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[Home](#) > [This Week's Issue](#) > [Arbitration Sought In Auction Rate Securities Fight](#)

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### Arbitration Sought In Auction Rate Securities Fight

By [Mary Alice Robbins](#)  
Texas Lawyer  
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Houston-based Amegy Bank and its investment arm, Amegy Investments Inc., are asking in an arbitration proceeding that Merrill Lynch, Pierce, Fenner & Smith be required to buy back \$140 million in auction rate securities (ARS) that it sold to them.

Yetter, Warden & Coleman partner Paul Yetter of Houston, lead counsel for the Amegy claimants, says to his knowledge, *Amegy Investments Inc., et al. v. Merrill Lynch, Pierce, Fenner & Smith Inc., et al.* is the first arbitration that an "innocent downstream [local] broker" has sought against a national brokerage firm in the wake of the ARS market's collapse.

In an e-mail, Financial Industry Regulatory Authority (FINRA) spokesman Brendan Intindola writes he is not certain *Amegy* is the first broker-to-broker arbitration of an ARS dispute. "I can say the large majority of cases in this have been customers filing claims against firms," Intindola writes. "There were 301 ARS-related arbitration claims filed in 2008."

In their statement of claim filed Jan. 20 with FINRA, the Amegy claimants allege that Merrill Lynch, Pierce, Fenner & Smith falsely marketed ARS as "safe and liquid investments" without disclosing that "there was no sustainable market for the securities." The claimants further allege in *Amegy* that Merrill Lynch, Pierce, Fenner & Smith "hid from the public" that it was supporting the auctions with its own capital and eventually "abandoned the market when it became a financial burden."

But in an e-mail, Merrill Lynch & Co. spokesman Mark Herr says, "There is no basis for or merit to any of Amegy's claims." Merrill Lynch & Co. owned Merrill Lynch, Pierce, Fenner & Smith at the time of the ARS auction sales, according to the statement of claim filed by the Amegy claimants.

An ARS is a type of debt instrument with an unusual twist. The ARS market allowed issuers of these securities to issue long-term debt at short-term interest rates, which reset every seven, 14, 28 or 35 days through a specialized bidding process. Widespread failure of the auctions began in early 2008, according to the statement of claim Amegy filed with FINRA.

Kimberly McMullan, one of the attorneys representing the Amegy claimants and a partner in Yetter, Warden in Houston, explains in an e-mail that Amegy Investments is required to arbitrate its claims against the Merrill entities, because both Amegy Investments and Merrill Lynch, Pierce, Fenner & Smith are members of FINRA, a nongovernmental regulatory body that oversees securities firms that do business in the United States. Three arbitrators will be on the arbitration panel, McMullan says.

The Amegy claimants' statement of claim provides the following information about the parties: Amegy Bank specializes in small-business banking and private financial management, and Amegy Investments Inc. is a registered broker-dealer and investment adviser. Merrill Lynch & Co., one of the world's largest wealth management, capital markets and advisory companies, directed the management and policies of Merrill Lynch, Pierce, Fenner & Smith Inc., which acts as a broker for corporate, institutional, government and other clients and is a dealer in the purchase and sale of corporate debt and securities. Both Merrill entities now are wholly owned subsidiaries of Bank of America Corp., which is not named as a respondent in *Amegy*.

The Amegy claimants' statement of claim provides the following "operative facts": The ARS market first emerged in 1984 as an alternative to long-maturity debt. Municipalities, student loan finance authorities and other government or tax-exempt entities historically issued ARS. However, the market for these types of securities expanded significantly during the current decade, with Merrill Lynch, Pierce, Fenner & Smith and other large investment banks acting as underwriters, brokers, lead managers and auction agents. By early 2008, the ARS market was estimated at \$330 billion.

Houston attorney David K. Bissinger, a Siegmyer, Oshman & Bissinger partner who has litigated ARS cases but who is not involved in *Amegy*, says many brokers sold the ARS in the past but chiefly to

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cases but who is not involved in Amegy, says many brokers sold the ARS in the past but chiefly to large institutional investors, such as insurance companies.

According to the U.S. Securities and Exchange Commission's 2006 order in its administrative proceeding against Merrill Lynch, Pierce, Fenner & Smith and 15 other major broker-dealers, smaller investors began participating in the ARS market in more recent times.

The Amegy claimants note in their statement of claim that in May 2006, the SEC announced a settlement with the 15 brokers, including Merrill Lynch, Pierce, Fenner & Smith, which the SEC said had engaged in improper conduct in the ARS market from January 2003 through June 2004. According to the statement of claim, the SEC concluded that Merrill Lynch, Pierce, Fenner & Smith and other brokers improperly intervened in ARS auctions, asked customers to make change orders to prevent failed auctions, allowed customers to submit or change orders after auction deadlines, and favored some customers over others. As alleged in the statement of claim, the SEC issued an order that required Merrill Lynch, Pierce, Fenner & Smith and other brokers to change their conduct and to provide mandatory disclosures of their material and current auction practices and procedures to customers.

As noted in the SEC's 2006 order, Merrill Lynch, Pierce, Fenner & Smith is one of the entities that the SEC ordered to pay \$1.5 million in civil penalties.

As alleged by the Amegy claimants in their statement of claim, "certain market influences" began negatively impacting Merrill Lynch, Pierce, Fenner & Smith's ARS business beginning in July 2007. When investors began selling their ARS securities, Merrill Lynch, Pierce, Fenner & Smith bought the securities to prevent auctions from failing but knew that the market was beginning to collapse, Amegy alleges.

The statement of claim quotes an internal message that Frances Constable, managing director in charge of Merrill Lynch, Pierce, Fenner & Smith's auction desk, allegedly wrote in August 2007: "Markets are shutting down bit by bit. We have 5 failed auctions so far, with three more likely today."

The Amegy claimants allege in the statement of claim that Merrill Lynch, Pierce, Fenner & Smith's ARS inventory rose significantly in September 2007, and the company's auction desk was nearing the internal limit of \$1 billion of those securities for its own proprietary account. As further alleged by the Amegy entities in the claim, John Price, Merrill Lynch, Pierce, Fenner & Smith's head of credit and trading, wrote a Dec. 4, 2007, e-mail stressing the broker's increasing ARS inventory problem: "Trading — we need to reduce balance sheet into year end. The desk is over it's [sic] target by \$3bln and we need to get it down."

As alleged in the statement of claim, Merrill Lynch, Pierce, Fenner & Smith never told Amegy Investments that the brokerage firm had surpassed its internal ARS inventory limit and was prepared to take extraordinary steps to reduce its inventory. The way Merrill Lynch, Pierce, Fenner & Smith sought to reduce its inventory, the Amegy claimants allege, was to encourage its sales force to sell more ARS to the public as "the conservative's conservative investment in the auction market."

The Amegy claimants allege in the statement of claim that on Feb. 12, 2008, Merrill Lynch, Pierce, Fenner & Smith decided to stop supporting its ARS program and to allow most of its auctions to fail the next day, leaving those who had bought the securities with frozen investments.

In an Aug. 7, 2008, news release, Merrill Lynch announced a \$12 billion repurchase of ARS sold to its retail clients. Under the plan Merrill Lynch announced, as of Jan. 15, 2009, and through Jan. 15, 2010, Merrill Lynch will offer to buy at par auction rate securities sold by it to its retail clients.

Yetter says Amegy Investments and its clients are excluded from Merrill Lynch's repurchase program. "We think the fair thing to do is for Merrill to buy back all of these securities, not just some of them, that it sold," he says.

Amegy Investments is "an innocent downstream broker" that bought ARS securities from Merrill Lynch, Pierce, Fenner & Smith for Amegy's clients, Yetter says.

The Merrill Lynch entities' attorney, Paul Lockwood, a partner in Skadden, Arps, Slate, Meagher & Flom in Wilmington, Del., declines comment on Amegy's statement of claim.

Herr, the Merrill Lynch spokesman, writes in his e-mail that "there is no rational basis to support a demand by broker-dealers to be reimbursed by Merrill Lynch for their business decisions to sell ARS to their clients. Broker-dealer clients such as Amegy are seasoned investment professionals and knew or should have known and understood what products they are selling to their clients. They had no business offering these products to their clients if they did not."

Yetter responds that Amegy understood everything that was properly disclosed to it. At issue in this arbitration, he says, is what Merrill Lynch, Pierce, Fenner & Smith did not disclose to brokers and investors.

#### Disclosure Questions

Bissinger says investors have alleged that many broker-dealers touted ARS as being as liquid as commercial paper or money market funds but with slightly higher returns. Unlike commercial paper or

commercial paper or money market funds but with slightly higher returns. Unlike commercial paper or other cash equivalents, however, the ARS often do not mature for 20, 30, 40 or even 50 years, he says.

"The short-term auction feature gave the impression that it [ARS] was more liquid," Bissinger says.

A key question in these types of cases, he says, is what the broker-dealers disclosed about their active support of the auctions.

The Amegy claimants allege in their statement of claim that from Jan. 3, 2006, through May 27, 2008, "nearly 6,000 ARS auctions for which Merrill was the sole lead dealer would have failed but for its support." As further alleged in the claim, Merrill Lynch, Pierce, Fenner & Smith continued its aggressive marketing of the securities as safe, liquid investments even as it was withdrawing from the ARS market, "which it knew would lead to widespread auction failures."

In his e-mail, Herr writes that the February 2008 ARS auction failures "were brought on by an unprecedented dislocation in the credit markets. In fact, Amegy cannot deny that until February 2008, Amegy's clients liquidated the ARS positions Amegy sold them routinely and without incident. It also is inarguable that ARS paid higher returns than money market funds, which is why Amegy sold them to its clients."

Herr also disputes the Amegy claimants' allegation that Merrill Lynch, Pierce, Fenner & Smith was secretly propping up the ARS market. "The allegation is untrue; the firm's disclosures, which Amegy had access to, made plain that Merrill Lynch had the option, but not the obligation, to support auctions," Herr says in his e-mail.

But the Amegy claimants allege in their statement of claim that the SEC's 2006 order required Merrill Lynch, Pierce, Fenner & Smith to make detailed written disclosures of its ARS practices and procedures to all customers and broker-dealers participating through the brokerage firm in the auctions. As alleged in the claim, Merrill Lynch, Pierce, Fenner & Smith failed to provide Amegy Investments with a written description of its auction practices and procedures "at or before the completion" of the transactions in the manner the SEC order required.

The Amegy entities further allege in the statement of claim that Merrill Lynch, Pierce, Fenner & Smith permitted its sales managers, including those on its auction desk, to influence its research department, resulting in the publishing of biased research that endorsed the safety and quality of ARS.

According to Herr, that claim also is false. "Our analysts called the ARS market the way they saw it, not the way anyone else did," he writes in the e-mail.

In the statement of claim, the Amegy claimants allege, among other things, that Merrill Lynch, Pierce, Fenner & Smith violated federal securities laws and the Texas Securities Act by making untrue statements to Amegy Investments about the liquidity of ARS and Merrill Lynch, Pierce, Fenner & Smith's active participation in the ARS auctions. The Amegy claimants also allege fraud, fraudulent inducement and negligent misrepresentation with regard to the alleged misrepresentations about the liquidity of the securities, and they also allege that Merrill Lynch & Co. has liability because it had the power to and did influence its brokerage firm's conduct.

The Amegy claimants are seeking an unspecified amount of damages, including exemplary damages, attorneys' fees and the costs for arbitration in addition to a requirement that Merrill Lynch, Pierce, Fenner & Smith buy back the \$140 million in securities. Yetter says he expects the dispute to be resolved before the end of 2009.