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COMMON SENSE

Auction-Rate Securities And the Ugly Truth

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The big Wall Street firms are finally coming clean about the collapse of the auction-rate-securities market -- now that New York Attorney General Andrew Cuomo and other regulators have put a gun to their heads.

The truth is even uglier than I suspected.

Auction-rate securities were sold by nearly all the big firms as a slightly higher-yielding, but safe, alternative to money-market funds. They proved anything but when the auction markets froze in February, stranding thousands of investors with more than $300 billion in illiquid holdings.

As regular readers know, I was among the victims. My shares were issued by **BlackRock**, the asset-management firm almost half-owned by **Merrill Lynch**. I've since heard from hundreds of others. Wall Street's reaction was to offer to lend investors their own money -- using our other assets as collateral and charging us market rates. It was insult on top of injury.

It's not like we were clamoring to buy these securities. Like other victims I've heard from, I got a call urging me to take advantage of an offer that was being extended to valuable clients.

My pleas to firms to do the right thing and reimburse their clients went unheeded. Representatives of firms I spoke to either refused to comment or said their balance sheets, already under strain from the credit crisis and their own lending practices, couldn't support such a move. They maintained that they, too, were victims of an unforeseeable crisis.

Thanks to a wave of subpoenas, lawsuits or threatened lawsuits, and the prospect of public disclosure, three of the biggest sellers of auction-rate securities agreed last week to reimburse clients. **Citigroup** led the pack by reaching an agreement with Mr. Cuomo and the Securities and Exchange Commission to stave off a lawsuit. Merrill Lynch, also under investigation, announced that it would reimburse clients. And **UBS** settled a pending lawsuit by agreeing to reimburse clients and pay a $150 million fine. Those firms said they will buy back a total of nearly $40 billion in the securities, a sum that, while large, can indeed be absorbed by their balance sheets.

What's really shocking are the allegations and evidence that some executives may have known that the auction-rate market was about to collapse even as they pressed their brokers to push the product on unsuspecting clients.

Mr. Cuomo's complaint against UBS is a withering portrayal of what he calls a "multibillion-dollar consumer and securities fraud." At UBS, top bank executives unloaded more than $21 million of their personal holdings of auction-rate securities as they realized the market was in trouble, the complaint alleges. In December, UBS's trading desk manager sent an email to the global head of municipal securities saying, "The auction product does not work." Other emails referred to the securities as a "huge albatross" for the firm and a "scary and delicate" situation.

Yet the firm kept peddling them to clients. According to the complaint, within "hours" of learning of trouble in the auctions, one UBS executive instructed his personal broker that "I want to get out of arcs [auction-rate certificates]" and sold off all $250,000 of his holdings. More than 50,000 UBS customers ended up owning more than $37 billion of the illiquid securities, according to the complaint. Mr. Cuomo characterized UBS's actions as a "flagrant breach of trust."

Katrina Byrne, a spokeswoman for UBS, responded: "We categorically reject any claim that the firm engaged in any widespread campaign to move auction-rate-securities inventory from our own books into private client accounts." As for the emails, she said, "We were disappointed the New York attorney general released details on certain transactions when we conducted our own internal investigation with the assistance of external counsel. We found no evidence of unlawful conduct by any employees." She added that "there may have been cases of poor judgment," and said UBS is evaluating what, if any, disciplinary actions might be appropriate.

"UBS is not alone in this scheme," Mr. Cuomo maintained.

Citigroup, in response to its settlement, issued a statement saying, "Our most important focus continues to be on helping our clients," and added that it would neither confirm nor deny that its officials knew about troubles with the auctions as it continued to sell the securities as cash equivalents.

Merrill Lynch won't comment on whether it continued to sell auction-rate securities after its officials knew the market was in trouble, but an official there told me that he hasn't heard any such allegations. Merrill remains under investigation, and although Mr. Cuomo said he welcomes its offer to reimburse clients, the terms fall short of the Citigroup and UBS standards.

This week, Mr. Cuomo said his probe had been extended to include **Morgan Stanley**, **J.P. Morgan Chase** and Wachovia, and there's no indication it will stop there. Monday, Morgan Stanley announced it would buy back $4.5 billion in auction-rate securities -- a move that Cuomo calls "too little, too late."

At least one firm, HSBC, deserves credit for acting more proactively to protect its clients. The firm offered to buy back its clients' auction-rate securities June 20 and completed the purchases by the end of July. HSBC said some customers didn't participate, and the firm is "continuing to address the needs of the few remaining customers." HSBC hasn't disclosed the total amount involved.

I'm glad that I and thousands of other unwitting investors appear likely to get back our money, albeit not for months. But that's not going to restore the trust that's been destroyed. We need to know the truth. We need to know who is taking responsibility. We need to know there has been accountability. And we need to know how we can be sure it won't happen again.

James B. Stewart, a columnist for SmartMoney magazine and SmartMoney.com, writes weekly about his personal investing strategy. Unlike Dow Jones reporters, he may have positions in the stocks he writes about. For his past columns, see: www.smartmoney.com/commonsense[1].

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