

Auction Rate Securities

Reporting Requirements for Settlements of Customer Disputes Involving Auction Rate Securities

Executive Summary

FINRA reminds firms that reach settlements of claims related to the sale of auction rate securities that, in determining the settlement amount for the purpose of potential reporting obligations pursuant to NASD Rule 3070 and Incorporated NYSE Rule 351 (Reporting Requirements) and Forms U4 and U5, firms must include the full dollar amount that was refunded to the customer as part of a repurchase agreement, plus any other damages identified in the settlement.¹

Questions/Further Information

Questions concerning this *Notice* may be directed to:

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Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registration
- ▶ Senior Management
- ▶ Technology

Key Topic(s)

- ▶ Arbitration
- ▶ Auction Rate Securities
- ▶ Central Registration Depository (CRD®)
- ▶ Customer Complaints
- ▶ Form U4
- ▶ Form U5
- ▶ Reporting Requirements

Referenced Rules & Notices

- ▶ NASD Rule 3070
- ▶ NYSE Rule 351

Background & Discussion

FINRA has reached final settlements with certain firms to resolve charges of misrepresentation in connection with the sale of auction rate securities (ARS).² More specifically, the agreements settle allegations that these firms misled investors regarding the liquidity risks associated with ARS. FINRA's investigation found evidence that these firms misrepresented to their customers that ARS were liquid investments that were equivalent to cash and failed to disclose the increasing risks associated with ARS, including the firms' reduced ability to support the auctions in early 2008.³

These firms have agreed, among other things, to offer to repurchase at par ARS that were purchased by individual investors and some institutions between May 31, 2006, and February 28, 2008. The firms have also agreed to make whole individual investors who sold ARS below par after February 28, 2008.⁴ Additionally, firms involved in the settlements have agreed to a special arbitration procedure to resolve investor claims for any consequential damages (*i.e.*, damages they may have suffered from their inability to access funds invested in ARS).⁵

The Securities and Exchange Commission and certain states have reached similar settlements for ARS-related misconduct.⁶ FINRA expects more settlements as ARS investigations continue. In addition, certain firms are similarly settling other ARS-related arbitration claims and customer complaints, not in relation to a regulatory settlement, by repurchasing the securities at par.

ARS Settlement Reporting

Depending on the nature of the claim being settled—civil litigation, arbitration or other claim for damages, such as a customer complaint—and the settlement amount, firms may have reporting or disclosure obligations pursuant to NASD Rule 3070 and NYSE Rule 351 and the requirements of Forms U4 and U5.⁷ When determining the dollar amount for reporting an ARS settlement, firms must include the full dollar amount that was refunded to the customer as part of a repurchase agreement, plus any other damages identified in the settlement.⁸ ARS settlement amounts may not be reduced by the actual (if it can be determined) or estimated market value of ARS.

The nature of the allegations in these circumstances is that customers were misled to believe that their purchases in ARS were cash equivalents. When those instruments could no longer be redeemed for full value on demand, those customers lost the entire value of the investment for which they had bargained (*i.e.*, that the funds in question would be available on a cash-equivalent basis). As such, the entire dollar amount refunded to a customer must be considered for the purpose of determining settlement reporting thresholds. For example, a firm that agrees to repurchase \$100,000 ARS at par from a customer would report \$100,000 as the settlement amount on this claim.

Endnotes

- 1 While this *Notice* speaks to reporting obligations of member firms, in the case of the Forms U4 and U5, the reporting obligation resides with the member firm and its registered person(s) involved in the matter. FINRA further notes that firms may have additional reporting obligations under the Form BD.
- 2 For information on auction rate securities, see www.finra.org/Investors/InvestmentChoices/AuctionRateSecurities/index.htm.
- 3 The investigation additionally found evidence that firms failed to establish and maintain supervisory systems reasonably designed to achieve compliance with the securities laws and FINRA rules with respect to the marketing and sale of ARS. As part of the settlements, the firms neither admitted nor denied the charges, but consented to the entry of FINRA's findings.
- 4 For the latest developments and a detailed description of the FINRA ARS cases and settlements, see www.finra.org/ArbitrationMediation/P116972.
- 5 See www.finra.org/ArbitrationMediation/P117440.
- 6 For information on SEC and state ARS cases and settlements, see, respectively, www.sec.gov and www.nasaa.org/issues__answers/enforcement__legal_activity/9431.cfm.
- 7 See *Regulatory Notice 08-17* (Reporting of Customer Complaints Relating to Auction Rate Securities) (April 2008). FINRA added three new product categories for use by firms in reporting customer complaints relating to ARS.
- 8 See *Notice to Members 96-85* (Customer Complaint Reporting Rule Update) (December 1996), Interpretive Questions and Answers, Question #5.