New Jersey held that "equivalent" meant "equal in value," while discussing the amount of taxes charged for a park admission ticket.¹²² Casino Control Commission/Casino Reinvestment Development Authority of New Jersey, defined "cash equivalent" to include certified checks, cashiers checks, treasurers' checks, recognized travelers checks or recognized money orders.¹²³ Again, these are forms of cash with no liquidity risk. However, in Montana, cash equivalent is defined slightly differently and it moves ever so slightly from the zero liquidity risk definition. In Montana, "[c]ash equivalent" means any short-term, highly liquid investment that is: (a) readily convertible to known amounts of cash; and (b) so near its maturity that it presents insignificant risk of changes in value because of changes in interest rates. Only an investment with an original maturity of three months or less qualifies as "cash equivalent."¹²⁴ In the Montana definition, part (a) does not seem to present any liquidity risk, however, under section (b) there is a move away from ready conversion to cash. Clearly, ARS has significant risk of changes in interest rates because the rates are reset at different periods. Also, since

115. *See Id.*

116. *Id.*

117. *See Id.* at 1.

118. Justin B. Goldstein, *Investing 101: Getting Started with Asset Allocation of your Investments*, 4 LAWYERS J. 6 (2002).

119. *Id.* Money market accounts are defined as interest earning savings accounts offered by banks that are insured by Federal Deposit Insurance Corporation for up to \$100,000.00 *See* Richard Loth, *Do Money Market Funds Pay?*, <http://www.investopedia.com/articles/02/120602.asp?viewall=1> (last visited Sept. 28, 2008).

120. For cash withdrawal, banks usually require a one or two days advanced notice.

121. *Great Adventure Inc. v. Director, Division of Taxation*, 7 N.J. Tax 58, 16 (1984).

122. *Great Adventure*, 7 N.J. Tax at 16.

123. N.J. ADMIN. CODE, § 19:45-1.1 (2007).

124. MONT. CODE ANN. § 33-28-101 (2007).

ARS is a long-term security with maturity dates of 20 to 30 years, under Montana's Code, it cannot be considered to be cash equivalent.

Finally, in *Cowden v. Commissioner*, the Fifth Circuit Court of Appeals held that "[a] promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument . . . might be denied a ready acceptance in the market place."¹²⁵ A promissory note is "[a]n unconditional written promise, signed by the maker, to pay absolutely and at all events a sum certain in money, either to the bearer or to a person therein designated or his order, at a time specified therein, or at a time which must certainly arrive."¹²⁶ The promissory note is negotiable "if signed by the maker and containing promise to pay a sum certain in money or either on demand or at a definite time and payable to order or bearer."¹²⁷ The Fifth Circuit goes on to define what is equivalent to cash by stating that:

If a promise to pay of a solvent obligor is *unconditional* and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is equivalent of cash¹²⁸ (emphasis added).

The promise to pay ARS principal and interest is conditional, because the interest rate on the ARS is dependent upon the results of an auction, a condition of payment that is not assignable. Furthermore, these securities are not sold at discount but rather at par. Given *Cowden's* definition, one can conclude that ARS is not a cash equivalent. Also, ARS is not a promissory note since there is no certainty as to the interest payments. Analyzing the various legally accepted definitions of cash equivalents above, it can be concluded that ARS is not cash or cash-like or cash-equivalent. Therefore, ARS is not cash, and it can be concluded that the defendants in *Burton* misrepresented the true nature of ARS.

The defendants knew that ARS was not a cash equivalent investment and by falsely stating them as such, induced the plaintiff to buy these securities to their detriment.¹²⁹ The detriment to the plaintiff was the potential illiquidity and loss in value of these securities when ARS auctions fail.

A defendant can be found liable for violating Rule 10b-5(b) if they meet the three requirements stated earlier.¹³⁰ A defendant can be also found liable for fraud under Rule 10b-5. A plaintiff must show that with the sale or pur-

125. 289 F.2d 20, 24 (5th Cir. 1961). See also Robert B. Chapman, *A Matter of Trust, or Why "ERISA-QUALIFIED" is "NONSENSE UPON STILTS": The Tax and Bankruptcy Treatment of Section 457 Deferred Compensation Plans As Exemplar*, 40 WILLAMETTE L. REV. 1 (2004).

126. BLACK'S LAW DICTIONARY 1214 (6th ed. 1990).

127. *Id.*

128. See Chapman, *supra* note 125, at 15.

130. See *Burton*, No. 08-03037 at 12.

130. See *Grandon*, 147 F.3d at 102.

chase of the security (1) the defendant made a false statement or omission of material fact, (2) with scienter, (3) upon which the plaintiff justifiably relied, and (4) that the misrepresentation proximately caused the plaintiff's damages.¹³¹ Here, the defendants intended the plaintiff to act on the reliance of his misrepresentation.¹³² The first two requirements are discussed *supra*, but as to the third requirement of justifiable reliance, the plaintiff bought the ARS based on the misrepresented fact of these securities being cash equivalent and cash-like. Other ARS holders have stated that they wanted something that is safe and "as good as cash."¹³³ It is clear that if the ARS was not liquid, the plaintiff would not have invested in these securities. Moreover, in the past, there had never been an auction failure, and the investors were previously able to buy and sell as they wished, as there was no way one could speculate on the illiquidity of these shares. Thus, it can be shown that the plaintiff's reliance was justifiable.

The fourth requirement that must be satisfied is that the defendants' false statement proximately caused the plaintiff's damages. This factor may be difficult to prove, since the primary damage that the plaintiff and others have accrued is the opportunity to use the money for some other purpose. This factor may be the biggest obstacle in terms of recovering any damages from the defendants. This is critical, because this is the likely justification for some broker-dealers' refusing to allow the plaintiff to sell his securities at a loss.¹³⁴ Nevertheless, it can be argued that because of the lack of the cash, the ARS holder had to borrow money and pay interest that they would have avoided if they had access to funds from sale of their securities. In other words, the amount of their loss is the opportunity cost¹³⁵ of being unable to use their money.

131. Hillson Partners Ltd. P'ship v. Adage, Inc., 42 F.3d 204, 208 (4th Cir. 1994).

132. See Gretchen Morgenson, *If You Can't Sell, Good Luck*, THE NEW YORK TIMES, (Mar. 30, 2008), available at <http://www.nytimes.com/2008/03/30/business/30gret.html?pagewanted=print>, (stating that "investors in these securities almost certainly relied on their brokers' assurances that the stocks were safe and sound. That is because the sales were not accompanied by prospectuses outlining the risks").

133. *Id.* The author of the article also states that persons with whom she spoke to "wanted a place to stash their short-term cash, not investment for life." *Id.* It also states an experience of an investor who contends that UBS Financial Services put her shares in ARS even though she repeatedly told the broker that safety and access to her money were paramount issues. *Id.*

134. See Carney, *supra* note 47 (quoting Bryan Lantagne, Massachusetts Secretary of State William Gavin "[b]y allowing customers to sell at a discount, the banks allow customers to establish damages"). It also describes efforts by Bank of America, UBS, Wachovia and others, in their attempt to block creation of secondary market for ARS, and justifying it by stating that banks are doing so to prevent customers from selling at a discount and needless loss. Another reason the banks want to avoid trading of ARS in secondary markets is that if the ARS began to trade at a discount in the secondary markets, the banks have to state these values at market rate, thus the beginning of subsequent huge write-downs on their balance sheets.

135. Opportunity cost is the highest valued alternative that must be given up to engage in an activity. See R. Glenn Hubbard & Anthony Patrick O'Brien, MICROECONOMICS, (2nd ed. 2008). In economics, while determining cost, the economists always consider the opportunity cost as real cost of an opportunity that is foregone in choosing the activity the person engages in.

An example of this situation would be if the plaintiff needed \$500,000 to purchase a retirement house. If the plaintiff had the money, he could just go and buy the house. Now, because of the ARS market collapse, the plaintiff has to instead borrow funds and make interest payments on that amount. If he has good financial credit, then he is able to get a loan at market rate of 6% interest. Here, there is actual pecuniary loss since the plaintiff did not receive his \$500,000. He has to now pay the interest that he could have avoided if he was able to redeem his ARS holdings. Alternatively, if the plaintiff had cash, he could have invested those funds in a better paying instrument, thereby foregoing interest income but for the ARS market failure.

Additionally, other investors have alleged that the value of their securities is not at par or rather valued at discount because of auction failure and illiquidity in the ARS market. That is, if the securities are sold at a value (market price during auction collapse) less than their par value, then broker-dealers/banks would be liable for paying the difference.

In *Burton*, the plaintiff also alleged that the defendant, Merrill Lynch & Co., Inc., acted as a control person of the second defendant Merrill Lynch, Pierce, Fenner & Smith Inc., within the meaning of section 20(a) of the 1934 Act.¹³⁶ Pursuant to "sections 20 (a) of the [1934] Exchange Act, 15 U.S.C. § 78t(a), and section 15 of the [1933] Securities Act, 15 U.S.C. § 77o, a person who controls another person or entity is jointly & severally liable with the controlled entity unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."¹³⁷ It is established that Merrill Lynch is the parent entity and Merrill Lynch, Pierce, Fenner & Smith Inc., is a registered broker-dealer of Merrill Lynch & Co., Inc.¹³⁸ If the allegations are true that Merrill Lynch & Co., Inc. was provided with or had unlimited access to copies, press releases, public filings and the parent company--Merrill Lynch & Co., Inc.--did not take any steps to correct or prevent the dissemination of misleading statements, then the parent company will be held liable.

B. *SEC vs. TZOLOV*¹³⁹

In late 2008, the SEC brought a lawsuit against defendants Tozlov and Butler¹⁴⁰ for violation of sections 17(a) of the 1933 Act¹⁴¹ and section 10(b) of the 1934 Act¹⁴² and Rule 10b-5.¹⁴³ This section of this article will only

136. *Burton*, No. 08-03037 at 15.

137. *SEC vs. Fitzgerald*, 135 F. Supp.2d 992, 1004-05, (N.D.Cal. 2001).

138. Merrill Lynch & Co., Inc., Annual Report 2007, at 152,

<http://www.ml.com/annualmeetingmaterials/2007/ar/download.asp>, (last visited Sept. 13, 2008).

139. *SEC v. Tzolov*, No. 08-7699, (S.D.N.Y. filed Sept. 03, 2008).

140. *SEC v. Tzolov*, No. 08-7699.

141. 15 U.S.C. § 77q(a)

142. 15 U.S.C. § 78j(b)

143. See *SEC*, *supra* note 23, at 2; 17 C.F.R. § 240.10b-5.

discuss the liability under section 17(a), since section 10(b) and its requirements have already been discussed *supra*.

Defendants Tozlov and Butler worked for Credit Suisse Securities (USA) LLC and purchased ARS on behalf of their clients.¹⁴⁴ The SEC, in its lawsuit, alleged that Tozlov and Butler were only authorized to purchase federally guaranteed student loans, and in contravention of customers' instructions, purchased the more risky sub-prime mortgages, collateralized debt obligations ("CDOs") and corporate bonds.¹⁴⁵ Moreover, it was alleged that Tozlov & Butler changed the names of ARS instruments that they purchased for their clients.¹⁴⁶ For example, Butler sent an e-mail that stated that he made a purchase of a security that was issued by Greenpoint Student Assistance, wherein it was actually issued by Greenpoint Credit LLC, which was backed by loans on mobile homes and not considered a federally guaranteed student loan.¹⁴⁷ Tozlov similarly sent an e-mail to a client that stated that the security purchased for the client's account was from South Coast Funding St. Loan rather than by South Coast Funding V Ltd., which was supported by collateralized sub-prime mortgages.¹⁴⁸

Section 17(a) of the Securities Act states the following:

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act¹⁴⁹) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.¹⁵⁰

To establish violation under section 17 (a)(1) of the 1933 Act,¹⁵¹ the SEC must show that "defendants acted with scienter, or an intent to deceive, ma-

144. See SEC, No. 08-7699 at 1.

145. See SEC, *supra* note 23 at 4.

146. See SEC, No. 08-7699 at 2.

147. *Id.* at 9.

148. *Id.* at 10.

149. 15 U.S.C. § 78(c).

150. 15 U.S.C. § 77u(a).

151. 15 U.S.C. § 77q(a).

nipulate, or defraud."¹⁵² Scierer can be established by showing that the defendants acted recklessly.¹⁵³ "Reckless conduct is . . . an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and sellers that is either known to defendant or is so obvious that the [defendants] must have been aware of it."¹⁵⁴ Here, the exchange of e-mail messages and directing assistants to change the names of the securities certainly seem to meet the recklessness requirement under scierer. Tzolov and Butler must have been aware that one cannot change the name of the underlying product that supported the securities they purchased. Indeed, an extreme departure from the standard of ordinary care that clearly mislead their clients in accepting those purchases.

To establish violations of sections 17(a)(2) or (3), the plaintiff SEC does not need to show scierer.¹⁵⁵ Rather, the plaintiff needs to show that the defendants acted negligently.¹⁵⁶ Negligence in securities market context is defined as the failure to exercise reasonable care or competence.¹⁵⁷ Here, the defendants exercised no care, and have only shown competency in taking steps that deprives confidence in their professionalism.

III. CONCLUSION

The legal analysis leads one to conclude that the defendant brokers violated many securities laws if all allegations are proven true in a court of law. It is obvious that the defendants misrepresented or lied about the true nature of ARS. In a nutshell, the professionals who marketed, promoted and sold ARS communicated exactly the opposite of true character of ARS in terms of liquidity and value. Overall, the ARS industry and the brokers communicated a safe, liquid investment while the reality was completely opposite. One of the reasons advanced by the defendants' conduct is that since there has never been any market failure (or auction failure) in the thirty-three year history of ARS, they could not have imagined the ARS to be a risky instrument. Even if there had been no ARS market failure in the past, it does not take away from the fact that these instruments had inherent risk. The brokers knew or should have known that once they artificially stopped supporting the ARS auctions, the market for ARS would collapse as it happened in 2007 and much of 2008.

A second, and more plausible, argument against the plaintiffs' allegations is that the plaintiffs, especially when the allegation is only of misrepresentation of ARS as cash equivalent, should have known better than to believe

152. See *SEC*, 135 F. Supp.2d at 1028.

153. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990).

154. *Hollinger*, 914 F.2d at 1569. (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977)).

155. *Id.*

156. *Id.*

157. *Id.*

that ARS were cash equivalents. In other words, if these instruments were like cash, then the question arises as to why someone would call them cash equivalents. The plaintiffs are akin to an accredited investor, since the minimum investment amount is \$25,000. The investors are not the type who can be taken advantage of by wily brokers. ARS investors have the means to hire lawyers, accountants and other professionals who could or should have told them about the illiquidity risk.

Finally, the third argument against the plaintiffs' claim is that any person with basic knowledge of finance ought to know that high reward means high risk, or in the oft repeated saying--no pain, no gain. Since the interest rates for ARS were higher than the interest rates in bank savings accounts and for treasury-bills, there has to be some kind of risk, otherwise the interest rate for the ARS has to be same as the bank savings accounts/treasury bills.

Overall, the analysis of this issue leads to the conclusion that the SEC and other state officials have rightfully prosecuted these reckless acts and intervened in this market to protect investors. These actions will lead to improving the liquidity of the \$380 billion ARS market and more importantly bring confidence to this market. The continued success of ARS market is critical for our society, since a majority of the ARS securities are investments in municipalities and other governmental institutions. Municipalities and other governmental institutions provide critical services which are not provided by private actors. Given all of this information, however, it has to be noted that investors in the ARS market are sophisticated and knowledgeable about risk and return. Therefore, the ARS holders must also share the blame for not appreciating the illiquidity and other risks. Arguably, if the ARS holders are successful in these lawsuits, this may lead to a chilling effect on financial innovations. It is an old axiom that higher the risk, higher the reward. There is no free ride.