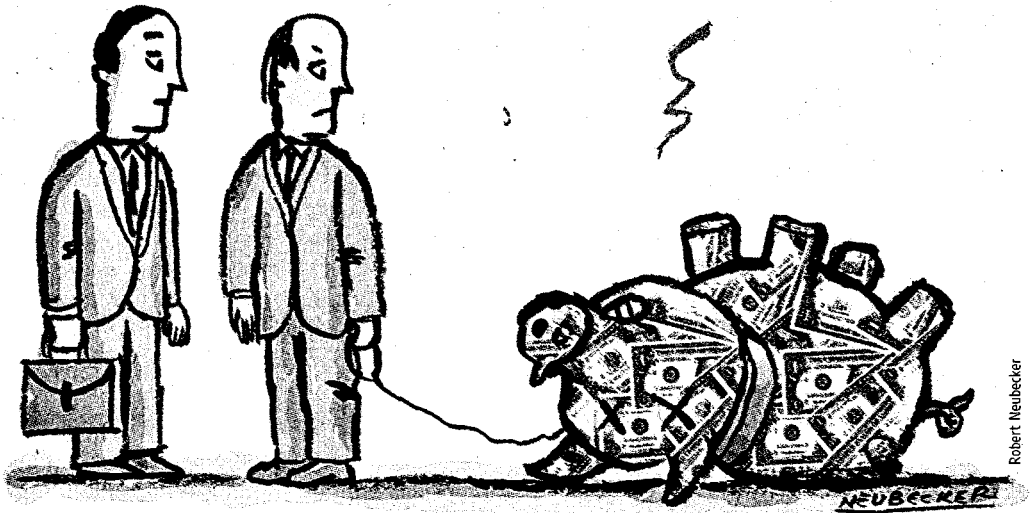


In Auction Securities Crisis, Are Brokers the Victims, Too?



Robert Neubecker

By Daisy Maxey

IN JULY, Anotolio Pellizzetti, a 70-year-old retired physician in Tavernier, Fla., filed an arbitration claim accusing UBS AG's wealth-management unit of fraud in selling him \$2.5 million of auction-rate securities. Arbitration claims over investment products gone bad are nothing unusual on Wall Street, but one feature of this litigation stands out: Mr. Pellizzetti was referred to an attorney by his son—a former UBS broker who first sold his father the securities.

For years, financial advisers promoted auction-rate securities to clients, friends and even family. Now, in the latest twist of the roiled credit markets, some brokers are siding with customers who allege that the securities weren't as billed. They were widely pitched as higher-yielding alternatives to easily bought-and-sold, super-safe money-market mutual funds—but investors like Mr. Pellizzetti have been trapped in them since February, unable to cash out at full value after the market for auction-rate securities collapsed.

The auction-market crisis appears to be slowly working itself out. In recent weeks, most of Wall Street's biggest brokerage firms, including UBS, have agreed to buy back more than \$40 billion of auction-rate securities from their clients, including individuals, charities and small businesses.

Some have reached pacts with state and federal authorities to resolve probes into their sales, while other investigations continue. The pacts may help investors like Mr. Pellizzetti get their money back.

In the wake of all this, a behind-the-scenes debate is unfolding about the role played by brokers. Even as the auction market burgeoned to \$330 billion in recent years, many brokers knew little about its inner workings, according to regulatory documents, lawsuits and interviews with brokers and their clients. Does that make financial advisers victims, too, if they reasonably relied on their firms' descriptions of the products, however thin they were? Or are securities brokers obligated to learn as much as they can about any investment they pitch, ensuring they themselves fully understand what they are selling?

Brian McNiff, a spokesman for Massachusetts Secretary of State William Galvin, notes that the state opted to file civil-fraud suits against units of UBS and **Merrill Lynch & Co.**, not their financial advisers. "I will not say one way or another about the brokers, but the companies were the ones who sold these and, if you look at the allegations in the complaint, sold them even though they knew that the market was cracking if not broken, so those are the ones we went after, not the brokers."

Tamar Frankel, a professor at Boston University
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 City School of Law, says brokers' legal liability is a bit of a gray area, but her opinion is that a broker is obligated to learn about what he sells. "If he sells poison, he's got to know."

Caught in the Middle

UBS and Merrill Lynch have both settled their complaints with Massachusetts regulators without admitting or denying wrongdoing. Merrill said in a statement before the settlements that its advisers sold auction-rate securities solely because they believed they were good investments for clients willing to trade some liquidity for higher return. In a statement after the settlements, Robert J. McCann, president of Merrill's Global Wealth Management unit, said "We have been working on behalf of our clients since this liquidity problem began." Merrill "will continue to work actively across the industry, as well as with our financial advisors, to ensure that we continue to serve our clients well."

Brokers are caught in the middle because the auction market was both obscure and complex—but filled a need for their clients at a time when money-market funds offered often-paltry returns. In short, an auction-rate security is a form of debt security that pays a short-term interest rate that is reset periodically. The securities were sold, and the rates set, at auctions orchestrated by Wall Street firms. Big issuers included municipalities, nonprofit institutions, student-lending companies and closed-end funds, a cousin of regular mutual funds that use often leverage to boost their returns.

Sometimes the big Wall Street firms placed bids to support the auctions of securities they had underwritten. As turmoil from subprime-mortgage defaults began spreading through the debt markets last year, many highly sophisticated investors, including corporate treasurers, stepped back from the auction market, and demand fell. Problems worsened when the Wall Street firms quit putting in bids to support their securities, struggling with losses in other parts of their business. As activity froze, those still holding the auction-rate securities suddenly were stuck.

According to a complaint filed by New York's attorney general against two UBS units, which the company settled in August without admitting or denying wrongdoing, the firm's financial advisers "readily admit that they represented auction-rate securities to be cash equivalents, as that was their understanding."

Many UBS brokers, the complaint says, "did not even have the most basic understanding of how auction-rate securities worked until after UBS determined not to participate in auctions on Feb. 13, 2008."

In interviews conducted by Massachusetts regulators and included in the state's complaint against UBS, a UBS financial adviser, Leonard Burd, acknowledged receiving no training on the securities other than market-

Merrill said in its statement before its settlements that "the inarguable fact is the number of auctions that had failed in nearly two decades of ARS sales was small. And most of the paper was rated AAA."

At UBS, Massachusetts investigators "uncovered a profound disconnect" between top executives' understanding of the worsening bidding situation and how the securities were promoted to financial advisers and their clients, the state's complaint says.

According to Mr. Pellizzetti's arbitration claim against the UBS Financial Services unit, filed with the Financial Industry Regulatory Authority, the retired doctor's son sold his father auction-rate securities in early 2003. The son, who left UBS in 2004 and isn't identified by name in the claim, had been "encouraged to promote such securities" by UBS management, the claim says. They were pitched "as the perfect safe investment vehicle to attract clients away from bank money-market funds," with investors able to cash out every seven to 35 days based on the auction schedule, the claim says.

"According to Mr. Pellizzetti's son, internal UBS sales meetings described any chance of auction failure as 'remote & temporary' explaining that at worst any illiquidity would be resolved" in the very next auction for that security, the claim alleges. After his son left UBS, Mr. Pellizzetti continued to purchase the securities through another UBS broker, the claim says.

Mr. Pellizzetti doesn't blame his son for misleading him in any way, but blames UBS and UBS management, says Stuart Meissner, Mr. Pellizzetti's lawyer. "Both the evidence revealed by Massachusetts as well as from my client's son is that the brokers themselves were just as misled as the clients were and were surprisingly kept in the dark," Mr. Meissner says. UBS says it doesn't comment on specific clients' issues.

Reputations at Risk

Even if financial advisers aren't legally at fault, their reputations may be damaged because they were so ill-informed.

Ivan Bailey, a 72-year-old retired Lockheed Martin Corp. worker in Burbank, Calif., put more than \$500,000 into auction-rate securities through a UBS broker, \$250,000 of it in January of this year. "That's the majority of the money I have in the world," he says. His broker, who is no longer with UBS, told him that the broker's mother-in-law had \$600,000 invested in auction-rate securities, that they were just like money-market funds, and that Mr. Bailey could get his money within seven or 28 days if he wanted, Mr. Bailey says.

He's not sure whether his bro-

ker was aware of the dangers, but says the broker should have known. "They are registered brokers," says Mr. Bailey. "He was handling a lot of money, so he should have to know. If you take your car to a mechanic, he should know how to fix it."

Mr. Bailey says UBS has told him that he will be bought out of the shares in October. A UBS spokeswoman says the company doesn't comment on individual clients, but adds that since the "breakdown" in the adjustable-rate securities market, "UBS clients have been offered multiple liquidity options, including the ability to borrow 100% of par value" of their adjustable-rate securities holdings.

One factor in financial advisers' willingness to promote the securities may have been the richer commissions they brought. At UBS, for instance, financial advisers received a portion of the 0.25% reward received by their firms for managing the securities, while no com-

mission was available for putting the same investors in UBS's standard money-market fund, according to the Massachusetts complaint.

UBS denies that its advisers had an incentive to put clients into auction-rate securities.

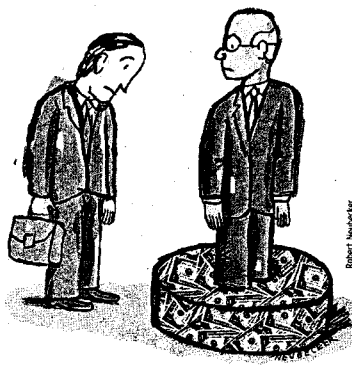
Some brokers apparently did dig deeply enough to figure out that the securities were problematic. The Massachusetts complaint against UBS cites Jan. 10 emails from Sarah M. Sullivan, a financial adviser in Boston, to a senior manager explaining her reluctance to pitch the securities to clients who wanted alternatives to low-yielding money-market funds.

She had just listened to a conference call by UBS auction-market specialists aimed at boosting sales of the securities, according to the complaint. "We continue to be frustrated by the lack of information that they are providing to us," she wrote. She said she would be particularly concerned about putting any client into the

securities just ahead of the April 15 tax-filing deadline. "If there is a failed auction, the client may not be able to access the funds. The bottom line is that rather than moving more cash into [the securities] we will probably be liquidating them for many clients."

She concluded: "Given the strange and difficult environment, it is imperative that we are fully aware of the risk we are taking. We do not want to imperil any relationships over something as 'simple' as their cash investments."

A follow-up email from the senior manager instructed a colleague to "get one of your people on the phone with Sarah ASAP so we can provide the appropriate color." The complaint doesn't detail Ms. Sullivan's subsequent actions. A spokesman for Mr. Galvin, the Massachusetts attorney general, said the state wouldn't comment beyond what is in the filings. UBS declined to elaborate or make Ms. Sullivan available for an interview.



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ing materials posted on UBS's intranet, and said he didn't read those materials or know of any risks before UBS pulled out of the market in February.

"All I knew" was that the auctions "worked in my career for 10 years seamlessly, and I had no understanding as to the backdrops of it at all," said Mr. Burd in the interview. Reached by phone, he said attorneys didn't want him to speak to the media.

UBS says the marketing and sale of auction-rate securities to its wealth-management clients "was done in the best interests of our clients and in the context of 20 years of experience in the market. There was no intentional hiding or efforts to hide the facts regarding the risks inherent in" these securities.

'A Profound Disconnect'

When isolated auctions of the riskiest securities had begun failing in summer 2007 amid overall weakness in the credit markets, managers at Merrill Lynch decided how to respond to questions from financial advisers, according to the Massachusetts complaint. As the managers worried about the market's outlook, they launched an "aggressive public sales and marketing campaign touting the safety and quality" of the securities, the complaint says. The firm "was providing its sales force, and consequently its customers, with half-truths about the nature of" the auction market during the fall of 2007 and early this year, the complaint says.

How the Largest Funds Fared

Performance numbers are total returns (changes in net asset values with reinvested distributions) as of August 29; assets are as of July 31. Fixed-income performance numbers are preliminary.

The Largest Stock Mutual Funds

Fund	Ticker	Assets (\$ billions)	TOTAL RETURN (%)				
			August	1-year	3-year	5-year	10-year
American Funds Gro/A	AGTHX	81.49	-0.1	-8.2	5.5	9.1	10.8
SPDR Trust:1	SPY	76.35	1.4	-11.2	3.6	6.8	4.6
American Funds CIB:A	CAIBX	75.86	-1.8	-8.2	6.9	10.6	8.8
American Funds CWG:A	CWGX	75.40	-3.1	-9.0	9.9	14.8	12.2
Fidelity Contrafund	FCNTX	70.69	-0.8	-4.9	7.6	11.5	9.2
American Funds ICA:A	AIVSX	61.86	0.4	-12.9	3.8	7.3	7.2
American Funds Inc:A	AMECX	58.03	-0.4	-10.9	4.1	7.9	7.5
American Funds Wsh:A	AWSHX	54.51	1.7	-13.1	3.6	6.8	6.2
Vanguard 500 Index:Inv	VFINX	54.22	1.5	-11.2	3.6	6.8	4.6
American Funds EuPCA	AEPGX	53.40	-4.9	-10.6	10.2	15.3	10.3
Vanguard T Stk Idx:Inv	VTSMX	50.74	1.6	-10.1	4.1	7.7	5.6
Fidelity Divd Intl	FDIVX	47.74	-4.2	-11.9	8.6	14.4	11.3
American Funds NPer:A	ANWPX	42.25	-2.7	-8.5	8.5	12.0	10.1
iShares:MSCI EAFE Idx	VFINX	41.82	1.5	-11.2	3.7	6.9	4.7
American Funds Flw:A	EFA	40.70	-4.1	-14.6	7.9	13.6	N.A.
Fidelity Magellan Fund	AMCFX	36.56	0.1	-7.5	8.0	12.0	9.1
American Funds Bal:A	FBAGX	35.65	-0.1	-8.6	4.1	6.1	4.7
Fidelity Gro Company	FDGRX	34.59	-1.2	-4.0	8.5	10.1	8.9
American Funds Bal:A	ABALX	34.08	1.2	-7.3	3.7	6.0	7.7
Franklin Cust:Inc:A	FKINX	31.86	-0.3	-6.4	4.3	8.4	8.4
Fidelity Lw-Prd Stk	FLPSX	29.04	1.0	-8.9	4.4	10.8	13.6
Vanguard Wellington:Inv	VWELX	28.96	0.7	-4.0	6.2	8.8	7.8
Vanguard Totl Stk:Inv	VGTSX	26.19	-5.1	-14.4	9.2	14.9	7.4
Davis NY Venture:A	NYVFX	26.01	1.8	-11.8	3.8	8.6	7.7
Vanguard Windsor Intl:Inv	VWVFX	25.72	0.9	-16.2	2.2	6.6	6.4
Fidelity Equity:Inc	FEQIX	25.53	0.7	-18.3	2.3	6.5	5.9
Fidelity Balanced	FBALX	25.09	0.6	-7.3	4.9	8.4	8.4
Harbor:Intl:Stk	HAIXX	24.63	-5.7	-8.0	14.9	18.2	11.6
Vanguard Euro Stk:Inv	VEURX	22.75	-3.9	-14.9	8.9	15.0	6.1
iShares:MSCI Emerg Mkt	EEM	22.37	-7.1	-8.4	17.5	23.3	N.A.
Fidelity Puritan	FPURX	21.48	0.4	-7.4	4.4	6.9	6.2
Vanguard PRIMECAP:Inv	VPMCX	21.37	0.3	-0.4	8.5	11.2	10.8
Templeton Growth:A	TFPLX	20.28	-1.6	-17.4	2.1	8.2	8.9
Fidelity Freedom 2020	FFFDX	20.15	-0.2	-7.0	4.6	7.3	6.7
T Rowe Price Gro Stk	PRGFX	19.44	-0.1	0.4	5.0	7.5	6.6
Fidelity Sp US Eqty:Inv	FUSEX	19.08	1.5	-11.2	3.6	6.8	4.6
Fidelity Value Fund	FVLSX	17.38	3.1	-13.9	3.6	10.5	10.6
T Rowe Price Eq Inc	PRFDX	17.24	2.3	-11.8	3.5	7.9	7.2
PowerShares QQQ Trust:1	QQQQ	16.97	1.3	-5.7	6.0	7.1	N.A.
iShares:SAP 500 Index	IUV	16.90	1.4	-11.2	3.6	6.9	N.A.
American Funds SMC:A	SMCWK	16.30	-2.8	-17.8	7.7	12.9	9.8
American Funds AMCP:A	AMCPX	14.99	-2.2	-13.2	1.9	5.1	7.5
American Funds Mut:A	AMRMX	14.05	1.0	-11.0	3.9	7.1	6.6
T Rowe Price MC Gr	RPMGX	14.56	0.3	-6.1	7.0	11.2	11.7
Fidelity Freedom 2030	FFFCX	13.67	-0.3	-9.3	4.7	7.8	6.5
Fidelity Freedom 2010	FFFCX	13.66	-0.2	-4.3	4.1	5.9	6.4
Oakmark Eqty & Incl	OAKBX	13.54	1.3	5.1	8.4	9.8	12.4
Fidelity Blue Chip Gr	FBGRX	13.35	1.4	-6.6	3.1	4.9	3.0
Vanguard Stk:Inv	VGSTX	13.34	0.2	-6.2	4.3	7.6	7.3
Emerging Markets Growth	EMGX	13.32	-7.3	-8.9	21.9	24.3	17.1
Vanguard HthCare:Inv	VGHGX	13.30	1.1	-3.3	5.0	10.0	12.7
Hartfd:Cap Appr:A	IHAXX	13.19	-1.5	-8.2	8.1	12.9	14.1
American Funds NWld:A	NEWFX	13.17	-6.2	-2.4	18.1	21.1	N.A.
iShares:Russ 1000 Gr	IWF	12.96	1.1	-6.9	4.2	5.9	N.A.
First Eagle:Global:A	SGENX	12.82	-0.4	-2.4	10.0	14.2	14.6

The Largest Bond Mutual Funds

Fund	Ticker	Assets (\$ billions)	TOTAL RETURN (%)				
			August	1-year	3-year	5-year	10-year

Mutual Fund Yardsticks: How Fund Categories Stack Up

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