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It’s a Long, Cold, Cashless Siege

By GRETCHEN MORGENSON

CRAIG JOFFE, an investor who owns a laser surgery business in Minneapolis, says that a couple of years ago he was looking for a safe place to put most of his life savings. So he said that on the advice of his broker, he invested 90 percent of his wealth in something he thought was just as conservative, reliable and liquid as cash: three auction-rate securities.

In fact, he says, his broker at UBS put so much of his money into just one of those securities, issued by John Hancock, that he now holds more than 5 percent of the shares outstanding.

“They were sold to me as cash equivalents,” Mr. Joffe said. “In the fourth quarter of last year, I very explicitly said to my broker, ‘Do I have any market risk in these securities?’ and he said no. I’m usually a thorough guy, but my radar wasn’t up at all.”

It wasn’t until two months ago — when the cash-out window of the $330 billion auction-rate securities market slammed shut — that warning signs began flashing across the radar screens of many people like Mr. Joffe. With the market now frozen, investors like Mr. Joffe are in limbo, and many are having to report losses, if only on paper.

Institutional investors are also feeling the pain.

Some of the big underwriters — UBS is one — are marking down the value of auction rate securities in their clients’ accounts, and companies are also writing down the value of their holdings. Last week, Palm Inc. recorded a $25 million write-down related to auction-rate securities it cannot sell. Others are sure to follow, analysts say.

But even though Wall Street heavyweights and major corporations have been stung, many of them also appear to have bailed out of the market well ahead of individuals. At the end of 2006, institutional investors held about 80 percent of all auction-rate securities issues, according to Treasury Strategies, a consulting firm in Chicago. At the end of last year that portion had fallen to just 30 percent.

“A number of corporations understood there was a rising threat to their securities; there had been failures and warnings,” Anthony Carfang, chief executive of Treasury Strategies, said in a conference call late last month.

As big holders of these securities accelerated their selling late last year, Wall Street firms overseeing the auctions would have come under greater pressure to find buyers to make the auctions succeed. It is unclear whether they turned to individual clients to fill this void.

UBS officials declined to discuss this issue or the specifics of Mr. Joffe’s case.

Only a handful of the issuers — municipalities, student loan companies or closed-end funds — have offered to redeem the securities. And brokerage firms in charge of the periodic auctions that determined the securities’ interest rates say the auctions have simply stalled because of a lack of buyers.

Thomas Martin, head of America’s Watchdog, a consumer protection advocacy group, says he has heard from more than 1,000 investors who cannot get the money out of these securities. He said they ranged from young people with $25,000 at stake to others with $1 million invested.

“The majority of people have $200,000 to $300,000 invested, but it’s their life savings, and they were told this was the same as a money market or C.D.,” Mr. Martin said. “I must have 50 or 60 people that were buying houses that were supposed to close in March and their earnest money is at risk of forfeiture because they relied on the liquidity in these things.”

While Mr. Joffe is still receiving interest payments on his securities, he is unable to retrieve his principal.

A UBS spokesman said that to help clients in need of liquidity, the firm had just begun a program to let them borrow 100 percent of the par value of their securities at a modest interest rate.

A John Hancock spokeswoman said the company was actively pursuing solutions to the liquidity crisis.

NOW that the initial shock of the auction-rate freeze has worn off, investors are pleading with issuers to buy back the securities and suing the brokers who, they said, told them they were the equivalent of cash.

Regulators are also nosing around Wall Street, asking whether the firms disclosed all the risks of these securities to the investors who bought them.

Investors should prepare for a long and dispiriting siege, experts who know the structure of these securities say. Although many of the assets and issuers backing these securities are solid, or “money good” in Wall Street parlance, the mechanics of the auction-rate securities market as well as the continuing credit squeeze give issuers and brokers little incentive to help the investors.

For example, even as investors wait in exasperation for the return of their money, Wall Street firms continue to earn the same fees for running the auctions — typically 0.25 percent of the amount of shares or notes outstanding on an annual basis — even though few auctions are succeeding.

Because the so-called penalty rates — what issuers must pay to investors when auctions fail — are relatively low, often only a bit higher than a short-term benchmark like Libor, the London Interbank Offered Rate, issuers don’t want to redeem them early. Considering that the investors have no access to their money, the low penalty rates they are receiving only add to their distress.

Many individual investors say their brokers put them into these securities for the first time in the second half of 2007 — just as big companies were aggressively dumping their stakes.

Investors were not provided with prospectuses outlining the risks in these securities because they are considered secondary market issues. Unlike primary issues, like initial public offerings, secondary issues do not require the delivery of offering circulars.

Auction-rate securities, invented in the 1980s, are debt obligations whose interest rates are set at auctions every 7 to 35 days. The bonds typically have maturities of 30 years, but the preferred shares have no maturity date.

The first issue was of preferred shares in American Express; other financial institutions soon followed because the shares were considered equity capital and bolstered their balance sheets. Industrial companies also issued them because they were a relatively cheap source of capital.

In 1989, a big auction failed because a company that issued the securities, MBank, defaulted. Later, the Federal Reserve changed the capital requirements, barring banks from listing auction-rate preferred securities as highly rated equity on a balance sheet because they could be redeemed and weren't really permanent capital. Most corporations stopped issuing the securities in the early 1990s.

Closed-end funds soon took them up, issuing auction-rate preferred shares to generate higher returns for their common stockholders. They now account for $65 billion of the market. Student-loan companies also issue auction-rate securities to finance their lending, and the collapse of the auctions may make it hard for some students to get loans.

Municipalities flocked to the auction-rate market for low-cost money. New issues peaked in 2004, according to Thomson Financial, when $44 billion was raised. Auction-rate securities morphed from a product sold mainly to corporations to one marketed heavily to individual investors; minimum investments were dropped to $25,000.

The top underwriters in the municipal part of the market were Citigroup, UBS, Merrill Lynch and Morgan Stanley. Many of these firms' customers wound up owning the securities and are now up in arms.

The market worked relatively smoothly until mid-February this year, when the credit crisis made big brokerage firms reluctant to put up precious capital to keep the auctions going. Investors could no longer sell their securities — and cannot to this day.

Dwight Grant is a managing director at Duff & Phelps, a financial advisory firm that helps corporate clients assign values to their auction-rate holdings. (It is unrelated to the closed-end fund company of the same name.)

"I talked to a very senior person at a large financial institution who inferred that she believed this could last quite a long time," Mr. Grant said. "There is a very difficult calculus in the process with respect to capital and reserves of the underwriters. To maintain auctions they were going to have to commit substantial reserves. It is not obvious when they are going to reallocate capital to this market."

Indeed, experts say that calling these securities auction-oriented is something of a misnomer because real auctions — during which buyers and sellers meet and an interest rate is set based upon their interest — weren't taking place in recent years. Instead, the Wall Street firms in charge of the auctions smoothed the process by bidding with their own capital rather than rustling up thousands of buyers to meet up with sellers every week or so.

Given this market’s size, it became harder for Wall Street to arrange true auctions regularly. Last Wednesday, for example, some 545 auctions were scheduled covering $27.2 billion of securities. Conducting that many auctions — one for each security whose interest rate expires that day — would be an enormous undertaking for the handful of underwriters in the arena.

“Auction securities became a managed bidding system, not a true investor auction,” said Joseph S. Fichera, chief executive of Saber Partners, a financial advisory firm. “The investor never knew how many investors there were, how often the brokerage firms were stepping in to make the system work, nor that the broker’s support could stop all of a sudden.

“If we had transparency in the system, investors could have judged the ability to sell in the individual auctions and bid accordingly,” he added.

Sure enough, back in May 2006, liquidity problems associated with auction-rate notes emerged when the Securities and Exchange Commission brought a case against 14 big brokerage firms that sold them. The commission accused the firms — including Bear Stearns, J. P. Morgan Securities, Goldman Sachs and Lehman Brothers — of favoring some customers over others and manipulating the auctions by adding capital to smooth out the process.

Such arrangements, while easing the bidding process, hid the potential for this market to freeze up, the regulators said. In announcing a settlement, the S.E.C. said that “investors may not have been aware of the liquidity and credit risks associated” with the securities. The firms paid $13 million to settle the matter, neither admitting nor denying the allegations.

Today, investors say they had no idea that their securities could be tied up indefinitely if the big brokerage firms couldn’t find buyers. The Financial Industry Regulatory Authority, which polices much of Wall Street, is asking firms about sales practices and risk disclosures.

How Wall Street is paid for these auctions is central to understanding why the firms have little interest in resolving the problem of failed auctions. The firms earn money at least twice: First, when the notes or shares are underwritten, they receive 1.5 percent of the amount of money raised, in the form of a fee. Then they receive 0.25 percent annually for conducting the auctions — a total of $825 million this year, based on the size of the market.

But they receive these auction fees even when the auctions fail, so the firms have no incentive to help revive this market.

On auction-rate notes backed by municipalities, Wall Street firms sometimes earn a third fee by selling an interest-rate swap alongside the note. These swaps help lower the interest rates that municipalities pay on the securities but can add considerably to the complexity of unwinding them when auctions fail.

Auction-rate securities have been popular among both individual investors and corporations looking for higher yields on their cash because they typically pay up to one percentage point more than money market funds. As of July 1, 2007, corporations owned $170 billion of these securities, or just over half of the total outstanding, according to Treasury Strategies.

But through the second half of 2007, corporate investors were dumping their stakes, Treasury Strategies said. During these months, corporations cut their holdings to $98 billion.

At the same time, many individual investors were being persuaded by their brokers to buy auction-rate securities for the first time. Jacob H. Zamansky, a lawyer in New York, says he has 50 cases involving individuals stuck in auction-rate securities who say they weren’t told of the risks. Of those, he said, 80 percent were put into the securities in the second half of 2007.

“THESE securities really worked very well for a relatively long period of time,” said Mr. Grant at Duff & Phelps. “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 to the terms of the contract.”

Lewis D. Lowenfels, a securities lawyer at Tolins & Lowenfels in New York, represents several investors who are stranded in auction-rate securities. “If the evidence shows that large corporate clients were being advised to unload these securities at the same time that the investing public was being counseled to purchase the same securities,” he said, “one begins to slip over the line from questions of due diligence and suitability into the realm of securities fraud.”