

CDOs and the Cities: Merrill's Legal Issues in Springfield May Lead to More Suits. Acknowledging Liability?

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Investment Dealers Digest - The complaint that Springfield County, Mass., filed against Merrill Lynch last week might have opened a Pandora's box for the firm and its peers, as other suits and investigations looking into their use of subprime-related products are lining up.

The administrative complaint, filed last week by Massachusetts Secretary of State William Galvin against Merrill and two of its brokers, Carl Kipper and Manuel Choy, accuses the firm of fraud and misrepresentation in conjunction with CDOs it sold to the city of Springfield.

The complaint came a day after Merrill had brokered a deal with the Massachusetts Attorney General, Martha Coakley, agreeing to reimburse \$13.9 million to the city after the CDOs lost 91% in value. "We are puzzled by this suit," says Mark Herr, a Merrill spokesman, adding that the firm "has been cooperating with Mr. Galvin's office in its inquiry."

Brian McNiff, a spokesman for Secretary Galvin, says that the complaint is part of a broader investigation into Merrill's sales of similar investments to other Massachusetts towns and cities, but he declined to name which ones or how many were affected. "No complaints have been filed yet, but the inquiry is still proceeding," he says.

In a statement, Coakley says she will continue to review the matter to determine if additional action by her office is necessary.

Galvin's complaint alleges that the highly risky and esoteric CDOs were unsuitable for the city of Springfield, that Merrill Lynch did not properly disclose to the city the risks of owning these CDOs, and that the sale was inappropriate and illegal, according to legal documents.

In a document entitled "Introduction to Auction Market Securities" that the brokers used as part of their marketing pitch in November 2006, Merrill explained that the investments were term securities earning income at a rate that is frequently reset to reflect current market conditions. The firm cites the advantage for investors, including a large and liquid market and high-quality credits with more than 92% of the market rated AAA.

"The city did not authorize these specific CDO purchases in advance. The traders were verbally instructed to pick instruments that yielded more than Merrill Lynch's money market account as long as the products were AAA-rated by the major credit rating agencies," the complaint reads. "The basic fact that these instruments were CDOs was not even disclosed to the city until months after the sale."

The two brokers were terminated last week, Herr says.

Merrill agreed to reimburse the city -- an unusual move - saying that after reviewing the facts, "we have determined the purchases of these securities were made without the express permission of the city. As a result, we are making the city whole and we have taken appropriate steps internally to ensure this conduct is not repeated," according to a statement.

However, in a letter dated Nov. 29, 2007, and used as an exhibit in the complaint, James Mann, Merrill's assistant general counsel, responds to city Treasurer Salvatore Calvanese's concerns regarding the dwindling investments, saying that "while Merrill Lynch is disappointed with the unfortunate disappearance for liquidity in residential mortgage-backed CDO markets, Merrill Lynch has no legal responsibility to the city concerning the financial performance of this investment. The city's account is not a discretionary or advisory account. The city made its own investment decisions."

The Springfield quagmire comes as one element in the larger subprime backdrop affecting Merrill. The Securities and Exchange Commission started an investigation into the firm in November as part of its broader investigation into subprime, was joined last week by the Department of Justice, which asked the SEC to share the information it had gathered so far about the firm, according to reports.

Merrill's Herr says the firm does not comment on ongoing regulatory matters, but cooperates when asked.

Last spring, the SEC started a subprime working group, which comprises 100 attorneys, and has started 36 separate investigations. "They involve the whole subprime spectrum, says SEC spokesman John Nester. "From originators to secondary characters to the securitization process." Nester declined to comment on Merrill Lynch's investigation.

A spokeswoman for the Justice Department's Attorney in Manhattan declined to either confirm or deny an investigation into the firm, or comment on whether they had approached the SEC.

And last week, securities law firm Klayman & Toskes announced it had started an investigation into one of Merrill's CDOs, Norma, which sustained major losses by betting heavily on the success of the subprime market. The law firm says it is investigating whether Merrill properly disclosed the risks of Norma to its customers and whether the investment was suitable for the institutional and retail customers that invested in it.

But the fact that Merrill agreed to reimburse Springfield, as well as pay its legal fees, is an acknowledgment of liability, says Boyd Page, a partner specializing in investment fraud with Atlanta-based firm Page Perry. Merrill declined to comment on that specific matter.

"Merrill Lynch is not in the business of giving away money," Page says. "You can dress it up any way you want but this is an acknowledgment of liability," he says. "This kind of investment was never suitable for an entity like Springfield, it was just off the charts. The fact that they never delivered them a prospectus describing risk and problems of investments they sold, is way over board," he says.

Asked whether city officials bear any responsibility for the losses, Page says that in his experience most city finance officers have very little financial experience. "But even if they were sophisticated investors, they are entitled to want Merrill to tell the truth, and Merrill didn't. A prospectus was not delivered until months after they invested," he says.

Page says his firm has been contacted by municipalities for similar complaints. He declined to reveal which ones, saying those municipalities are still evaluating their options.

Recent similar suits include the one filed in US District Court for the Southern District of Texas by the Houston Police Officers Pension System against State Street Bank and Trust Co. late last month.

The suit claims that State Street said it would invest \$72 million of the pension assets in conservative, low-risk investments, but instead invested in "subprime, mortgage-related financial derivatives," leading to major losses.

Officials at the pension plan were not available to comment.