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ACA Insight

Collateral Selection and Disclosure: Adviser and Merrill Lynch in SEC Settlements

The SEC last month reached two settlements that highlight the need for CDO collateral managers to retain control of the collateral selection process and properly disclose. The settlements are the latest chapter in an investigation and legal action involving a group of advisers, a third-party hedge fund manager and **Merrill Lynch.**

The December 12 settlements — one with the two managing partners of North Carolina-based adviser **NIR Capital Management,** which acted as the collateral manager, and the **others** with Merrill, which structured and marketed the fund revolve around both firms' alleged failure to disclose that they allowed third-party hedge fund manager **Magnetar** Capital to "influence the portfolio selection process," according to the agency. In Merrill Lynch's case, the failure to disclose was to investors, while in N1R's case the failure was to disclose to the fund itself.

Investors in the fund involved lost more than $515 million, the SEC claimed, while NIR received approximately $2 million in management fees, with each of the managing partners receiving more than $116,000 from that total.

NIR Capital's managing partners agreed to pay more than $472,000 in disgorgement and penalties, and exit the securities industry, the agency said. Merrill agreed to pay $131.8 million in disgorgement and penalties to settle the SEC charges, which also include maintaining inaccurate books and records for a third CDO. In making the settlement with the agency, Merrill consented to the order finding that it "willfully violated" Sections 17(a)(2) and (3) of the Securities Exchange Act and related Rule 17a-3(a)(2), which prohibit, respectively, using untrue statements of material fact or their omission to obtain money and property, and engaging in in fraud.

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The administrative order instituting Merrill Lynch's settlement also charged it with collateral selection and disclosure violations involving another adviser, Harding Advisory. The agency reached a settlement with Harding and its CEO this past October (ACA Insight, 11/11/13). "We're pleased to resolve this matter," said a Merrill spokesperson, noting that the transactions involved occurred prior to **Bank of America's** acquisition of Merrill Lynch. NIR could not be reached for comment. "Merrill Lynch got off real cheap on this deal," said **Warshaw Burstein** partner **Paul Lieberman,** a former vice president in Merrill's legal

department. Despite the multi-million-dollar settlement, he noted that individuals at Merrill were not charged, and compared this with the individuals from NIR who were. Merrill's alleged involvement with three advisers and a hedge-fund manager in these cases constitute "a major scheme," he said. "Wouldn't the regulators achieve greater deterrent effects for the industry and protection of investors if it charged the officers and employees of the largest firms whenever warranted by the facts?" Magnetar, which as the third-party hedge fund manager allegedly exercised collateral approval, has not been charged *by* the SEC. "Magnetar has cooperated with the SEC on CDO matters since 2008," the firm said in a statement, noting that "at no point during this period has the SEC taken any action against Magnetar," The firm also said that it received a "closing letter" from the SEC stating that the agency staff "completed its investigation as to Magnetar's activities regarding the relevant CDOs and will not recommend any action against the firm, its funds or any of its personnel." The SEC, when contacted about such a letter, declined comment.

The role of the collateral manager

What makes these cases interesting from an investment adviser perspective is the unique nature and role of collateral managers, said Stradley Ronan partner **Lawrence Stadulis,** who declined to comment on the specifics of either case. Unlike SEC registered investment advisers that actively manage the assets of their separate and pooled account clients, collateral managers serve in the more limited role of selecting on a one-time basis the assets that will serve as collateral for a largely fixed and unmanaged pool, he said. He added that the pool, essentially, is structured as a pass-through special purpose vehicle with little or no ongoing operations comparable to hedge and other more actively managed pooled vehicles. While collateral managers frequently are not required to register as investment advisers, they nonetheless fall within the statutory definition of that term and remain subject to Section 206 of the Advisers Act.

Norma

The case revolves around a $1.5 billion hybrid COO, Norma, which closed on March 1, 2007, and was backed with collateral consisting "approximately 90 percent" of credit default swaps that referenced residential mortgage backed securities, according to the SEC. It was structured and marketed by Merrill Lynch.

Norma was created after Magnetar, as a prospective equity purchaser, approached Merrill in 2006 about arranging a COO series that would meet specifications that would allow Magnetar to purchase the equity, according to the agency. "In industry parlance, this was a so-called 'reverse inquiry' deal because it came about at the behest of an investor rather than an arranging bank or collateral manager," the SEC said.

The reason Magnetar came to have such influence over the collateral selection process, the agency said, was because the equity piece of a CDO transaction "was typically the hardest to sell and therefore the greatest impediment to closing a CDO." Magnetar approved NIR as the collateral manager for the CDO after Merrill introduced NIR to Magnetar, according to the order instituting the settlement with the NIR managing partners.

On August 17, 2006, NIR and Merrill entered into a warehouse agreement that gave NIR the responsibility to "select and acquire collateral that, with Merrill's approval, would be warehoused at Merrill," the SEC said.

Divergent goals ... and consequences

Collateral for CDOs is supposed to be chosen and approved by the CDO collateral manager, with the manager keeping the best interests of investors in mind. However, the SEC alleged, Magnetar was interested in hedging its investments in CDO equity with short positions of CDO debt (other positions it took were long). NIR managing partners "should have realized that Magnetar's interests were not necessarily the same as those of potential investors in the debt trenches of Norma, whose investments depended solely on the CDO and its collateral performing well," the SEC said.

NIR, however, apparently was not at first aware that Magnetar would be selecting collateral on its own, according to its settlement order. It describes Magnetar making $600 million in long selections without informing NIR that it was doing so, while NIR at the same time was making more than $1 billion in collateral selections of its own.

Merrill, the SEC alleged, never sent the NIR managing partners trade confirmations for those selections, as the agency said it should have under the warehouse agreement. "Thus, respondents, despite being the investment managers for Norma, were unaware of the trades."

When the NIR managing partners learned from Merrill on or about November 9, 2006 of the Magnetar selections, they "were confused that a third party had purchased collateral for the portfolio," the agency said. Because the combined selections from both Magnetar and NIR exceeded the portfolio size cap, $260 million of collateral that NIR had selected was moved into a separate warehouse.

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As for the collateral chosen by Magnetar – which the NIR ultimately decided to accept in November 2006 –the NIR managing partner responsible for Norma's collateral selection described at least one as "a real stinker," according to the SEC. In a separate communication, the partner allegedly emailed a credit analyst about accepting the Magnetar choices, "This will pick up some bonds that we would not otherwise have bought based on recent performance, but they will be in the portfolio." In total, according to the SEC, in November 2006 NIR incorporated "at least $67.5 million, and as much as $157.5 million, in collateral that [the managing partner involved] had sought to exclude."

The NIR managing partners "could not serve two masters," said SEC Division of Enforcement co-director **George Canellos** in an SEC statement on the NIR settlement. "They allowed Magnetar to influence asset selection and abdicated their duty to pick only the assets they believed were best for the client.

Disclosure needed

Merrill Lynch failed to inform investors of Magnetar's third-party role, while NIR failed to notify the fund, the SEC said. Disclosures, in fact, indicated that NIR would be solely selecting the assets.

"Merrill Lynch marketed complex CDO investments using misleading materials that portrayed an independent process for collateral selection that was in the best interests of long-term debt investors," said Canellos in a separate SEC statement on the Merrill settlement. "Investors did not have the benefit of knowing that a prominent hedge fund with its own interests was heavily involved behind the scenes in selecting the underlying portfolios."

NIR, according to the SEC administrative order, said it would, among other things, "act in good faith and exercise reasonable care, using a degree of skill and attention no less than that which [NIR] exercises with respect to comparable assets that it manages for itself and in a commercially reasonable manner consistent with accepted practices and procedures applied by reasonable and prudent institutional managers of national standing in connection with the management of assets...."

"These representations were materially false or misleading," the SEC said.