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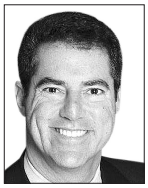
SECOND CIRCUIT REVIEW

Expert Analysis

Disclosures Negate Claim of Auction Rate Securities Market Manipulation



By **Martin Flumenbaum** And **Brad S. Karp**

This month, we discuss *Wilson v. Merrill Lynch & Co.*,[1] in which the U.S. Court of Appeals for the Second Circuit affirmed the district court's dismissal of a complaint alleging auction rate securities (ARS) market manipulation for failure to state a claim. The court's opinion, written by Judge Robert Katzmann and joined by Judge Amalya Kearse and Judge Robert Sack, considered whether a claim for market manipulation could be stated under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, where a broker-dealer made certain disclosures regarding its involvement in the auction rate securities market.

Background

Until recently, Merrill Lynch was actively engaged in the marketing and auctioning of ARS. ARS are debt or equity instruments that have long-term maturities, and their interest rates are set by periodic Dutch auctions. At a typical auction, participants submit orders to buy or sell ARS at particular quantities and rates. When buy orders exceed sell orders, the auction succeeds, and the "clearing rate" is set at whatever level allows the sale of all ARS being offered for sale. When sell orders exceed buy orders, the auction fails, and the interest rate reverts to a pre-set "maximum rate." Depending on buyer interest in ARS at the maximum rate, ARS may or may not be illiquid following a failed auction. From the 1980s until recently, nearly all auctions succeeded; beginning in February 2008, most auctions failed, leaving investors with billions of dollars in illiquid securities.

On July 17, 2007, Colin Wilson purchased from E*Trade, an online broker, $125,000 of ARS for which Merrill Lynch served as the dealer. According to the complaint, Merrill engaged in market manipulation by support bidding—using its own capital to place bids in order to prevent auction failure—which Merrill did in more than 5,800 auctions between January 2006 and May 2008. Wilson alleged that Merrill had a "uniform policy" of placing support bids to prevent auction failure whenever necessary in auctions for which it served as lead dealer. This practice allowed Merrill to set the clearing rate for auctions in which it intervened, which in turn enabled it to reduce its own inventory of ARS and sent a false signal to the market about the liquidity of those instruments.

> In light of 'Wilson'—and 'Ashland' before it—the universe of actionable ARS claims is narrowing, at least with respect to defendants that have made meaningful public disclosures.

Beginning in August 2007, Merrill began to waver in its practice of placing support bids to prevent auction failure, and it completely withdrew its support from the ARS market on Feb. 12, 2008. Wilson further alleged that Merrill misled investors by marketing ARS as safe and liquid; that its ARS trading desk encouraged its purportedly independent research department to take a more optimistic view on ARS; and that it created sales incentives to encourage its financial advisors to sell ARS to clients without disclosing the company's increasing pessimism about the ARS market.

Prior to Wilson's purchase of ARS, Merrill had made several public disclosures regarding its practice of support bidding, including a disclosure on its website in response to a 2006 SEC order. In that posting, Merrill disclosed: (1) that it was "permitted, but not obligated" to engage in support bidding and that it "routinely does so in its sole discretion"; (2) that it "may routinely place one or more bids…to prevent auction failure"; (3) that a successful auction may not indicate a lack of liquidity risk; and (4) that absent Merrill's support bidding, demand for ARS may not be sufficient to prevent auction failure.[2]

In October 2008, the U.S. District Court for the Southern District of New York consolidated two class actions brought by purchasers of Merrill Lynch ARS, the majority of whom were stuck holding now-illiquid securities following Merrill's withdrawal of support for the ARS market.[3] The court ordered Merrill to write a letter to the plaintiffs explaining the deficiencies it identified in the complaint, if any. Merrill sent such a letter in December 2008 and, after plaintiffs failed to make any amendments, in February 2009 Merrill moved to dismiss the complaint on the ground that the market manipulation claim should be dismissed in light of the website disclosures. On March 31, 2010, the district court granted Merrill's motion to dismiss. Wilson appealed.

Manipulative Acts

The Second Circuit panel agreed with the district court that Merrill's disclosures were sufficient to defeat Wilson's allegations. First, the panel considered the threshold issue of whether Merrill engaged in manipulative trading practices. Section 10(b) of the Exchange Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security…, any manipulative or deceptive device or contrivance in contravention of [SEC rules]."[4]

To plead an actionable market manipulation claim, a plaintiff must allege (1) manipulative acts; (2) damage (3) caused by reliance on the assumption of an efficient market free from manipulation; (4) scienter; (5) a connection to the purchase or sale of securities; and (6) that the manipulation was furthered through the use of the mail or a national securities exchange facility.[5] Merrill argued on appeal that Wilson's pleading was deficient with respect to the first element, manipulative acts. Wilson's primary arguments were that Merrill's disclosures understated the magnitude of risk, and specifically that Merrill failed to inform investors of the likelihood of its support bidding and of the near certainty of the collapse of the ARS market absent those support bids.[6]

The panel began with the premise that, "[i]n order for market activity to be manipulative,

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that conduct must involve misrepresentation or nondisclosure."[7] To determine whether Merrill's disclosures were sufficient to negate a manipulative acts claim, the panel turned to analogous "bespeaks caution" decisions, which hold that "[c]autionary words about future risk cannot insulate from liability the failure to disclose that risk has transpired."[8] Despite this line of cases, the panel rejected Wilson's arguments for several reasons.

First, the panel noted that, prior to Wilson's purchase of ARS in July 2007, the public was on notice that dealers could and did place support bids for ARS. Merrill itself had posted on its website detailed disclosures, which, at the very least, made clear that Merrill would bid in some, but not necessarily all, of the auctions it managed and that some auctions could fail absent these bids.

Second, the panel found that Wilson had not adequately set forth facts in his complaint that could support his arguments on appeal. Specifically, although Wilson argued on appeal that Merrill placed support bids in every single auction in which it was lead dealer, his complaint alleged that Merrill placed support bids "routinely" or "as needed."[9] These inconsistencies undermined Wilson's claim that Merrill's disclosures were misleading or deficient. Furthermore, the panel noted, even if the complaint had alleged that Merrill placed support bids in every single auction for Merrill ARS, Merrill's disclosure that it "may routinely" place such bids was consistent with that behavior. Similarly, the panel held that Wilson's complaint failed to assert an actionable allegation that Merrill knew with certainty that each of its auctions would fail absent its support bids.

Third, the panel found that Wilson's allegation that Merrill's ARS trading desk improperly influenced its research department was irrelevant because Wilson did not allege that he relied on any research report or other statement made by Merrill. Moreover, Wilson's allegations on this issue pertained only to Merrill's conduct after his purchase of securities in July 2007.

Finally, the panel held that Wilson's allegation that Merrill failed to disclose its true purposes for placing support bids—that is, to create a false impression of demand—was insufficient to sustain his claim that this action was manipulative. Merrill disclosed that it "may routinely" place support bids and warned investors that this practice might affect the clearing rates and ultimate success of auctions. These disclosures were sufficient to prevent a determination that Merrill's support-bidding practice communicated a false signal to the market.

Application of 'Ashland'

In addition to its allegation-by-allegation analysis of Wilson's brief on appeal, the panel also noted that its decision was consistent with—or perhaps compelled by—its earlier decision in *Ashland Inc. v. Morgan Stanley & Co.*[10] In *Ashland*, plaintiffs purchased student-loan-backed ARS brokered by Morgan Stanley allegedly in reliance upon misleading advice from a Morgan Stanley financial advisor. Plaintiffs alleged that Morgan Stanley made material misrepresentations regarding the liquidity of the ARS and the possibility of auction failure, in violation of Rule 10b-5. Like Wilson, the *Ashland* plaintiffs also alleged that Morgan Stanley failed to disclose the frequency of its support bidding and the fact that its bids were necessary to maintain the liquidity of the ARS. The district court dismissed the complaint in light of Morgan Stanley's disclosure that it routinely placed bids in its own auctions. The Second Circuit affirmed and charged plaintiffs with knowledge of the online disclosures.

The *Wilson* panel noted a few points of distinction between *Wilson* and *Ashland*. For example, the *Ashland* plaintiffs were institutional investors, whereas the *Wilson* plaintiffs were not all sophisticated, and *Ashland* considered whether website disclosures could negate reasonable reliance on contrary representations, while *Wilson* considered the effect of similar disclosures on a claim of manipulative acts. However, because the panel's decision did not turn on these distinctions, it held that Merrill's substantially similar website disclosures made it unlikely that its support bidding could have affected market liquidity.

Merrill disclosed that it 'may routinely' place support bids and warned investors that this practice might affect the clearing rates and ultimate success of auctions. These disclosures, the court found, were sufficient to prevent a determination that Merrill's support-bidding practice communicated a false signal to the market.

SEC Interpretation

Finally, the panel discussed the guidance provided in a brief that it had requested from the SEC. The SEC argued that Merrill's disclosures were misleading in implying that some auctions had sufficient demand to succeed absent support bids and in stating that Merrill only "routinely" placed support bids while, in reality, it placed bids in every single auction.[11] The SEC did not provide an example of what an adequate disclosure would entail, but it noted that it would have been more accurate to say that "Merrill currently placed support bids in all of its auctions, that without such bids the auctions would fail, and that Merrill reserved the right not to bid in the future."[12]

Wilson argued that the SEC's brief was entitled to "controlling" deference under *Auer v. Robbins*.[13] The *Auer* standard establishes that an agency's interpretation of its own ambiguous regulation, expressed in a legal brief, is entitled to deference unless it is plainly erroneous.[14] Merrill argued that the SEC's brief did not merit deference because the Supreme Court has expressed skepticism as to whether the SEC should be accorded deference in interpreting the private right of action under Rule 10b-5; because the SEC should not receive a high degree of deference in determinations of the sufficiency of a complaint; and because the SEC may have an interest in the outcome of the case, given its involvement in its own litigation efforts and a 2008 ARS-related settlement.

The panel declined to specify the precise level of deference it owed the SEC's opinion, but disagreed with the SEC's conclusion that Merrill's disclosures were insufficient, even under the *Auer* standard. Because Wilson's complaint was inconsistent with his arguments on appeal, and because *Ashland's* holding was irreconcilable with the SEC's conclusion, the panel disagreed with the SEC's contention that Merrill had disclosed only a "partial risk" instead of a "much greater" or certain risk.[15]

Conclusion

In light of *Wilson*—and *Ashland* before it—the universe of actionable ARS claims is narrowing, at least with respect to defendants that have made meaningful public disclosures. Although the panel in some respects confined its holding to the sufficiency of Wilson's complaint, plaintiffs likely will confront a greater burden in bringing and maintaining these types of claims, whether for misrepresentations or for market manipulation. By the same token, companies concerned with the proper level of disclosure can find guidance in *Wilson* and *Ashland*, particularly given the similarities between the disclosures in the two cases.

Finally, *Wilson* may have broad impact with respect to the level of deference to be accorded an agency's interpretation of its own regulations. Although the panel did not explicitly decide whether *Auer* applied in this case, it effectively disagreed with the SEC's position regarding the minimum level of disclosure required under the Securities Exchange Act. It will be interesting to see whether this portion of the decision is cited in support of an exception to *Auer*.

1. Docket No. 10-1528-cv, 2011 WL 5515958 (2d Cir. Nov. 14, 2011).
2. Id. at *3.
3. See *In re Merrill Lynch ARS Litig.*, 704 F.Supp.2d 378 (S.D.N.Y. 2010). The original lead plaintiffs, Gerald Wendel and Robert Berzin, accepted a settlement for which only certain plaintiffs were eligible. Plaintiffs' counsel sought leave to amend and replaced them with Wilson and two others, who would represent a class of plaintiffs who had purchased ARS through broker-dealers other than Merrill.
4. 15 U.S.C. §78j(b).
5. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 101 (2d Cir. 2007). Because scienter is an element, the PSLRA also requires the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u-4(b)(1).
6. Id. at *10.
7. *Wilson*, 2011 WL 5515958, at *8.
8. Id. (citing *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004)).
9. Id.
10. 652 F.3d 333 (2d Cir. 2011).
11. *Wilson*, 2011 WL 5515958, at *14.
12. Id. (quoting SEC Br. at 13).
13. 519 U.S. 452 (1997).
14. Id. at 461-62.
15. *Wilson*, 2011 WL 5515958, at *15.