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Auction-Rate Violations Result in $13M Penalty

SEC Announces Settlement With 15 Firms

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The Securities and Exchange Commission yesterday announced a $13 million global settlement with 15 broker-dealer firms for engaging in industry-wide practices that violated the securities laws in the municipal, corporate, and preferred stock auction-rate markets, which have grown to more than $260 billion in the 22 years since they were created.

The SEC charged that from Jan. 1, 2003, through June 30, 2004, the firms acted negligently by following a series of practices that, among other things, favored certain investors over others, or issuers over investors, and manipulated clearing rates. These practices were not disclosed to investors and other market participants in disclosure and other documents, the SEC said.

“This matter highlights both the industry-wide violations that existed in the auction securities market and benefits to firms that cooperate with the SEC to quickly address problems,” said Linda Chatman Thomsen, director of the SEC’s enforcement division. “This case signals that the commission is willing to take measured sanctions when broker-dealers are cooperative with the SEC in curing industry-wide violations and there is relatively modest investor harm.”

“While the auction rate securities market is not well-known to the general public, it is in fact a large and important market,” said Kenneth Lench, an SEC assistant director of enforcement. “The commission obviously was very concerned, therefore, to find that so many of the major market participants were not following the rules. By this settlement, as well as the remedial measures undertaken by the firms, this industry has cleaned up its act. The relatively modest sanctions of the settlement reflect the cooperation and remediation of the firms.

The SEC noted, also, that the firms voluntarily disclosed their practices to the SEC.

“Integrity in our profession is paramount,” said Joseph Fichera, chief executive officer of Saber Partners LLC, a New York firm that was retained as an expert adviser by the SEC in this matter. “These are serious issues that our industry needed to address to maintain the fundamental integrity of the auction process.”

Fichera declined to comment on the specific terms of the settlement.

Meanwhile, The Bond Market Association yesterday issued a draft set of best practices developed by a task force of member-firm traders, lawyers and compliance officers that, if approved, would essentially outlaw some of the practices cited by the SEC in enforcement documents.

The broker-dealer trade group also is preparing to unveil on Monday eight new indices developed by Municipal Market Data that are designed to give issuers and investors benchmarks of prevailing interest rates for different types of auction rate securities.

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There were $263 billion of auction rate securities outstanding as of the end of 2005, TBMA said yesterday, citing statistics from the five major auction agents. About 46% of that amount was municipal debt and about 92% of the total amount was rated AAA or Aaa, the group said.

In the municipal market, auction rate securities are municipal bonds whose interest rates are periodically reset through auctions, typically every 7, 14, 28, or 35 days. Auction rate bonds can have maturities that range from five years to perpetuity, but are usually 30 years, the SEC said. Issuers often use these securities as an alternative to variable rate bond financing and by investors as an alternative to money market funds.

Auction rate securities are auctioned at par so the return on the investment to the investor and the cost of the financing to the issuer between auction dates is determined by the interest rate set through the auctions. Broker-dealers underwrite, and manage auctions, for auction rate securities. The issuer pays them an annualized fee, typically 25 basis points for the par value of the securities the firm manages, the SEC said. The issuer also hires an auction agent, often a bank, to collect the orders and determine the clearing rate for the auction.

In an auction, investors can submit “hold” orders to keep their securities at the rate at which the auction clears; “hold-at-rate” orders to keep the securities is at or above a specified level; “sell” orders to sell the securities regardless of the clearing rate; and “buy” bids to buy the securities at the clearing or other specific rate.

The clearing rate is the lowest rate bid sufficient to cover all of the securities for sale in the auction. If there are not enough bids to cover the securities for sale, then the auction fails and the issuer must pay an above-market rate set by a pre-determined formula. If all of the holders of the securities chose to hold their positions without bidding a particular rate, then the clearing rate is the all-hold rate, a below-market rate set by a pre-determined formula, the SEC said.

In its order against the broker-dealer firms, the SEC said it found in its investigation that the disclosure documents for auction rate securities “varied as to what, if anything, they disclosed about broker-dealers bidding in auctions that they were managing” and typically did not spell out other questionable practices.

Specifically, the SEC charged the broker-dealers’ with conduct that included:

— Allowing certain investors to place “open” or “market” orders in auctions so that the broker-dealer can later designate some of all of the bid’s parameters, such as the specific security, rate, or quantity;

— Intervening in auctions by bidding for a firm’s proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a “market” rate, or to prevent all-hold auctions;

— Submitting or changing orders, or allowing customers to do so, after auction deadlines;

— Prioritizing certain customers’ bids to increase the likelihood that their bids will be filled;

— Taking action, or allowing customers to take action, to submit or revise bids after deadlines;

— Allocating securities to investors who bid at the clearing rate instead of allocating the securities between investors on a pro rata basis, as stated in disclosed procedures;

— Not requiring certain customers to purchase partially-filled orders, when an auction was over-subscribed, even though the orders were supposed to be irrevocable;

— Having an express or tacit understanding prior to the auction to provide certain customers with higher returns than the auction clearing rate; and

— Engaging in “price talk” and providing certain customers with information that gave them an advantage over other customers in determining what rate to bid.

Under the settlement, eight broker-dealers who had a large share of the market and therefore more frequently engaged in such practices, will each pay $1.5 million. They are: Bear, Stearns & Co.; Citigroup Global Markets Inc.; Goldman, Sachs & Co.; JPMorgan; Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner & Smith Inc.; Morgan Stanley & Co, Inc./Morgan Stanley DW Inc., and the former RBC Dain Rauscher Inc., now RBC Capital Markets.

While Banc of America Securities LLC also was a major player in the market, the SEC said it would pay $750,000 rather than $1.5 million because the firm had high-quality self-monitoring capabilities in the auction-rate securities area.

Five other broker-dealers with smaller shares of the market are to pay $125,000 each. They are: A. G. Edwards & Sons Inc.; Morgan Keegan & Co.; Piper Jaffray & Co.; SunTrust Capital Markets Inc.; and Wachovia Capital Markets LLC.

In addition to imposing civil penalties on the firms, the SEC censured them, ordered them to cease and desist from future violations, and required them to take two "undertakings" or major remedial actions.

Within six months, either the chief executive officers or general counsel of the broker-dealer firms must certify in writing that they have implemented policies and procedures designed to detect noncompliance with securities laws and rules in the auction rate securities area.

In addition, the firms must provide all customers who hold auction rate securities, first-time purchasers of such securities, and issuers of such securities with a written description of their auction rate securities practices.

"The undertakings in the order are designed to widely disseminate accurate and complete information regarding the operation of the auction rate market to issuers, investors, and potential investors so that they may make knowledgeable decisions about participating in that market," said Martha Mahan Haines, chief of the SEC's Office of Municipal Securities.

The SEC said it is continuing to investigate other participants in the auction rate securities market but officials declined to comment further. Market sources say the commission is investigating the activities of auction agents. Five major auction agents exist in this market and the two largest are Deutsche Bank and Bank of New York.

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