

FUND STRATEGY

September 22, 2008

Stateside: 'Choirboys aren't running Wall Street'

Events continue to shake Wall Street to its foundations but some may have overlooked the failure of the \$330 billion auction rate securities market - the result of yet more shady practices.

Seeds of destruction

The failure of the auction rate securities (ARS) market pales compared with the mortgage tsunami, the government takeover of "Frannie", or the implosions of major banks. Yet even in these tumultuous times, a \$330 billion (£184 billion) market can hardly be considered puny, and the consequences could wreak ugly fallout. In addition, some nasty moral practices have come to light, a reminder that choirboys aren't running Wall Street.

In past weeks, major banks have reached settlements with government regulators, including the States of Massachusetts and New York, to buy back the frozen ARS securities from investors, compensate individuals for losses, and pay other penalties. Citigroup, JP Morgan, Morgan Stanley, UBS and Wachovia have all made such deals. The settlements benefit individual rather than corporate investors, who are deemed to be more sophisticated, and should have known better.

The ARS market had functioned smoothly for decades, providing debt instruments that reset periodically at auctions. Issuers, a ragtag band of municipalities, closed-ended funds and the student loan sector, used them as a quick and easy mechanism to fund their budgets. But the dominoes began to topple last year when the monoline bond insurers faltered. Bonds that had previously been rated AAA by an insurance company were assessed per their underlying credit quality, so ARS instruments were now in danger of losing their stellar grade.

Money-market funds found themselves in a tight spot, says Andrew Clinton, who advises individual investors on municipal bonds. "Money funds, by prospectus, must invest in the highest quality securities with maturities not to exceed 13 months," he says. To honour their guidelines, funds started to liquidate ARS holdings in January 2008, which dropped the variable rates dramatically.

To make matters worse, few investors understood the Dutch auctions involved. Investors bid at a given interest rate, assuming there is sufficient demand. If not, the auction fails, and the rate automatically resets to a pre-specified level. Reset rates could vault from about 4% to 11% or 12%. In early 2008, the intermediary

banks had to step in to prop up the auctions. "For example, UBS apparently committed bids that prevented auction failures in 85.7% of cases," reports Ken Johnson, a Dallas attorney at Kane Russell Coleman and Logan.

Plus ca change...

The Wall Street firms kept it might quiet that they were bolstering the auction process. Investors had no idea, having been blithely put into ARS by their brokers. In the meantime, high-level bank executives were selling out themselves, while they were pitching the securities to clients. According to the Massachusetts settlement, senior executives at UBS liquidated £31m in ARS, right before the winter crisis.

Jacob Zamansky, a New York attorney, is representing wounded ARS investors. Zamansky is no stranger to Wall Street iniquities, having formerly represented an investor in 2001 in a precedent-setting claim against Merrill Lynch and its one-time superstar analyst Henry Blodget. You may recall that Blodget had promoted internet stocks as strong buys, without disclosing Merrill's stake in them.

"We see the same conflicts again which we demonstrated in the Merrill case," Zamansky notes. Similar violations, supposedly outlawed, have been taking place. He describes how the ARS trading desks corrupted the research departments, who were on the brink of issuing a negative report on ARS. The researchers were warned they could tank the whole ARS market. By the end of 2007, traders got their optimistic report, with some altered text and timing... and the research department even cited the help they gave the ARS desk, as added rationale for annual bonuses. As if that is not enough, Zamansky adds, "According to the complaint in the recent

Massachusetts case, Merrill is also alleged to have given financial incentives to brokers to push the securities."

Putting out the fires

The story is not over. Of the investors who got stuck with ARS securities, individuals look most likely to come out close to whole once the settlements are finalised. Since these instruments trade in \$25,000 increments, investors were typically well heeled, but may have suffered consequential losses. Believing their cash was safe, some were planning to use the funds in the short term for paying taxes, buying property or even sponsoring a child's education.

On the issuer side, some counties and municipalities face severe financial stress down the road from high-penalty interest rates and lack of alternative funding sources while ARS remains dormant. When the auctions failed, municipalities owed \$165 billion. Those with good ratings and infrastructure could refinance, and did so, trimming the amount to \$66 billion. Jim Colby, a senior municipal strategist at Van Eck Global, recounts how builders of sports stadiums in Dallas and New York got stung, although managed to refinance. Others must pay a bigger cheque each month. Suppose they initially budgeted for \$10 million, and owe \$12 million. "Should they compromise on the fire department, or schools, or raise taxes?" asks John Jay, a senior analyst at Aite Group in Boston.

Much accounting remains under wraps. Municipal officials may not be eager to wax loud about their grievances if it sheds light on their management skills. Private corporations, with egg on their faces, have similar incentives to keep mum. A CFO or controller who steered their firm into ARS might not be keen to write the securities down to fair value.

Brokers have less room to hide. They have suffered immense reputational harm as irate clients desert them. Corporate treasury departments are not pleased, either.

Nonetheless, five years hence we will probably see some similar type of product resurface. "Wall Street is rarely original," says Colby. "We repeat variations on a theme."

