

FINANCIAL WEEK

March 10, 2008

New Exchanges to Rescue?

No Way, Say Skeptics of Secondary Market. 'Security Class Is Going to Die.'

By Megan Johnston

A FIRST STAB AT SECOND OFFERS

Barry Silbert started listing failed auction-rate securities last week.

Companies holding failed auction-rate securities have a new escape option: an emerging secondary market for trading the now-illiquid instruments. But treasury experts say the secondary market is no cure-all for holders of ARS. Some investors are turning to legal action instead—and the growing threat of claims against broker-dealers may be contributing to continued chaos in the marketplace.

A new venture by the Restricted Stock Trading Network (RSTN) last Monday started listing failed auction-rate securities for sale. As of Friday, around 115 issues were available for purchase, said CEO Barry Silbert, who believes he's running the only operating secondary market for failed ARS. (The website for the Securities Industry and Financial Markets Association has a list of other firms that have expressed interest in getting involved in the trading of illiquid ARS.)

But the bid/offer spreads on the securities are still “fairly wide,” said Mr. Silbert. That's because most of his sellers have been holders of failed ARS who are strapped for liquidity, and the buyers have tended to be vulture investors. “We're far from an efficient secondary market right now. There are too many disparate sources of liquidity and supply.”

Still, Mr. Silbert expects spreads to tighten as more buyers and sellers enter the market. “Once there's a little more transparency, there will be a better idea about who has securities that are worth par, and we'll see more secondary trading and more successful auctions because of that.”

Some observers remain skeptical. “I think people are being forced to find a secondary market, rather than doing so willingly,” said Joe Morgan, head of portfolio management for SVB Asset Management. “From what we hear, it's painful. It's ill-informed—there's not a tremendous amount of transparency—and markdowns are not making any of the original investors very happy.”

Added Lance Pan, director of investment research for Capital Advisors Group: “The secondary market offered up looks suspect. People looking to have an exit point will not be able to get out at a good place.”

Indeed, Mr. Pan said some holders of ARS have sold for as little as 60 cents on the dollar.

Mr. Silbert counters that RSTN is the only source right now for corporate treasurers and other investors who want to find out what their failed securities could fetch on a secondary market. RSTN's sister company, Pluris Valuation Advisors, is attempting to calculate the value of specific failed auction issues, he added.

“We are trying to be part of the solution, to provide liquidity to holders of securities and to help provide a level of transparency so there is a larger percent of auctions that start to succeed again,” he said. “Until firms on Wall Street figure out the solutions to specific issues, this is a place to go to get some information about how the market is developing.”

Some experts suggest companies try approaching their broker-dealers for help first, despite the fact that the same firms hung them out to dry when they allowed auctions to fail over the past few months.

“We have asked clients to work actively with dealers—that’s their best source of liquidity,” said Mr. Pan.

A UBS spokesman said the bank is working with clients on a case-by-case basis, offering some investors lines of credit and margin loans.

Mr. Morgan said it’s important for investors to call their broker the day before each auction date with an order to sell their holdings into the auction. “If you’re not giving your broker that order to sell,” he explained, “there may be an auction, but if you put in no order it is assumed that you want to hold your position.”

Others say treasurers should not be surprised if they don’t get much help from their broker-dealers. “Some brokers aren’t speaking with their clients very much,” said Adam Dean, president of SVB, citing fear of legal action. “What they say can and will be used against them.”

Added Mr. Morgan: “What these brokers did was not follow [the client

companies’] investment policies, in either letter or spirit. At the end of the day, that is what is causing the uproar on the client side.”

No surprise, then, that some investors in ARS have begun pursuing legal remedies.

Dallas-based telecom firm MetroPCS Communications last October filed a lawsuit against Merrill Lynch in a Texas state court, alleging that Merrill brokers invested \$133.9 million in ARS that had been backed by collateralized debt obligations. And a wealthy New Jersey family in January filed a \$1.4 billion Financial Industry Regulatory Authority claim against Lehman Brothers, alleging they’d lost access to \$286 million due to ARS illiquidity.

Jake Zamansky, a securities arbitration attorney in New York, claims he has been fielding calls for weeks from companies, individuals and institutions that have suffered losses related to failed ARS.

“I’ve spoken with businesses that had virtually all of their working capital tied up in auction-rate securities and are now unable to fund business operations,” Mr. Zamansky said, citing Merrill Lynch, UBS and Citigroup as the firms that tend to come up most frequently during those conversations. (Merrill and UBS declined to comment. Citigroup did not respond to a request for comment.)

Some observers believe the mounting confusion in the ARS market signals its inevitable end. “We believe the security class is going to die,” Mr. Dean said. “We expect lawsuits to occur, and we feel there’s been a loss of faith in the broker model as a cash manager.”