

# Auction-Rate Securities: Disappearing Money

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Last year E\*Trade sued one of its brokers, Scott S. Reilly. The complaint said, according to an article in Forbes, "Reilly vacated his office so fast in late January that he left behind handwritten 'to do' lists. These were reproduced in the pleading and said, 'Call Clients using cell phone to determine their interest in coming w/me,' and 'Copy as many names #'s as possible.'"

I was one of those clients. Though E\*Trade was concerned about Reilly taking his customer list and trying to solicit them to transfer money to his new firm, I was troubled about another aspect of Reilly's behavior. He had been selling ARPS (Auction Rate Preferred Securities). In my opinion, he had been less than transparent about their risk, at least to me. This scenario happened to many others at multiple brokerage firms. A conversation between the client and his broker might have proceeded like this.

**Investor:** The money market rates stink. The short term treasuries aren't a lot better. How can I make more money on my cash?

**Broker:** ARPS.

**Investor:** *(thinking ARPS rhymes with barks and that's a way to remember the pronunciation)* What's that?

**Broker:** ARPS stands for auction-rate preferred securities. It's debt that has an interest rate reset periodically, often every 7, 28, or 35 days. Interest is paid at the end of each auction. The interest rate is better than the money market or other short term debt.

**Investor:** I'm not sure I understand this. Just tell me, what are the risks to me?

**Broker:** I've never seen a default on one of these.

**Investor:** That sounds pretty safe. How much interest is more?

**Broker:** We're talking a half to two percent more than what you can get in comparable short terms.

**Investor:** Does the rate stay the same?

**Broker:** No, it changes every time period. In order to find out your new rate, you'll have to do some figures, or just call me.

**Investor:** It's appealing. Put me in for \$33,000.00. *(He figures in his head, "Yes, that's 33% of my investable money, the part that I want to keep safe.")*

**Broker:** OK. You should know that after the first period, you'll be automatically enrolled. It's for your convenience.

**Investor:** What if I want to get out?

**Broker:** You call me.

**Investor:** OK.

That night the investor sleeps like a baby. He is happy his money is "safe" due to his interpretation of what the broker said. He is also pleased that his money is making more than it could in the money market. In fact, he is thinking he is pretty smart. The investor feels so comfortable that he rarely checks his ARPS. He doesn't think he needs to.

Three months later, though, he has some time on his hands when his wife is out of town. He opens his brokerage statement and notices that the ARPS are down in value. He is incredulous. This wasn't supposed to happen.

The next morning he calls his broker to find out what is going on. His broker tells him, "The market for ARPS collapsed." The investor says he wants to sell them before they go down further. The broker says he can't. There is no market. The money was virtually disappearing.

Fortunately, this scenario didn't happen to me. I exited in January, 2008 just before the value of ARPS tumbled, only because I followed them carefully. Many were not so lucky. Lawsuits are pending. Though some of the brokerage houses have paid back clients for their ARPS loss, others, like Raymond James, say they are unable to do so.

This cautionary tale tells us once again that higher return almost always means elevated risk. Lack of information or misinformation about danger was apparently common when ARPS were sold. Now, lawyers are weaving their way through the mess. For those who avoided ARPS or bought them, but followed them closely and exited at the first sign of trouble, I congratulate you. For those who lost money and need legal help some resources include:

- [AuctionRateHelp.com](http://AuctionRateHelp.com)
- [Crosby & Higgins](#)
- [Girard Gibbs](#)
- [Giuliani Law Firm](#)

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