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## If It's Broken, Sometimes It Can't Be Fixed: Why the Auction Rate Securities market Was Faulty from Its Inception and how Broker-Dealers Caused Its Downfall

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## NOTES

### IF IT'S BROKEN, SOMETIMES IT CAN'T BE FIXED:

### WHY THE AUCTION RATE SECURITIES MARKET WAS FAULTY FROM ITS INCEPTION AND HOW BROKER-DEALERS CAUSED ITS DOWNFALL

*Brendan P. Tracy*

#### INTRODUCTION

In late 2007, brothers Brian and Basil Maher lost access to approximately a quarter of the massive fortune the two had entrusted with various financial firms, including the now defunct Lehman Brothers.<sup>1</sup> The Maher brothers had recently sold their almost fifty-year-old shipping business to one of Deutsche Bank's investment units for more than \$1 billion.<sup>2</sup> Hoping to "[p]reserve capital"<sup>3</sup> and maintain "sufficient liquidity"<sup>4</sup> with the profits made from the sale, the Mahers spread their cash among three separate financial firms to deal with their short-term investments.<sup>5</sup> However, when Lehman Brothers invested about \$400 million of the Mahers' account in investments known as "auction rate securities," the Mahers became alarmed because they did not think that these investments fit into their prescribed investment objectives.<sup>6</sup> It turns out the Mahers' concerns were justified.

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1. Robert Frank, *Debt Crisis Hits a Dynasty*, WALL ST. J., Feb. 14, 2008, at A1.

2. *Id.* Michael Maher, the father of Brian and Basil, created a shipping terminal in Port Elizabeth, N.J. in the 1950s, and the company quickly expanded into a massive shipping empire. *Id.* In the 1960s, Michael "invested heavily in building a facility that could load and unload 'containers'—the giant metal boxes that are now the main building block of the global shipping trade." *Id.* In the early 1990s, Brian was named chief executive of the company, and Basil took the position of president. *Id.* In July of 2007, the brothers completed the sale of their company, Maher Terminals, to Deutsche Bank's RREEF Infrastructure. American Shipper, *Maher Brothers Make \$1.1 Billion Claim Against Lehman*, Jan. 21, 2008, [http://www.americanshipper.com/SNW\\_story.asp?news=82206](http://www.americanshipper.com/SNW_story.asp?news=82206).

3. Frank, *supra* note 1.

4. *Id.*

5. *Id.*

6. *Id.* The Maher brothers and their financial advisor had a list of three financial objectives: (1) "[p]reserve capital"; (2) "provide sufficient liquidity"; and (3) "capture a market rate of return based on [the brothers'] investment policy parameters and market conditions." *Id.* (quoting a "letter the family sent the banks"). These financial objectives were laid out to Lehman Brothers, UBS AG, and JP Morgan Chase & Co., the three investment firms the Mahers entrusted their money with. *Id.*

Over the next several months, the Mahers' funds, tied up in these auction rate securities, become extremely inaccessible, losing any sense of liquidity they might have once possessed.<sup>7</sup> Auction rate securities are known in the financial world as long-term corporate or municipal bonds "with interest rates . . . that are periodically re-set . . . typically every 7, 14, 28, or 35 days."<sup>8</sup> First developed in 1984,<sup>9</sup> these investments were marketed to potential investors as short-term, safe, highly-liquid alternatives to money market funds.<sup>10</sup> Auction rate securities differ from normal types of bonds, with the "interest rate [for each security being] set through an auction (commonly referred to as a 'Dutch' auction) in which bids with successively higher rates are accepted until all of the securities in the auction are sold."<sup>11</sup> However, when there is not enough demand for the securities, an auction failure results.<sup>12</sup> An auction failure means that few, if any, of the securities change hands, resulting in an inability on the part of the investors to sell the investments.<sup>13</sup> Over the last few decades, broker-dealers and investment banks have intervened in order to prevent auction failures, by acting as "buyers of . . . last resort," keeping the rate of failed auctions at a very low level.<sup>14</sup>

However, in late 2007, the market for auction rate securities froze up, preventing investors from liquidating their investments in the market.<sup>15</sup> When demand for these securities declined substantially, broker-dealers and investment bankers ceased acting as "buyers of . . . last resort," refusing to bid on the excess of auction rate securities available.<sup>16</sup> The departure of broker-dealers and investment banks from the market has resulted in devastating illiquidity for thousands of investors in the United States. It has also caused a massive flood of litigation and investigation aimed at financial institutions, with investors claiming that they were not fully

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7. *See id.*

8. Bear Stearns & Co., Securities Act Release No. 8684, Exchange Act Release No. 53,888, 88 SEC Docket 259, 260 (May 31, 2006).

9. *Id.*

10. Frank, *supra* note 1.

11. Bear Stearns & Co., 88 SEC Docket at 260.

12. *See* Glenn S. Gitomer, *Auction Rate Securities: A Crisis Foretold*, in SECURITIES ARBITRATION 2008: EVOLVING & IMPROVING, at 361, 363–64 (PLI Corp. Law & Practice, Course Handbook Series No. 14,310, 2008).

13. *See* Megan Johnston, *Auction-Rate Securities Suffer Total Insecurity*, FIN. WK., Feb. 18, 2008, <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080218/REG/698824530>.

14. John Carney, *Did Auction Rate Securities Ever Have a Natural Success Rate?*, DEALBREAKER, Feb. 27, 2008, [http://dealbreaker.com/2008/02/did\\_auction\\_rate\\_securities\\_ev.php](http://dealbreaker.com/2008/02/did_auction_rate_securities_ev.php). While there had been very few failures of auctions throughout the past few decades in the auction rate securities market, eighty-seven percent of all of the auctions in the market experienced failures on Thursday, February 14, 2008. Johnston, *supra* note 13.

15. *See* Darrell Preston, *Auction Debt Succumbs to Bid-Rig Taint as Citi Flees (Update4)*, BLOOMBERG, Feb. 21, 2008, <http://www.bloomberg.com/apps/news?pid=20601103&sid=aXXucptLVGuc&refer=news>.

16. Carney, *supra* note 14.

apprised of all of the risks of these so-called highly-liquid and safe investments.<sup>17</sup>

To understand how the market, once advertised as a safe alternative for investors with a low-risk appetite, collapsed and froze-up, it is necessary to analyze the history and development of auction rate securities. Part I of this note summarizes the creation and expansion of the auction rate securities market.<sup>18</sup> Part II examines how the market collapsed, including the effect that the subprime mortgage meltdown and the ensuing credit crisis had on the breakdown of these investments.<sup>19</sup> Part III explores the practice of broker-dealers in “stabilizing” certain markets in order to facilitate liquidity and how this practice differed from the “manipulation” practices that the financial institutions used in the auction rate securities market.<sup>20</sup> Part IV argues that the market was doomed to fail because of the irrational and irresponsible actions of the broker-dealers in propping-up the market in order to fuel their desire for larger investment fees.<sup>21</sup> This note will further argue that the broker-dealers never should have played such a large role and that in order for the market to have followed on its natural path there needed to be much less intervention by the broker-dealers. Part V offers solutions as to how to restore confidence in the markets by prohibiting the creation of products such as auction rate securities in the future.<sup>22</sup> Part VI concludes this note by summarizing the importance of these issues.<sup>23</sup>

## I. THE AUCTION RATE SECURITIES MARKETS

### A. THE CREATION AND DEVELOPMENT OF THE MARKET

Auction rate securities were first introduced in 1984,<sup>24</sup> and further developed in 1988, when Goldman Sachs introduced the first ““periodic auction asset securities’[] through a \$121,400,000 offering for the Industrial Development Authority of Pima County, Arizona.”<sup>25</sup> While auction rate securities may seem to be extremely complex investment alternatives, they “are far simpler than the mysterious name suggests.”<sup>26</sup>

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17. See Posting of Amir Efrati to WSJ Law Blog, <http://blogs.wsj.com/law/2008/05/13/auction-rate-securities-legal-headache-for-wall-street-and-how/> (May 13, 2008, 12:27 DST).

18. See *infra* pp. 299–305.

19. See *infra* pp. 305–10.

20. See *infra* pp. 310–14.

21. See *infra* pp. 314–17.

22. See *infra* pp. 318–20.

23. See *infra* pp. 320–21.

24. Bear Stearns & Co., Securities Act Release No. 8684, Exchange Act Release No. 53,888, 88 SEC Docket 259, at 260 (May 31, 2006).

25. Gitomer, *supra* note 12, at 364.

26. *Id.* at 361.

Auction rate securities are long-term debt instruments,<sup>27</sup> with “interest rates that reset monthly or weekly according to a scheduled auction process.”<sup>28</sup> These bonds are normally issued by state and local government agencies, corporations,<sup>29</sup> and college student-loan programs.<sup>30</sup> “The principal difference between typical debt instruments and [auction rate securities] is how interest rates are set.”<sup>31</sup> Instead of having an interest rate that is fixed at the time of issuance, auction rate securities have interest rates that fluctuate on a weekly or monthly basis, depending on the interest rate that investors are willing to accept at the time of auction.<sup>32</sup>

This trait makes auction rate securities attractive not only to investors, but also to the corporations, government agencies, and municipalities who issue these securities because of the lower interest rate that is normally paid on them as compared to long-term bonds.<sup>33</sup> In recent years, the popularity of auction rate securities “has ballooned . . . amid low interest rates as investors look for short-term investments that offer better [interest rates] than Treasury bills, certificates of deposit, or money-market funds.”<sup>34</sup> Therefore, the issuers of these securities have “the ability to raise long-term money at short-term rates and retain the right to change the [frequency at which interest rates are set].”<sup>35</sup>

## B. HOW THE AUCTIONS WORK

The issuer of auction rate securities hires broker-dealers “such as Goldman Sachs, . . . Citicorp, Lehman Bro[thers], etc., as well as many regional brokers” to issue the bonds and run the auctions.<sup>36</sup> The broker-

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27. Bear Stearns & Co., 88 SEC Docket at 260. (“Auction rate bonds are usually issued with maturities of 30 years, but the maturities can range from 5 years to perpetuity.”).

28. *Know the Risks and Rewards*, AUCTION RATE SEC. (SVB Fin. Group & SVB Asset Mgmt., S.F., Cal.), Aug. 15, 2007, <http://www.svbassetmanagement.com/pdfs/AuctionRateSecurities0907.pdf> [hereinafter *Risks & Rewards*].

29. Gitomer, *supra* note 12, at 361–62.

30. Frank, *supra* note 1.

31. Gitomer, *supra* note 12, at 362.

32. *Id.* Normal debt instruments have an interest rate that is set forth at issuance. *Id.* Because the investor in long-term fixed interest debt “bears the risk of changes in the market price of the debt instrument due to fluctuations in the interest rate environment and changes in the credit risk of the issuer,” the interest rates paid on short-term debt are normally much lower than those paid on long-term debt. *Id.*

33. *Risks & Rewards*, *supra* note 28 (explaining “[f]ew AAA-rated securities offer such valuation simplicity and enhanced yield over Treasuries that ARS provide, making them a popular cash management tool”).

34. Allison Bisbey Colter, *Auction-Rate Securities Under Fire*, WALL ST. J., Mar. 24, 2005, at D6.

35. *Id.*

36. Adam Warren & Dwight Grant, Commentary, *Auction-Rate Securities: Legal and Valuation Insights*, ANDREWS SEC. LITIG. & REG. REP., June 3, 2008, at 1, available at <http://www.duffandphelps.com/SiteCollectionDocuments/AuctionRateSecuritiesLegalandValuationInsights.pdf#page=1>. Broker-dealers usually earned fees from the issuers for helping to issue the bonds and also normally earned a “regular 25-basis-point annual fee for running the auction.” *Id.*

dealers, while receiving fees from the issuers, are also responsible to the investors purchasing the securities.<sup>37</sup> The broker-dealers have an obligation to the issuer “to solicit bids on the regularly scheduled auction dates, and [an] obligation to the investors of the securities . . . to manage the auction process [according to the securities’ guidelines].”<sup>38</sup>

On the specified dates, the securities are auctioned at par value<sup>39</sup> with the broker-dealers submitting bids for investors, or on their own behalf, for “\$25,000 . . . [blocks of the securities] they are willing to buy at a given interest rate.”<sup>40</sup> Therefore, in the auction rate market, it is “the interest rate that fluctuates, not the value of the debt instrument.”<sup>41</sup> In an auction, investors can submit the following types of orders to their broker-dealer:

- 1) [A] “hold” order, which is the default order for current investors (i.e., the order that is entered for a current holder if the holder takes no action), where a current investor will keep the securities at the rate at which the auction clears; 2) a “hold-at-rate” bid, where a current investor will only keep the securities if the clearing rate is at or above the specified rate; 3) a “sell” order, where a current investor will sell the securities regardless of the clearing rate; or 4) a “buy” bid, where a prospective investor, or a current investor who wants more securities, will buy securities if the clearing rate is at or above the[ir] specified rate.<sup>42</sup>

The broker-dealers then submit these bids to an auction agent, who is hired by the issuer of the securities.<sup>43</sup> The auction agent then calculates the “Clearing Rate,” “which is the highest rate bid at the point that there are sufficient bids to purchase all shares offered for sale.”<sup>44</sup> The auction agent is then responsible for allocating the securities to the proper investors.<sup>45</sup>

In essence, the investors “submit the lowest [interest rate that] they are willing to accept, and the auction manager fills the bids with the available

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“Investors can only submit orders [for the auction] through the selected broker-dealers,” making this a very lucrative market for those broker-dealers who are lucky enough to be the lead underwriter of these offerings. Bear Stearns & Co., Securities Act Release No. 8684, Exchange Act Release No. 53,888, 88 SEC Docket 259, at 260 (May 31, 2006).

37. *Risks & Rewards*, *supra* note 28.

38. *Id.*

39. Bear Stearns & Co., 88 SEC Docket 259, at 260. The “securities are auctioned at par so the return on investment to the investor and the cost of financing to the issuer between auction dates is determined by the interest rate or dividend yield set through the auctions.” *Id.*

40. Gitomer, *supra* note 12, at 362. “Typically, the minimum investment [in auction rate securities] is \$25,000.” Bear Stearns & Co., 88 SEC Docket at 260.

41. Gitomer, *supra* note 12, at 362.

42. Bear Stearns & Co., 88 SEC Docket at 260. In most auctions, the disclosure documents related to the auctions “often state that an investor’s order is an irrevocable offer.” *Id.*

43. *Risks & Rewards*, *supra* note 28.

44. Gitomer, *supra* note 12, at 362. “The final rate at which all of the securities are sold at is [known as] the ‘clearing rate’ that applies to all of the securities in the auction until the next auction.” Bear Stearns & Co., 88 SEC Docket at 260.

45. *Risks & Rewards*, *supra* note 28.

securities starting at the bottom until all the securities are allocated.”<sup>46</sup> Through this auction process, the auction agent is able to determine the lowest interest rate necessary (the Clearing Rate) to sell all of the securities available in that auction.<sup>47</sup> “[Every investor] who bids [an interest rate that is] lower than the clearing rate receives the value of securities desired and earns the clearing rate.”<sup>48</sup> Bids, starting “with the lowest rate and then [moving] successively [to the] higher rates[,] are accepted until all of the sell orders are filled.”<sup>49</sup>

When allocating the securities among the investors, the auction agent distributes the securities based on the orders the broker-dealers submitted on behalf of themselves and other investors.<sup>50</sup> “When there are more bids for securities at the clearing rate than securities remaining for sale, the securities are allocated on a pro-rata basis first to the hold-at-rate bidders and then to the buy bidders.”<sup>51</sup> “If there are no sellers of [the securities at a particular auction] the result is an ‘all hold’ outcome where interest rates are set at a default rate that is generally lower than the current rate.”<sup>52</sup>

However, the opposite situation could arise where there is a lower demand for the securities being auctioned, resulting in an overabundance in the supply of these securities at a given auction.<sup>53</sup> “If there are not enough investors willing to purchase . . . all shares of a particular issue offered for sale, *the auction fails* and no securities change hands.”<sup>54</sup> Essentially, “[a]uctions fail if there aren’t enough interested bidders,” or buyers, on a specific auction date.<sup>55</sup> There can be major ramifications for both the investors and issuers of these securities when an auction fails, including a

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46. Warren & Grant, *supra* note 36, at 1.

47. *Id.*

48. *Id.*

49. Bear Stearns & Co., 88 SEC Docket 259, at 260.

50. *Id.* at 261.

51. *Id.*

For example, suppose \$100,000 of securities were for sale and the auction received four buy bids. Bid A was for \$50,000 at 1.10%, Bid B was for \$50,000 at 1.15%, Bid C was for \$50,000 at 1.15%, and Bid D was for \$25,000 at 1.20%. Under these circumstances, the “clearing rate” would be 1.15%, meaning all of the securities in the auction would pay interest at a rate of 1.15% until the next auction. Bid A would be allocated \$50,000, Bids B and C would receive pro-rata allocations (\$25,000 each), and Bid D would receive no allocation [due to the fact that the interest rate bid in Bid D was higher than the ultimate “clearing rate”].

*Id.* at 260 n.4.

52. Warren & Grant, *supra* note 36, at 2.

53. See Daniel Rockey, *Auction-Rate Securities: The Next Frontier in Subprime Litigation or a Dead End for the Plaintiffs’ Bar?*, 22 NO. 23 ANDREWS DEL. CORP. LITIG. REP. 13 (June 2, 2008).

54. Gitomer, *supra* note 12, at 362–63 (emphasis in original).

55. Johnston, *supra* note 13.

loss of liquidity for those particular securities.<sup>56</sup> “In the event of a [f]ailed [a]uction, a [f]ail [r]ate,<sup>57</sup> is then paid to the holders of the securities by the issuer of the securities.<sup>58</sup>

The fail rate, defined in the securities’ prospectus, can range “anywhere from a few percentage points to as high as 20[%],”<sup>59</sup> and “is often some percentage above comparable commercial paper or LIBOR (London Interbank Offered Rate) rates.”<sup>60</sup> If investors in auction rate securities have no pressing liquidity needs, a failed auction may result in a fairly profitable occurrence because they would now be reaping the benefits of higher interest payments.<sup>61</sup> However, if investors require liquidity in their investments, they are faced with the unenviable position of holding the securities until liquidity opens up,<sup>62</sup> or possibly selling the auction rate securities in “a thin secondary market for less than par value.”<sup>63</sup> There are also damaging consequences for issuers of auction rate securities if an auction for their securities fails, with the issuer “hav[ing] to pay substantially higher interest rates on their debt.”<sup>64</sup>

### C. BROKER-DEALERS’ ROLE IN THE AUCTIONS

Broker-dealers such as Goldman Sachs, Morgan Stanley, and Merrill Lynch play a significant role in the sale of auction rate securities by underwriting the offerings and managing the auction process.<sup>65</sup> The issuer of the securities also “pays an annualized fee to [the broker-dealers who] manage an auction (typically [twenty-five] basis points for the par value of the securities that it manages).”<sup>66</sup> In order for the process to run efficiently, the broker-dealers specify a time by which investors must submit their bids to it.<sup>67</sup> The broker-dealers then process and submit the orders to the

56. Gitomer, *supra* note 12, at 363. “Between auctions, investors might . . . [have the opportunity] to buy or sell [the] auction rate securities in . . . [some type of] secondary market at prices greater than, equal to, or less than par.” Bear Stearns & Co., 88 SEC Docket at 260 n.3.

57. Gitomer, *supra* note 12, at 363. The fail rate “is the [m]aximum [a]uction [r]ate specified in the prospectus or debt instrument.” *Id.*

58. *Id.*

59. Warren & Grant, *supra* note 36, at 2.

60. Gitomer, *supra* note 12, at 363.

61. *Id.*

62. Outside of a very thin secondary market, an investor would most likely have to hold their securities until the sooner of “the next successful auction at which there are sufficient purchasers willing to buy all of the [auction rate securities] offered . . . or the maturity or earlier call of the [auction rate securities].” *Id.*

63. *Id.* While there is not a large secondary market for these auction rate securities, some “firms with electronic trading networks are now attempting to offer secondary markets for auction-rate securities that cannot be sold at auction.” Alan Rappeport, *Buyers Be Where?*, CFO.COM, Apr. 1, 2008, <http://www.cfo.com/article.cfm/10950592?f=search>.

64. Warren & Grant, *supra* note 36, at 2.

65. Bear Stearns & Co., Securities Act Release No. 8684, Exchange Act Release No. 53,888, 88 SEC Docket 259, at 260 (May 31, 2006).

66. *Id.*

67. *Id.*



assigned auction agent before a certain deadline.<sup>68</sup> As the auction rate securities market has progressed, the role of broker-dealers has become increasingly more involved with the facilitation of successful auctions.<sup>69</sup>

Since its inception, the value of the auction rate securities market has blossomed, reaching over \$200 billion in 2006, and over<sup>70</sup> \$330 billion in February 2008.<sup>71</sup> Much of this success was due to the fact that the broker-dealers themselves are able to place bids in the auctions for these securities, along with the other investors whom the broker-dealers are helping to purchase or sell these securities.<sup>72</sup> Broker-dealers submit their bids for several reasons, including “to avoid having a [f]ailed [a]uction or to avoid having an [a]uction clear at a [r]ate the [b]roker-[d]ealer in good faith believes is above its [e]stimated [m]arket [r]ate.”<sup>73</sup> Broker-dealers, while not obligated to submit bids in a particular auction, may place bids that ultimately have an effect on the outcome of the auction “as long as it is an [e]stimated [m]arket [b]id.”<sup>74</sup>

Since the market’s creation, broker-dealers have consistently submitted bids on their own behalf in auctions claiming that “their intervention is for the good of the market as a whole.”<sup>75</sup> Due to “imbalances in bidding interest in a particular [a]uction,”<sup>76</sup> the auction may be subject to failing or it may be “subject to clearing at a [r]ate that the [b]roker-[d]ealer in good faith believes is above an [e]stimated [m]arket [r]ate.”<sup>77</sup> Therefore, broker-

68. *Id.*

69. See generally Gitomer, *supra* note 12.

70. Martha Mahan Haines, Chief, Office of Mun. Secs., SEC, Comments to the Tenth Annual Conference of Women in Public Finance (Sept. 29, 2006).

71. Michael Quint, *Muni Regulators Seek Disclosure on Auction-Rate Bonds (Update1)*, BLOOMBERG, Feb. 15, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=ayejZe3dpOeQ&refer=home>.

72. See BEST PRACTICES FOR BROKER-DEALERS OF AUCTION RATE SECURITIES § 4.3.2 (Sec. Indus. & Fin. Mkt. Ass’n 2007), available at [http://www.sifma.org/services/pdf/AuctionRateSecurities\\_FinalBestPractices.pdf](http://www.sifma.org/services/pdf/AuctionRateSecurities_FinalBestPractices.pdf) [hereinafter SIFMA].

73. *Id.* “Estimated Market Rate” is defined as

[a] Rate or range of Rates which, in the Broker-Dealer’s good faith judgment, reflects a fair and reasonable Rate, taking into consideration such circumstances as it believes are relevant, including prevailing market conditions with respect to such security at the time of the determination, general economic conditions and trends, current Rates for comparable securities, and the issuer’s financial condition and prospects. In determining the Estimated Market Rate, a Broker-Dealer should not take into consideration the interest of the issuer in paying a low Rate or the interest of investors in receiving a high Rate. In addition, in determining the Estimated Market Rate for purposes of submitting a Bid for its own account, the Broker-Dealer may also consider such factors as the expense involved, the size of the Broker-Dealer’s inventory position, its capital requirements and its risk management needs.

*Id.* § 3.

74. *Id.* § 4.3.2.

75. Mahan Haines, *supra* note 70.

76. SIFMA, *supra* note 72, § 4.3.2.

77. *Id.*

dealers have intervened to play a larger role in the market, providing increased liquidity to the auction rate securities market in order to prevent failed auctions.<sup>78</sup>

By injecting their own bids into the market to prevent failed auctions, the broker-dealers were market saviors; that is, “[i]f you had more sell orders than buy orders, they’d pick up the difference and you wouldn’t have a failed auction.”<sup>79</sup> In short, the broker-dealers were acting as “buyers of . . . last resort.”<sup>80</sup> According to some, the reason the broker-dealers consistently submitted bids in order to prevent auction failures was obvious since the “broker-dealers had every financial incentive to sell them to their customers.”<sup>81</sup>

## II. THE COLLAPSE OF THE AUCTION RATE SECURITIES MARKET

For over two decades, the auction rate securities market seemed to work seamlessly, with the “market facilitat[ing] incredible amounts of volume” among investors.<sup>82</sup> Until late 2007, “there were less than [fifty] failed auctions,”<sup>83</sup> which resulted in confidence among investors and a high demand for the auction rate securities. However, under this shroud of success was a somewhat finicky market that did not always operate the way that its creators intended. In early February 2008, the auction rate securities market, touted as a safe, highly liquid, and short term investment option for investors, “vanished into thin air . . . [and] became illiquid.”<sup>84</sup> “In the week of Feb[ruary] 11, 2008 alone, almost 1,000 [auction rate securities auctions] failed,” resulting in the loss of liquidity for thousands of investors who held a significant number of these securities.<sup>85</sup> By tracing the history of the auction rate securities market, it is easy to see why the market ultimately collapsed in early 2008. As this note suggests, the main reason for the collapse was the role that broker-dealers and investment banks were playing in the market—acting as bidders of last resort.

As explained in Part I, broker-dealers and the investment banks that ran the auctions would submit bids on their own behalf in order to prevent an auction failure and to facilitate the exchange of these securities among

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78. Preston, *supra* note 15.

79. *Id.*

80. Carney, *supra* note 14.

81. Melanie Cherdack & Daniel A. Ball, *Auction Rate Securities: The New Frontier*, in *SECURITIES ARBITRATION 2008: EVOLVING & IMPROVING*, at 335, 343 (PLI Corp. Law & Practice, Course Handbook Series No. 14,310, 2008).

82. John Fazio et al., *The Genesis of a Troubled Product: Auction Rate Securities*, in *SECURITIES ARBITRATION 2008: EVOLVING & IMPROVING*, at 325, 330 (PLI Corp. Law & Practice, Course Handbook Series No. 14, 1310, 2008).

83. *Id.*

84. Cherdack & Ball, *supra* note 81, at 337.

85. Warren & Grant, *supra* note 36, at 2.

investors.<sup>86</sup> While this may have continued to keep the market afloat when there were not enough investors in a particular auction willing to purchase the securities, this practice was also the main cause of the demise of the market.<sup>87</sup> Broker-dealers, by submitting their own bids, created a “managed bidding system” within the auctions.<sup>88</sup> “Broker-dealers participated in the auctions by infusing their own capital in order to prevent them from failing” when there was not enough demand for a particular security.<sup>89</sup> Because of the increased participation of the broker-dealers in the auctions, the auction rate securities market had an “illusory liquidity.”<sup>90</sup>

As the size of the auction rate securities market boomed, and the small number of broker-dealers managing the auctions stayed relatively the same, “it became [more difficult] for [the broker-dealers] to arrange true auctions regularly.”<sup>91</sup> Therefore, in order to keep the market running smoothly, the broker-dealers continually intervened by participating in the auctions at a greater rate than they had in the past, instead of “rustling up thousands of buyers to meet up with sellers every week or so.”<sup>92</sup> For example, during the period between January 2006 to February 2008, it is reported that Swiss bank “UBS alone may have submitted bids in just under 70% of [the] auctions” that it managed.<sup>93</sup> By intervening in the auctions to keep them afloat, “[t]he banks were the backstop,”<sup>94</sup> by preventing failed auctions from occurring. The investment banks had a number of reasons to keep the market afloat, most notably because they received significant fees from the issuers of these securities for managing the auctions.<sup>95</sup> However, as the United States’ economy began to struggle over the last two years, the broker-dealers became nervous about their involvement in the market.<sup>96</sup>

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86. See *supra* Part I.C.

87. See Preston, *supra* note 15.

88. Cherdack & Ball, *supra* note 81, at 344. “Given the size of the [auction rate securities] market, and the fact that each security required a separate auction on the date that the interest rate was set to expire, conducting the weekly auctions became unwieldy.” *Id.* at 343. Therefore, in order to further facilitate the market, the broker-dealers used their own funds to keep the securities moving between investors. *Id.* at 343.

89. *Id.* at 343 (“Having invested their own capital in the [auction rate securities] market in order to make a secondary market, broker-dealers had every financial incentive to sell them to their customers.”).

90. *Id.*

91. Gretchen Morgenson, *It’s a Long, Cold, Cashless Siege*, N.Y. TIMES, Apr. 13, 2008, at BU.

92. *Id.* Instead of finding a sufficient number of buyers to meet up with the number of sellers, the broker-dealers put up more and more of their own funds to purchase the securities from those who wanted to sell them. *Id.* Finding a sufficient number of participants would “be an enormous undertaking for the handful of underwriters in the arena.” *Id.*

93. David Enke, *The Auction-Rate Security Mess: Reading the Writing on the Wall*, SEEKINGALPHA.COM, Aug. 10, 2008, <http://seekingalpha.com/article/90168-the-auction-rate-security-mess-read-the-writing-on-the-wall>.

94. Preston, *supra* note 15.

95. See Cherdack & Ball, *supra* note 81, at 343.

96. See Rockey, *supra* note 53.

The collapse of the auction rate securities market “traces back to the surprise surge in mortgage defaults that started” in 2007.<sup>97</sup> As the subprime mortgage crisis unfolded, the “\$146 billion in credit losses and write[-]downs” that investment banks experienced began to negatively affect other securities markets as well.<sup>98</sup> Due to these losses, the broker-dealers had a “shortage of cash available to commit to the auctions.”<sup>99</sup> In short, the auction rate securities market became the odd man out because “given their exposure to other subprime-tainted securities related to the credit crunch, many banks [could] no longer afford to provide . . . support” to the auctions.<sup>100</sup> Furthermore, the balance of ownership of auction rate securities seemed to shift from institutional investors, such as mutual funds and insurance companies, to individual investors, such as the Maher brothers and other wealthy investors.<sup>101</sup> This led to a scenario in which many of the auction rate securities were held by less sophisticated investors unfamiliar with the true risks of the instruments.<sup>102</sup>

All of these problems culminated in February 2008, with the auction rate securities market coming to a near standstill.<sup>103</sup> Due to investors’ fears regarding the strength of the financial markets, the interest of institutional and individual investors in purchasing auction rate securities diminished greatly, resulting in a shortage of buyers, putting great pressure on the investment bank and broker-dealers to prop-up the markets.<sup>104</sup> Finally, during the week of February 11, 2008, “the broker-dealers, *en masse*, ceased participating in the [auctions],”<sup>105</sup> and no longer acted as “buyers of last resort.”<sup>106</sup> The broker-dealers and investment banks essentially “remain[ed] on the sidelines,” neglecting to play the role of savior in the auction rate securities auctions as they had done in the past.<sup>107</sup> On February 13, 2008, approximately “80% of [the] auctions failed,”<sup>108</sup> and on February

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97. Laura Mandaro, *Latest Credit-Market Trap Could Hit Closed-End Funds: Failures of Auctions to Reprice this Debt has Already Walloped Municipal Bonds*, MARKETWATCH, Feb. 14, 2008, <http://www.marketwatch.com/story/latest-credit-landmine-could-hit-closed-end-funds-munis-suffer>.

98. Gitomer, *supra* note 12, at 364.

99. Warren & Grant, *supra* note 36, at 2.

100. Johnston, *supra* note 13.

101. Warren & Grant, *supra* note 36, at 2. As of July 1, 2007, corporations held a large amount of the auction rate securities available, owning “\$170 billion of these securities, or just over half of the total outstanding, according to Treasury Strategies.” Morgenson, *supra* note 91. However, institutional investors began to decrease their holdings through 2007, holding only \$98 billion of the almost \$330 billion auction rate securities available through the second half of 2007. *Id.*

102. Warren & Grant, *supra* note 36, at 2.

103. Frank, *supra* note 1.

104. Fazio et al., *supra* note 82, at 329.

105. Cherdack & Ball, *supra* note 81, at 343–44.

106. Fazio et al., *supra* note 82, at 329.

107. *Id.*

108. Mandaro, *supra* note 97. During the week of February 11, 2008, “[m]ore than \$1 billion of auctions of New York City and New York state-backed debt failed [and] . . . [o]ut of thirteen auctions of state-backed debt totaling \$867.2 million, only a single \$104.5 million series issued by

22, 2008, “more than 70% of the publicly offered bond auctions failed.”<sup>109</sup> “Three days in February alone marked the failure of more than 1,000 auctions.”<sup>110</sup> This is especially noteworthy, because “[p]rior to 2008, there were only [forty-four] recorded auction failures since the [auction rate securities] market’s inception in 1984.”<sup>111</sup>

So what did this mean for all of the investors who actually held these securities up to early February of 2008? Essentially, they were stuck with the auction rate securities and had no way of selling them to others because there was no one else looking to buy. Investors were informed by their brokers “that they could not sell the securities at auction and [therefore] could not access their funds” due to the lack of liquidity in the market.<sup>112</sup> The brokers told their clients “that the best [they] could do for them was to offer margin loans to ease the liquidity crunch or attempt to unload the securities at a discount to par value in the secondary markets.”<sup>113</sup> The Maher brothers are a typical example of investors who fell prey to the auction rate securities meltdown<sup>114</sup>—investors who placed their money in auction rate securities thinking the securities were safe, short-term, and highly liquid, yet ultimately could not sell these securities and lost almost any sense of liquidity their investments once possessed.

The freeze-up in the auction rate securities market also caused a diminution in value of many individual investors’ portfolios, at least for accounting purposes.<sup>115</sup> While these securities are still worth the same value that they were previously, their illiquidity has caused some brokers to write-down the value of some of their clients’ holdings.<sup>116</sup> For example, “UBS AG announced that despite the soundness of the collateral backing the auction[]rate securities, the bank was moving to lower the value of the

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the Dormitory Authority of the State of New York succeeded.” Dakin Campbell et al., *Auction-Rate Market Turmoil Continues*, BOND BUYER, Feb. 15, 2008, at 1. That week, “[t]he largest failed auction was \$100 million of bonds issued by the Empire State Development Corp. . . .” *Id.* To compare the fail rate versus the success rate, “[e]ight New York City auctions totaling \$442.6 million failed on [February 13] while seven totaling \$464.1 million did not fail.” *Id.*

109. Faten Sabry et al., *Subprime Securities Litigation: Key Players, Rising Stakes, and Emerging Trends*, J. ALTERNATIVE INVESTMENTS, Fall 2008, at 109, 115.

110. Stephanie Lee, *Auction-Rate Securities: Bidder’s Remorse? A Primer*, NERA ECONOMIC CONSULTING, May 6, 2008, at 1, 13, available at [http://www.nera.com/publication.asp?p\\_ID=3474](http://www.nera.com/publication.asp?p_ID=3474).

111. Sabry et al., *supra* note 109. “In 1989, a big auction failed because [the] company that issued the [auction rate] securities, MBank, defaulted.” Morgenson, *supra* note 91. Further, “[t]here have been several NYSE [New York Stock Exchange] and NASD [National Association of Securities Dealers] arbitration [a]wards involving ARS [auction rate securities].” Cherdack & Ball, *supra* note 81, at 346–47 (citing *Wholey v. Goldman Sachs & Co.*, NYSE Case No. 1992-002598, as the largest award resulting in a “\$2.8 million [a]ward for the [c]laimants in connection with their purchases of” auction rate securities issued by Ratners UK).

112. Rockey, *supra* note 53, at 3.

113. *Id.*

114. See *supra* Introduction.

115. Rappeport, *supra* note 63.

116. See Rockey, *supra* note 53.

issues its customers held in their investment accounts to reflect the lack of liquidity in the instruments.”<sup>117</sup> The loss of liquidity has also harmed small business owners, causing some who had invested in auction rate securities to draw funds from other sources in order to operate their businesses or pay their taxes.<sup>118</sup> Even though the collapse in the auction rate securities market is “not a credit problem, [but] a liquidity problem,”<sup>119</sup> the fact that investors in these securities cannot access their funds has had an extremely detrimental impact on the financial stability of the investors. And while the focus has been on the detriment caused to the individual investors, many corporate holders of these securities have faced massive write-downs in the value of their auction rate holdings.<sup>120</sup>

Not only did this collapse in the market have a significant impact on the investors who held these securities, it also greatly affected the issuers of these bonds. As explained earlier, when an auction fails, the issuer of the securities must pay a “fail rate” to the investors, which can be described as a punitive penalty rate specified in the bond documentation.<sup>121</sup> Therefore, when there are not enough buyers for a particular auction, the company that issued the bonds must pay the investors still holding these securities a higher interest rate than they would had the auction been successful.<sup>122</sup> For

117. *Id.* “As a rough measure of the magnitude of the problem faced by investment banks whose customers were sold these securities, Morgan Stanley announced in its March 19 conference call with investors that the value of the auction-rate securities held by its customers alone was roughly \$20 billion.” *Id.*

118. Rappoport, *supra* note 63. For example, Bill Freeman, an owner of a small copy-machine company in Irvine, California, had about \$200,000 invested in auction rate securities in an account held by UBS. *Id.* Without the liquidity once provided to his funds, “[he] may have to draw operating capital from his 25-employee company, Century Business Services, just to pay his taxes this year.” *Id.* Furthermore, “Freeman also has another \$550,000 locked up in auction-rates with Wells Fargo, which offered him an \$80 credit on his checking account to switch his money from a savings account into securities that he was told would take a few days longer to liquidate.” *Id.*

119. *Id.*

120. See Rockey, *supra* note 53. For example,

[i]n its most recent 10K annual report filed with the SEC, airline JetBlue announced that as of Dec[ember] 31, 2007, 72 percent of its \$834 million in cash and investment securities was held in auction-rate securities. Though it managed to trim its exposure [to auction rate securities] to \$330 million by Feb[ruary] 11, JetBlue confirmed that \$144 million of the securities was subject to failed auctions and that, because of current market conditions, auctions related to these securities will likely be unsuccessful in the near future.

*Id.* (footnote omitted). “Best Buy, the world’s largest consumer electronic retailer, owned \$397 million in auction-rate securities as of April 25[, 2008].” Mike Meyers & Chris Serres, *Auction-Rate Securities Get No Bidders; The Esoteric Debt Vehicles Promised Low Short-Term Interest Rates on Long-Term Debt but Wound Up Costing Millions to Minnesota Companies*, STAR TRIB., May 26, 2008, at 1D. However, the company had not marked down these investments as of May 2008, stating that they “believe that the credit quality of [their] auction-rate securities is high and that [they] will ultimately recover all the amounts invested in these securities.” *Id.*

121. See *supra* Part.I.B.

122. See discussion *supra* Part.I.B.

example, around the time of the freeze-up “[r]ates on \$100 million of bonds sold by the Port Authority of New York and New Jersey . . . soared to 20 percent . . . from 4.3 percent a week [earlier].”<sup>123</sup> This jump in interest rates was also reflected in the fact that “the average rate for seven-day municipal auction [rate securities] rose to a record 6.59 percent on Feb[ruary] 13[, 2008] from 4.03 percent the previous week.”<sup>124</sup> This deterioration of the auction rate market has also affected the plans of other companies and municipalities to raise capital for long-term projects, with most companies now relying on other debt markets to raise funds instead of using the once reliable auction rate securities market.<sup>125</sup>

### III. MARKET “STABILIZATION” VERSUS MARKET “MANIPULATION”

#### A. MARKET “STABILIZATION” AND ITS USES

“The Securities and Exchange Commission (SEC) stated in 1940 that ‘stabilization’ . . . may be ‘broadly defined’ as ‘. . . the buying of a security for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public.’”<sup>126</sup> Since that time, the SEC has promulgated numerous rules and regulations regarding the practices of broker-dealers in the stabilization and manipulation of the prices of securities within the financial markets, setting forth what practices are and are not allowed to be used by participants in the exchange of securities.<sup>127</sup> The most important regulation set forth by the

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123. Martin Z. Braun, *Auction-Bond Failures Roil Munis, Pushing Rates Up (Update 5)*, BLOOMBERG, Feb. 13, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aju0C0WBT8GI>.

124. Preston, *supra* note 15.

125. See Meyers & Serres, *supra* note 120.

CentraCare Health System, operator of St. Cloud Hospital, [in Summer 2007] planned a \$200 million debt issue to finance hospital and other construction projects before the end of 2007. Instead, the project, to be financed with auction rate securities, was delayed . . .

“We got very, very fortunate that we didn’t do it last fall. I think we would have done auction-rate securities,” [CentraCare’s Chief Financial Officer, John Seckinger] said. “That’s what all the financial advisers and underwriters said was the best market.”

*Id.* Instead, the company issued \$200 million in bonds, which sold in 15 minutes, just as the auction rate securities market was quietly collapsing. *Id.*

126. George S. Parlin & Edward Everett, *The Stabilization of Security Prices*, 49 COLUM. L. REV. 607, 607 (1949) (quoting Statement of the Commission Respecting Distinctions Between the Reporting Requirements of Section 16 (a) of the Securities Exchange Act of 1934 and Section 30 (f) of the Investment Company Act of 1940, Securities Exchange Act Release No. 2446, 11 Fed. Reg. 10971 (Mar. 18, 1940)).

127. See Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release No. 7375, Exchange Act Release No. 38,067, Investment Company Act Release No. 22,412, 62 Fed. Reg. 520 (Jan. 3, 1997) [hereinafter Anti-Manipulation Rules] (explaining the development of

Securities Act of 1934<sup>128</sup> regarding the practice of manipulation was § 10(b), which provided that

[i]t 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 security exchange— . . .

. . . .

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.<sup>129</sup>

Under the authority set forth in this statute, the SEC adopted Regulation M in December 1996.<sup>130</sup> “Regulation M restricts offerings, activities, and persons where there is a readily identifiable incentive to manipulate the price of an offered security.”<sup>131</sup> Regulation M is also meant to “govern[] the activities of underwriters, issuers, selling security holders, and others in connection with securities offerings.”<sup>132</sup>

Today “stabilizing” is defined by the SEC as “the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or maintaining a price of a security.”<sup>133</sup> Stabilization is permissible, but only in certain situations and when the regulations set forth by the SEC are specifically followed.<sup>134</sup> Regulation M prohibits bids or purchases “except for the purpose of preventing a retard or decline in the market price of a security,” and forbids “stabilizing at a price that the person stabilizing knows or has reason to know is . . . the result of activity that is fraudulent, manipulative, or deceptive.”<sup>135</sup> It is also interesting to note that this

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United States laws regarding the stabilization and manipulation practices that are and are not permissible).

128. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78nn (2006)).

129. 15 U.S.C. § 78j (2006).

130. Div. of Mkt. Reg., SEC, Revised Staff Legal Bulletin No. 9: Frequently Asked Questions About Regulation M (Apr. 12, 2002), <http://www.sec.gov/interps/legal/mrslb9.htm>; see also WILLIAM M. PRIFTI, SECURITIES: PUBLIC & PRIVATE OFFERINGS, § 5:24 (2d ed. 2009) (“Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21 were rescinded by the SEC effective March 4, 1997 and replaced by Regulation M.”). Regulation M became effective on March 4, 1997. PRIFTI, *supra*.

131. PRIFTI, *supra* note 130.

132. *Id.*

133. 17 C.F.R. § 242.100(b) (2009).

134. See Anti-Manipulation Rules, *supra* note 127, at 535–37.

135. 17 C.F.R. § 242.104 (2009). Specifically, § 242.104 states:



regulation does not allow for the placing of “more than one stabilizing bid in any one market at the same price at the same time.”<sup>136</sup>

The practice of price stabilization is a “price-influencing activity intended to induce others to purchase the offered security.”<sup>137</sup> Therefore, “when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders, underwriters, and issuers.”<sup>138</sup> The SEC has set forth strict guidelines regarding the practice of price stabilization in order to “address[] the risk that stabilization will create a false or misleading appearance [of the security] with respect to the trading market for the offered security.”<sup>139</sup> This practice of price stabilization is also meant to “occur[] most frequently during the period [when a new security enters the market, or] during the period of flotation of a new issue.”<sup>140</sup>

The practice of price stabilization stems from underwriters’ actions during the initial flotation of a security in the market.<sup>141</sup> When a corporation seeks to raise capital by issuing shares of equity or debt, it will hire an investment bank to underwrite the securities being issued to the public and to help sell these securities to investors.<sup>142</sup> However, when a security

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(a) *Unlawful Activity.* It shall be unlawful for any person, directly or indirectly, to stabilize, to effect any syndicate covering transaction, or to impose a penalty bid, in connection with an offering of any security, in contravention of the provisions of this section. No stabilizing shall be effected at a price that the person stabilizing knows or has reason to know is in contravention of this section, or is the result of activity that is fraudulent, manipulative, or deceptive under the securities laws, or any rule or regulation thereunder.

(b) *Purpose.* Stabilizing is prohibited except for the purpose of preventing or retarding a decline in the market price of a security.

(c) *Priority.* To the extent permitted or required by the market where stabilizing occurs, any person stabilizing shall grant priority to any independent bid at the same price irrespective of the size of such independent bid at the time that it is entered.

(d) *Control of Stabilizing.* No sole distributor or syndicate or group stabilizing the price of a security or any member or members of such syndicate or group shall maintain more than one stabilizing bid in any one market at the same price at the same time.

*Id.*

136. *Id.*

137. Anti-Manipulation Rules, *supra* note 127, at 535.

138. *Id.* (citing 25 U.S.C. 78i(a)(6) (2006)).

139. *Id.* (citing Securities Exchange Act Release No. 28732, 59 Fed Reg. 814, 815 (Jan. 8, 1991)).

140. Alexander Hamilton Frey, *Federal Regulation of the Over-the-Counter Securities Market*, 106 U. PA. L. REV. 1, 25 (1957). The practice of stabilization usually “consists of purchases of the security being distributed for the account of the underwriting syndicate in order to maintain the initial offering price or to prevent a decline.” *Id.*

141. *Id.*

142. *Id.* The corporation issuing the securities

contract[s] for these services with an investment banker or underwriter. This contract contains the agreed terms of the issue as well as the approximate price to the issuer and

initially hits the market, “there may . . . be a time lag between the offering of an issue at a stated price and public awareness of its worth, during which period the market price may sag.”<sup>143</sup> Therefore, instead of waiting for the public to realize the actual value of the security, the underwriter may “purchase blocks of the very issue they are trying to sell, in order to create artificially an appearance of real demand at the offering price, and thus to induce prompt public interest in purchasing the securities at that price.”<sup>144</sup>

### **B. MARKET MANIPULATION IN THE AUCTION RATE SECURITIES MARKET**

The main purpose of market stabilizing activities is to more efficiently facilitate the purchase and sale of a particular security when it is first offered to the public in order to prevent an extreme drop in the price of that security.<sup>145</sup> This practice is a way for broker-dealers and investment bankers to legally manipulate the price of a security for the betterment of the market as a whole. The SEC, in the Securities Act of 1934 and Regulation M, has laid out specific situations in which market stabilizing practices are allowed and guidelines that broker-dealers should follow when taking part in these practices.<sup>146</sup> While the practice of stabilization is legal and somewhat encouraged, this note argues that the practices used by the broker-dealers in the auction rate securities market went beyond the realm of stabilization, to a level of manipulation that contributed to the market’s breakdown.

By consistently injecting their own funds into the auctions in order to prevent failed auctions, the broker-dealers and financial institutions were acting as more than just “buyers of the last resort . . . . [They were] consistently called upon to stabilize the [auction rate securities] market.”<sup>147</sup> As one bond trader stated, “[t]he truth is there was no natural auction success rate. But for the banks acting as market-makers, these auctions would have failed from the get go.”<sup>148</sup> Rather than injecting capital into a security offering for a short period of time to stabilize and prevent undue decline in the security’s price, the broker-dealers and financial institutions

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the ‘spread’ (*i.e.*, the difference between the price realized by the issuer and the price charged to the public by the underwriter). The originating underwriter then forms an underwriting syndicate, the other members of which proportionately share the risk and the potential profit. The members of the underwriting group sell at least half of the issue to their customers, and the balance is sold for their account by a selling group which they form and with whom they split commissions on this latter amount of the total issue.

*Id.* at 25–26.

143. *Id.* at 26.

144. *Id.*

145. PRIFTI, *supra* note 130.

146. *See supra* Part III.A.

147. Carney, *supra* note 14.

148. *Id.* (internal quotation marks omitted).

manipulated the auction rate securities market for years. The broker-dealers caused the auction rate securities market to have an “illusory liquidity,” by consistently manipulating the auctions in order to prevent failures.<sup>149</sup>

Unlike the practice of market “stabilization,” in which a broker-dealer may attempt to keep the price of a security at a sufficient level for a short period of time after the security initially hits the market,<sup>150</sup> the broker-dealers continued to inject their own capital into the auction rate securities market on a weekly basis.<sup>151</sup> The purpose of stabilizing the price of a newly issued security is to show other market participants that the particular security is an attractive investment that is trading below its actual value.<sup>152</sup> Further, “[m]any courts have held that stabilization is legal if its purpose is in fact to provide support against unusual market conditions in a sincere effort to protect the interests of shareholders and investors.”<sup>153</sup> However, to create a “false impression as to the degree of real interest in a security is a form of deception,” and some forms of alleged stabilization may be used to disguise illicit manipulation. In the auction rate securities market, the alleged “stabilization” that took place was meant to further the interests of the broker-dealers and not the investors in those securities.<sup>154</sup> By continuing to support these auctions that should have failed, the broker-dealers were able to continue to reap the large fees that they charged both to the issuers of the securities and to the purchasers of the investments.

#### IV. HOW GREED FOR MORE FEES FUELED THE COLLAPSE OF THE AUCTION RATE SECURITIES MARKET

For the past two decades, the auction rate securities market provided broker-dealers and investment banks with the opportunity to collect enormous fees from both the issuers of auction rate securities and the investors who placed their funds into these markets.<sup>155</sup> The broker-dealers used what many would describe as deceptive practices in order to fool investors into believing that the market was as safe and as liquid as their savings account at their local bank. Most investors in auction rate securities now give the same explanation when asked why they invested so heavily in a market that was so dysfunctional on the inside; “they were told by their brokers [that] these [auction rate securities] were safe as cash . . . .”<sup>156</sup> What has resulted since the collapse of the market has become almost too

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149. Cherdack & Ball, *supra* note 81, at 343.

150. *See supra* Part III.A.

151. *See* Cherdack & Ball, *supra* note 81, at 343.

152. *See* Frey, *supra* note 140, at 26.

153. *Id.* at 50.

154. Cherdack & Ball, *supra* note 81, at 343.

155. *See id.* at 343–44.

156. Stephen Taub, *Auction-Rate Probes Go National*, CFO.COM, Apr. 21, 2008, [http://www.cfo.com/article.cfm/11078121/c\\_11075991?f=TodayInFinance\\_Inside](http://www.cfo.com/article.cfm/11078121/c_11075991?f=TodayInFinance_Inside) (quoting Bryan Lantagne, Securities Division Director for Massachusetts Secretary of State Willam Galvin).

recognizable in the financial services industry—a slew of lawsuits by investors and a rash of investigatory probes by state and federal government agencies targeted against the broker-dealers who propped-up this faulty market.<sup>157</sup>

As the auction rate securities market meltdown slowly unfolded to the public eye, many began to question the interventionist practices that the broker-dealers employed in the market. For example, Martha Mahan Haines, Chief of the Office of Municipal Securities at the SEC, asked the following question: “Was it in the best interests of issuers and investors to be so heavily dependent on broker-dealer intervention to support the expansion of [the auction rate securities] market?”<sup>158</sup> Looking back on what took place in the auction rate securities world over the past several years, the answer is clearly “No.” While the broker-dealers who worked in the market may defend their practices as stabilizing activities that helped to bring liquidity to the market, these practices were the ultimate reason that the auction rate securities market came to a extraordinary crash in early 2008.

In the auction rate securities market, there were rules and guidelines put in place to deal with failed auctions for a reason: failed auctions were a natural part of the market. By allowing an auction to fail early in its life, signals are sent to investors regarding the credit-worthiness of a particular investment, as well as signals sent to issuers that they may want to restructure their debt so that they do not use auction rate securities to raise capital. While some intervention by broker-dealers is proper and useful when dealing with the stabilization of a newly issued security, the continuous manipulation of a security over a long period of time could only lead to disaster. The intervention by broker-dealers “supported the rapid growth of [the auction rate securities] market to over \$200 billion.”<sup>159</sup> However, the only proper action that should have been taken by the broker-dealers was to allow the auction rate securities to continue along their true path, even if that meant allowing certain auctions to fail. That a particular offering of securities may prove to be unpopular to investors is a “risk inherent in the business of underwriting,”<sup>160</sup> and the broker-dealers should not have taken steps “to avoid this risk by creating an unreal appearance of demand for the securit[ies] at the expense of unsuspecting investors thus induced to pay artificially inflated prices” on a weekly basis.<sup>161</sup>

While many people have asked “[h]ow long did [the broker-dealers] know the auctions were on life support,”<sup>162</sup> the real question that should

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157. See Efrati, *supra* note 17.

158. Mahan Haines, *supra* note 70.

159. *Id.*

160. Frey, *supra* note 140, at 50.

161. *Id.*

162. Carney, *supra* note 14.

have been asked is why did the broker-dealers continually prop-up the market knowing that it was flawed from the beginning? The only answer to this question appears to be greed. While the financial services markets have benefited a great number of people with the creation of new products and investment vehicles, there always seems to be a group of people who are taken advantage of in order for a select few to gain exorbitant amounts of wealth. In the case of the auction rate securities market, not only were unsuspecting investors duped into believing they were investing in safe and liquid investments,<sup>163</sup> but the companies and municipalities that issued these securities were also deceived into believing that the securities they were issuing would always allow them to borrow money at low interest rates.<sup>164</sup> The actions of the broker-dealers in deceptively framing the auction rate securities market as safe and liquid adds to a long list of irrational behavior within the financial markets that has pervaded our newspapers and television sets over the last two years.<sup>165</sup>

As one managing director at a financial advisory firm stated, “[auction rate] securities really worked very well for a relatively long period of time . . . . It’s possible that people were lulled into a sense of false security because if something works well for 20 years you might not be as attentive.”<sup>166</sup> The “[s]upply [of auction rate securities] would have long since exceeded demand had [broker-dealers] not prevented failed auctions by buying [the securities] at auctions where there otherwise would not have been enough buyers to prevent auction failures.”<sup>167</sup> Investors in these securities were “unaware of the extent to which dealers were propping up the [auction rate securities] auctions,”<sup>168</sup> causing investors to believe that they could always easily liquidate their holdings regardless of the financial situation of the markets. By creating a market that was fueled by a thirst for more investment fees, the broker-dealers and investment banks essentially caused the mess that they are dealing with today.

When the auction rate securities market was first created, it was intended to be an investment vehicle for corporations and municipalities to raise capital using long-term debt with low, short-term interest rates.<sup>169</sup> These securities were also seen as highly safe investments for investors who wanted to gain a slightly higher interest rate on their funds, while maintaining liquidity that one would normally associate with a bank

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163. See discussion *supra* Part II.

164. See generally Meyers & Serres, *supra* note 120.

165. See generally Michael Lewis, *The End*, PORTFOLIO, Nov. 11, 2008, <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom?page=0>.

166. Morgenson, *supra* note 91.

167. Gitomer, *supra* note 12, at 364.

168. *Id.*

169. Bisbey Colter, *supra* note 34.

account or a money-market fund.<sup>170</sup> However, over time, this sense of liquidity eroded as fewer investors showed up for the auctions each week, and the demand for auction rate securities dwindled to extremely low levels.<sup>171</sup> But instead of allowing the auctions to fail when this demand first decreased, the broker-dealers used their own capital to supplement the market and plunge the investors into a dangerous state of affairs that resulted in the complete collapse of liquidity in the market.<sup>172</sup>

The problems that took place within the auction rate securities market are simply a furtherance of what we have witnessed in the securities markets for the past two decades: “The outrageous bonuses, the slender returns to shareholders, the never-ending scandals, the bursting of the internet bubble, [and] the crisis following the collapse of Long-Term Capital Management . . . .”<sup>173</sup> The collapse of the auction rate securities market likewise signals how the financial services industry has operated in our country, and the great reluctance of those who run the industry to “not fac[e] up to how badly [they] have mismanaged [their] business.”<sup>174</sup> The financial markets should function with a “survival of the fittest” mentality, with the strongest investment products and services rising to the top, while the inefficient and unproductive products and services are disposed of over time. As new and innovative investment tools and vehicles have been created, investors and issuers alike have realized more and more ways to not only raise capital, but also to subsequently distribute securities among those wishing to purchase them.<sup>175</sup> Whenever a new type of security or instrument does not function properly, or if demand in that type of security greatly decreases, one would imagine that investment banks and broker-dealers would just replace that security with a newer, more advanced investment. However, in the case of auction rate securities, broker-dealers and investment bankers continued to support a faulty market, instead of allowing the market to follow along on its path to either ultimate failure or greater innovation. And why? Because, the broker-dealers still “receive[d] . . . auction fees even when the auctions fail[ed].”<sup>176</sup>

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170. *Id.*

171. *See supra* Part II.

172. *See supra* Part II.

173. Lewis, *supra* note 165.

174. *Id.*

175. *See generally id.* (describing, for example, how secured assets like mortgages were pooled and divided into collateralized debt obligations, which were further divided and spooled into increasingly complicated and overrated collateralized debt obligations).

176. Morgenson, *supra* note 91.

## V. HOW TO HELP AUCTION RATE SECURITIES INVESTORS

### A. CONTINUED SETTLEMENTS WITH INVESTORS AND REGULATORY AGENCIES

Since 2008, a number of financial institutions, including Citigroup, Wachovia, and UBS, have reached massive settlements with various regulatory institutions regarding their involvement in the auction rate securities market meltdown.<sup>177</sup> These settlements were in response to state and federal investigations of the broker-dealers' marketing and selling of auction rate securities, with many regulatory agencies alleging that the broker-dealers and investment banks falsely sold these products as highly liquid and cash-equivalent securities.<sup>178</sup> In particular, these settlements, many of which were reached between the broker-dealers and groups such as the Financial Industry Regulatory Authority (FINRA) and the New York Attorney General's Office, have resulted in the buyback of approximately \$61 billion of auction rate securities from investors,<sup>179</sup> as well as the payment of over \$360 million in fines by the broker-dealers.<sup>180</sup>

Since these settlements began to unfold, broker-dealers and financial institutions have essentially performed a "mea culpa" of ultimate proportions, attempting to reimburse the damaged investors in auction rate securities with the hope of keeping them around for future business.<sup>181</sup> This is significant due to the nature of the financial services market, where very rarely will a financial institution reach out to help a struggling investor. In

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177. Elinor Comlay, *Auction-Rate Buybacks Add to Bank Writedown Worries*, REUTERS, Aug. 28, 2008, <http://www.reuters.com/article/reutersEdge/idUSN2745765720080828?sp=true>.

178. Adrian D'Silva et al., *Explaining the Decline in the Auction Rate Securities Market*, CHI. FED. LETTER (Fed. Res. Bank of Chi., Chi., Ill.), Nov. 2008, [http://www.chicagofed.org/publications/fedletter/cflnovember2008\\_256.pdf](http://www.chicagofed.org/publications/fedletter/cflnovember2008_256.pdf). For example, the SEC's Division of Enforcement reached a settlement with Merrill Lynch "that would enable investors who purchased auction rate securities . . . to receive a total of up to \$7 billion to restore their losses and liquidity." SEC, *Commission Announcements: SEC Enforcement Division Announces Preliminary Settlement with Merrill Lynch to Help Auction Rate Securities Investors*, SEC NEWS DIG. (SEC, Wash., D.C.), Aug. 22, 2008, <http://www.sec.gov/news/digest/2009/dig082208.htm>. The SEC claimed:

Merrill Lynch did not make adequate disclosures that the liquidity of these securities was based on Merrill Lynch supporting the auctions it managed when there was not enough demand . . . . Furthermore, Merrill Lynch continued to tout the purported liquidity of [auction rate securities] to customers despite its awareness of the escalating liquidity risks in the weeks and months preceding the collapse of the [auction rate securities] market.

*Id.*

179. Press Release, N.Y. State Attorney Gen., Attorney General Cuomo Announces the Release of an Assurance of Discontinuance in Auction Rate Securities Settlement with Wachovia (Feb. 5, 2009), [http://www.oag.state.ny.us/media\\_center/2009/feb/feb5c\\_09.html](http://www.oag.state.ny.us/media_center/2009/feb/feb5c_09.html) [hereinafter Press Release, N.Y. State Attorney Gen.].

180. *Lessons Learned from Auction Rate Securities*, INVESTMENTNEWS, Aug. 18, 2008, <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080818/REG/281531267/1003>.

181. *See id.*

today's financial world, where the trust that existed between investors and broker-dealers has essentially vanished, it is pertinent that the financial institutions "make good"<sup>182</sup> with their customers who were duped into purchasing auction rate securities.

As is expected in the financial markets, "we understand we assume risk when we purchase financial instruments, and don't expect sellers to compensate us for market vagaries."<sup>183</sup> However, if the financial institutions and broker-dealers are going to regain the trust of the spurned investors to try to jumpstart our struggling economy, they must be held accountable for their products that they manipulated in order to gain exorbitant profits. The settlements that have taken place since 2008 are a welcome sign that the broker-dealers recognized their "breach of fair-business-conduct-rules," an essential step in restoring confidence to an industry that has seemingly lost the respect of many American citizens.

#### **B. END INVESTMENTS OF THIS NATURE**

It is easy to see how the collapse of the auction rate securities market has affected the overall sentiment surrounding the financial markets; it has significantly added to the negativity that is so often associated with Wall Street. However, a broader picture that has been painted by this fiasco: the limits on how financial institutions and broker-dealers can make money. These limitations should be recognized and respected.

Auction rate securities were products created to fill a long term funding need for issuers while supplying investors with a short term borrowing opportunity.<sup>184</sup> This long-term/short-term arrangement was created with the hopes of constantly creating massive fees for broker-dealers, while attempting to keep clients and investors blinded from the dangers that came along with these investment instruments.<sup>185</sup> However, this breakdown in the market has shown us that "[s]uch an arrangement is impossible" because any type of arrangement that funds long term investments with short term liabilities is "inherently unstable."<sup>186</sup> Essentially, auction rate securities proved that it is unreasonable and irresponsible to match up sellers of oranges with buyers of apples, for the sole purpose of accumulating higher investment fees and profits for financial institutions.

Certain risks and limitations are inherent in the financial services market and they are essential restrictions against the creation of investment instruments such as auction rate securities. If confidence is going to be restored in the financial services industry, broker-dealers and investment institutions must understand that there are certain boundaries in which they

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182. *Id.*

183. *Id.*

184. *See* D'Silva et al., *supra* note 178.

185. *See id.*

186. *Id.*



can operate. And while there are countless numbers of investment products which have been created that have benefited both issuers and investors, not every investment instrument will prove to be successful. Financial institutions must realize that not every financial product that is created is beneficial, and only the strongest and safest investment products should be marketed to their customers.

## CONCLUSION

Since the breakdown of the auction rate securities market in early 2008, there has been a wave of litigation against the broker-dealers and investment banks that so recklessly helped to damage the financial circumstances of many.<sup>187</sup> Furthermore, the SEC and several state Attorney Generals, including New York's Andrew Cuomo, have conducted investigations of numerous broker-dealers<sup>188</sup> that have resulted in the buyback of millions of dollars worth of auction rate securities from investors harmed by the breakdown in the market.<sup>189</sup> However, there are still a large number of investors who have lost a great deal of wealth and liquidity from the destruction of the auction rate securities market,<sup>190</sup> which could negatively affect their financial situation for years to come.

The fear of many is that those who were spurned by the investment banks and broker-dealers in the auction rate securities meltdown may have finally lost all trust in Wall Street and will refuse to come back for their services in the future.<sup>191</sup> This refusal to return may be warranted, with the meltdown of the auction rate securities market causing individual investors to finally realize the “[m]e [f]irst”<sup>192</sup> motto that has been embraced by Wall Street for such a long time.

While new and innovative investment vehicles are beneficial to the securities market, not all investment tools prove to be successful. The auction rate securities market was created for those needing capital to raise long-term debt with short-term interest rates, and for those needing safe

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187. See Sabry et al., *supra* note 109. “The [auction rate securities] market problems have led to various lawsuits against broker-dealers such as Wachovia, Goldman Sachs, Wells Fargo, UBS, JP Morgan, Merrill Lynch, Morgan Stanley, TD Ameritrade, and others, all of which face allegations that they misrepresented the risk-level and liquidity of the [auction rate securities] they sold.” *Id.*

188. Efrati, *supra* note 17.

189. Press Release, N.Y. State Attorney Gen., *supra* note 179.

190. Robert Frank & Liz Rappaport, *The Auction-Rate Monster in the Closet—Settlement Excludes 4Kids, Other Firms; Battle With Lehman*, WALL ST. J., Aug. 29, 2008, at C1. There are hundreds of U.S. companies that have lost money in the auction rate securities crisis, including 4Kids, a children's entertainment company. *Id.* “While some investors—individuals, charities, municipalities—are getting their money back as part of the \$50 billion in settlements paid out by Wall Street . . . other companies are being left out.” *Id.*

191. See Evan Cooper, *The Auction-Rate Securities Backlash*, INVESTMENT NEWS, May 7, 2008, <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080507/REG/178666062/1098/INDAILYOPINION>.

192. *Id.*

investments to gain a reasonable interest rate using a highly liquid securities market.<sup>193</sup> However, once the broker-dealers began to manipulate the market by refusing to allow auctions to follow their natural path, the safety and security of the market vanished. Innovation and productivity are essential for the proliferation of wealth in the ever-changing financial markets. Yet, with innovation and productivity also comes the risk of failure that not every investment tool is worthy of the support of investors and financial institutions. The auction rate securities market may have been wildly successful for a period of time, but it never should have been falsely sustained for so long by the broker-dealers who were the key players in its inception.

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193. *Supra* Part II.

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