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UBS to Pay $19 Billion As Auction Mess Hits Wall Street

By LIZ RAPPAPORT and RANDALL SMITH
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(See Corrections and Amplifications item below.)

A once-obscure corner of the bond market is triggering one of the messiest Wall Street scandals in years -- and potentially the largest mass bailout of American individual investors ever.

On Friday, facing allegations of wrongdoing over its sales of so-called auction-rate securities, **UBS** AG agreed to buy back from investors nearly $19 billion of the investments as part of a settlement with federal and a group of state regulators. It will start buying from individuals and charities in October and from institutional clients in mid-2010.

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UBS was the third major firm this week to vow to buy back the securities, which allegedly were improperly sold as higher-rate equivalents for super-safe money-market funds.

UBS, **Merrill Lynch** & Co. and **Citigroup** Inc. have committed to taking back a total of more than $36 billion of the instruments. Other financial firms are expected to follow suit.

Auction-rate securities are a kind of debt that soared in popularity in recent years. They let issuers such as municipalities and student-loan organizations borrow for the long term, but at lower, short-term interest rates. The rates reset at periodic auctions, hence the name. Wall Street sold more than $330 billion of these securities to more than 100,000 individuals and other investors.

State regulators from Massachusetts and New York have sued Merrill Lynch and UBS for civil fraud, with the UBS case now settled. Regulators from several states have also shown up on Wachovia Corp.'s doorstep demanding documents; the bank says it is cooperating. A New York state official has accused **Citigroup** of destroying documents, a charge Citi has denied. Federal prosecutors are preparing to file criminal charges against two former **Credit Suisse** Group brokers who allegedly lied to investors about auction-rate securities.

It's rare that Wall Street firms make good on client losses, and the size of the auction-rate payments is unprecedented. But a review of several recent regulatory cases reveals the legal pressure facing Wall Street, and shows that some authorities believe the auction-rate market, which was created in the mid-1980s, got out of control.

Regulators say that financial firms, at various times, secretly propped up failed auctions; misled investors on the safety of the securities; pressed brokers and research analysts to sell the very securities executives were trying to unload; and resisted client demands for relief.

'No Real Control'

"It was kind of like a Moroccan bazaar," William Galvin, secretary of the Commonwealth of Massachusetts, said in describing the way Wall Street sold auction-rate securities. "There was no real control, no warranty, no worry about backing up what you said."

Wall Street executives say the auction market functioned smoothly for more than 20 years, and only buckled this year under the stress of a credit crunch that limited their ability to provide support. As a Merrill official put it Friday, its brokers believed such securities were "good investments" for clients seeking higher short-term returns in exchange for some risk the assets couldn't quickly be resold.

The auction-rate scandal has hit tens of thousands of American investors, such as Ken Pugh, a 60-year old retiree in Fort Lauderdale, Fla., who formerly supervised the delivery-truck operations for the Sun Sentinel newspaper.

Mr. Pugh has $350,000, or his entire life's retirement savings, in auction-rate securities in an account at Bank of America, $300,000 of which are backed by student loans; his statement puts a zero in the column for the value of the $350,000. The zero, said a person familiar with the firm, is meant to be read as "not available." Bank of America footnotes statements to notify clients that the securities they hold are not worthless but are illiquid and not easily valued.

"I'm not a financial wizard, that's all I know," says Mr. Pugh. "I took their word for it, and like a dope, this is where I am." Mr. Pugh says he was told the securities were "28-day CDs."

He has gone back to work at an environmental services company for extra cash to live on until he "gets some restitution," he says. "All the stuff my wife and I planned on doing, we can't."

Mr. Pugh has filed an arbitration claim against Bank of America. Bank of America says it "does not comment on client relationships."

Regulators and prosecutors have alleged several kinds of abuses in the auction-rate market, detailed in regulatory cases and investigations. One allegation is that brokers secretly propped up failed auctions.

Interest rates were supposed to be reset by weekly or monthly auctions, at which investors could cash out if they wanted to. Until the market collapsed in February, investors got the impression there was heavy demand for the securities because the auctions went off without a hitch. They weren't told how often Wall Street dealers stepped in to support the auctions with their own bids.

UBS submitted such bids in all of its auctions, according to Massachusetts regulators, who said the Swiss firm acted to prevent auction failures in no less than 69% of its 57,436 auctions between January 2006 and February 2008.

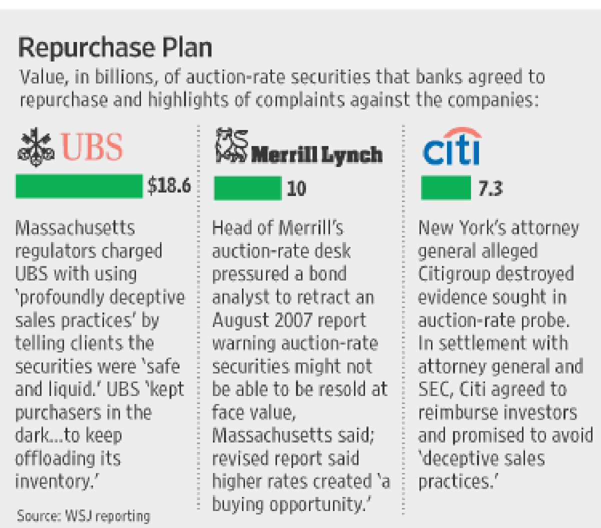
In an email to UBS executives last Dec. 15, David Shulman, who ran UBS's auction-rate desk, questioned whether the firm should continue to submit bids to support auctions.

In the email, Mr. Shulman acknowledged that investors expected UBS to make sure the auctions ran smoothly, even as he and others behind the scenes contemplated halting their bids entirely. "Retail clients have -- I am confident been told that these are 'demand' notes...and will be redeemed at par on demand," Mr. Shulman wrote. While there is no formal obligation to cash out clients at par, he added, "the moral obligation runs very deep."

UBS said it didn't intentionally hide the risks of auction-rate securities, and sold them "appropriately" to individuals for 20 years. UBS said it supported auctions "longer than any other major firm," and its inventory doubled while the number of issues in individuals' accounts declined.

A lawyer for Mr. Shulman said his emails were "taken largely out of context" and that Mr. Shulman was attempting "to be part of the solution, and was not part of the problem."

At Merrill, Massachusetts regulators allege, market-supporting bids by the firm "conceal[ed] the true level of investor demand and created a false impression that there were deep pools of liquidity in the auction market." Merrill says few auctions failed before 2008 and that it disclosed that risk and the possible withdrawal of its support bids to investors.



Another allegation by regulators is that some brokers misled investors on the safety of the securities.

Customers often were told that the securities, which had higher interest rates than rock-solid certificates of deposit, were just as safe and easily sold. They weren't told that the auctions could fail and leave them without the ability to sell.

'Other Cash'

Merrill categorized auction-rate securities as "other cash" on its brokerage statements. Its marketing materials noted that 92% of issues had a top triple-A rating. But, according to Massachusetts investigators, clients say they weren't told the auctions might fail if Merrill withdrew from making bids. Merrill said that while online statements listed auction-rate securities as cash, its "official monthly statements" listed them as "securities," and that most were in fact triple-A.

Some UBS brokers testified to the New York attorney general's office that even they didn't realize the auctions could fail. UBS executives testified that brokers never received any training on how auction-rate securities worked.

UBS says investor guides citing resale risks and the auction process were available online. The firm says it changed its classification of auction-rate securities at the suggestion of an industry group as a result of this year's market difficulties.

Also, regulators say brokers were paid unusually rich commissions to sell the securities. In some cases, they say, brokers received high commissions for a product that appeared to offer high returns but held hidden risks.

The brokers and firms typically shared commissions of 0.25% of the securities sold -- compared with 0.05% for Treasury securities and zero for plain-vanilla money-market funds. Merrill sometimes offered extra commissions, at times up to a total of 1%. Merrill says commissions "didn't change" brokers' approach to auction-rate securities.

To help sell the securities as the market's problems intensified, Citigroup and brokerage firm RBC Dain Rauscher last winter raised commissions to outside brokers for selling Citi's and Dain Rauscher's auction-rate securities inventory, according to emails sent from a Credit Suisse trading desk to Credit Suisse brokers. Dain Rauscher didn't return calls for comment.

Commissions on auction-rate securities were "much higher than for any other equivalent securities," says auction-rate specialist Joseph Fichera, chief executive of Saber Partners LLC, a financial consultant.

State regulators also point to the ways financial firms pressed brokers and research analysts to pitch the securities.

Merrill bond analyst Martin Mauro prepared a research report on last Aug. 22 warning of the dangers of auction-rate securities. It said investors "need to rely on other buyers in the market to redeem the securities at par."

Altered Report

The report was never published, Massachusetts regulators say, because Frances Constable, who ran Merrill's auction-rate-securities desk, shut it down. "It may single handedly undermine the auction market," she emailed two other Merrill employees later that day, according to a complaint filed by the regulators. The regulators say Ms. Constable demanded that the analyst retract and rewrite the report, which appeared the next day with language added that rising rates made the securities "a buying opportunity."

Merrill said the retraction demand didn't change the analyst's views but merely resulted in "a longer, fuller and clearer version." The firm said its research reflected that auction-rate securities offered "higher returns in exchange for less liquidity." Merrill said its employees weren't available to comment.

As the credit crunch developed, financial firms faced pressure to reduce their own holdings of the securities. UBS's holdings of them, for instance, soared through an internal limit of $2.5 billion last September, reaching $11 billon by the time the market froze up this February.

UBS's Mr. Shulman told colleagues on Aug. 22 that he was encouraging UBS brokers "to move more product through the system." But that same day, he sold personal holdings of auction-rate holdings worth as much as $475,000. He sold the last of his personal auction-rate holdings by mid-December, according to the Massachusetts complaint.

The reason, he told Massachusetts investigators, was that some auctions had already failed, and they exceeded his own "risk tolerance." UBS management brought up auction-rate securities in 15 calls with its brokers between August 2007 and February 2008.

Mr. Shulman was one of the UBS executives alluded to, but not charged, in a civil complaint by New York State Attorney General Andrew Cuomo. Mr. Shulman was named but not charged in the Massachusetts regulatory complaint for selling his own stake in auction-rate securities in August.

UBS said that, after its own internal probe, it "found cases of poor judgment" but not illegality by certain individuals, and is "evaluating appropriate disciplinary measures." UBS placed Mr. Shulman on administrative leave in July. Mr. Shulman's lawyer declined to comment on the securities sale.

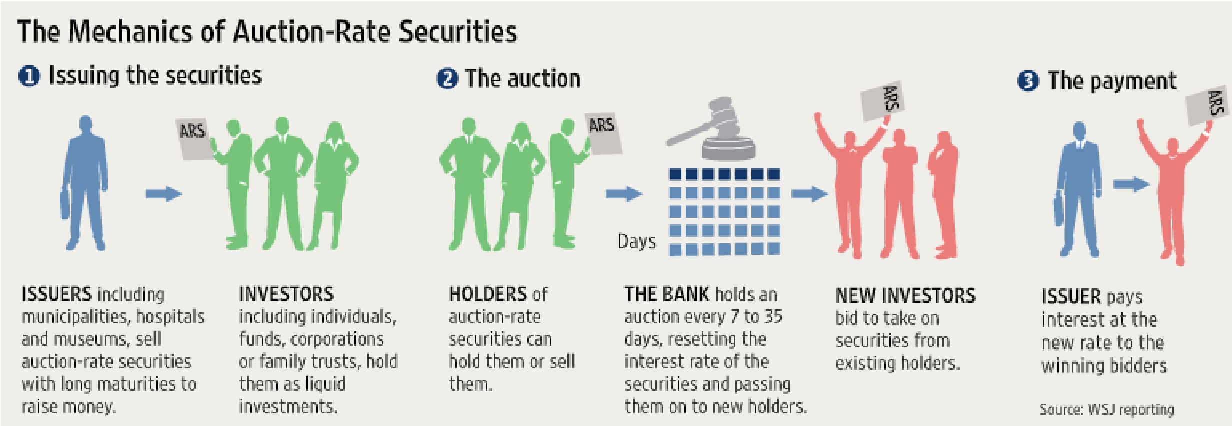
Brokers at Credit Suisse allegedly misled customers about the safety of auction-rate issues by falsely calling them "student loan" securities, according to a civil suit filed Wednesay. The plaintiff, Geneva chip maker STMicroelectronics NV, was filed Brooklyn federal court and seeks $415 million in damages. Federal prosecutors in Brooklyn, N.Y., are preparing to file criminal charges against two former Credit Suisse brokers whose clients included the chip maker, according to people familiar with the matter.

Credit Suisse said the brokers resigned in September after the firm "detected their prohibited activity," and that the firm has been assisting authorities. Credit Suisse said clients were given accurate trade confirmations and brokerage-account statements. As for the action filed by ST Microelectronics suit, a spokesman for Credit Suisse said it "declines to comment on meritless lawsuits."

It isn't clear how much in losses Wall Street firms ultimately will record by taking auction-rate securities back on their books. That will depend on if, when and how much the market recovers.

In UBS's Friday settlement, the Swiss bank agreed to buy back $8.3 billion in securities from individuals and charities and $10.3 billion later from institutions. It also has agreed to lend money to holders of the securities at 100% of their par value if they preferred.

On Thursday, Merrill agreed to buy back about $10 billion from about 30,000 investors, and Citigroup agreed to buy back about $7.3 billion from about 40,000 investors.



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Corrections & Amplifications

Joseph S. Fichera is an expert in auction-rate securities and a financial adviser to corporations and governments. This article describing him as a specialist and a financial consultant didn't mean to imply he was a broker.

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