'09 CIV 5174

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK



SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

DEUTSCHE BANK SECURITIES INC.,

Defendant.

Civil Action No.

## COMPLAINT

Plaintiff Securities and Exchange Commission ("Commission") alleges the following against Defendant Deutsche Bank Securities Inc. ("DBSI" or "Defendant"):

## NATURE OF THE ACTION

1. This is a case in which DBSI misled its customers about the fundamental nature and increasing risks associated with auction rate securities ("ARS") that it underwrote, marketed and/or sold. Through certain client advisors ("CAs") at one of its divisions, third-party marketing materials, and account statements, DBSI misrepresented to its customers that ARS were safe, highly liquid investments comparable to cash or money market instruments. As a result, numerous customers purchased ARS using funds that they needed to remain available on a short-term basis.

2. DBSI reinforced this perception of liquidity by committing its own capital to support ARS auctions for which it served as the lead manager to ensure that those auctions did not fail.

3. DBSI's CAs, however, failed to disclose to customers that DBSI placed supporting bids in ARS auctions to cover any potential shortfall of buyers and that, without such support, the auctions could fail, thereby rendering the customers' holdings illiquid.

4. During the fall of 2007, certain individuals at DBSI became aware of mounting evidence that the ARS market no longer retained its historical stability. Investor concerns about the creditworthiness of monoline insurance companies (which insured certain ARS and guaranteed timely repayment of bond principal and interest when an issuer defaults), higher than normal inventory levels in certain segments of the ARS market and auction failures in those markets indicated that the risk of auction failures had materially increased. Certain individuals at DBSI knew these material facts, but continued to market ARS as highly liquid and, therefore, did not disclose to its customers timely, complete and accurate information about ARS.

5. On February 12, 2008, a significant portion of ARS auctions failed, and on February 13, 2008, DBSI followed the lead of other broker-dealers and stopped supporting auctions. Without broker-dealer support, ARS auctions failed and approximately 1,600 of DBSI's retail accounts were unable to liquidate approximately $1.3 billion in ARS holdings.

6. By engaging in the conduct described in this Complaint, the Defendant violated Section 15(c) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §78o(c)]. Accordingly, the Commission seeks: (a) entry of a permanent injunction prohibiting DBSI from further violations of the relevant provision(s) of the Exchange Act; (b) the imposition of a civil penalty against DBSI; and (c) any other relief

this Court deems necessary and appropriate under the circumstances.

## JURISDICTION AND VENUE

7. This Court has jurisdiction over this matter pursuant to Sections 21(d)(1), 21(e), 21(f) and 27 of the Exchange Act [15 U.S.C. §§ 78u(d)(1), 78u(e), 78u(f) and 78aa].

8. DBSI, directly or indirectly, has made use of the mails and means and instrumentalities of interstate commerce in connection with the acts, practices, and courses of business alleged herein.

9. Venue is appropriate in this District pursuant to Section 27 of the Exchange Act [15 U.S.C. § 78aa] because DBSI has its headquarters in the Southern District of New York. In addition, the acts and transactions constituting the violations alleged herein occurred within the Southern District of New York, and DBSI transacts business within the Southern District of New York.

## DEFENDANT

10. DBSI is a Delaware corporation with its headquarters and principal place of business in New York, New York. DBSI, an indirect, wholly-owned subsidiary of Deutsche Bank AG, is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act, an investment adviser registered with the Commission pursuant to Section 203 of the Investment Advisers Act of 1940, a member of the Financial Regulatory Authority and a member of the New York Stock Exchange. DBSI consists of three main businesses: (1) Global Markets; (2) Global Banking; and (3) Private Wealth Management. The Private Wealth Management business consists of two separate divisions: a private bank (comprised of several legal entities) and Deutsche

Bank Alex. Brown ("DBAB"). DBAB, a division of DBSI, provides investment management and brokerage services to retail customers, including high net-worth individuals and institutional customers, through approximately 260 CAs. The orders for ARS from DBAB's customers are facilitated through the fixed income desk within Private Wealth Management ("Fixed Income Desk"). The Fixed Income Desk was designed to take very limited risk across fixed income products, including taxable, tax-exempt and short-term fixed income securities. Within DBSI, its Global Markets and Global Banking businesses, collectively, are referred to as the Corporate and Investment Bank ("CIB"). Global Banking, among other things, assists corporate customers in raising capital through, for example, private placements and structured products. Global Markets is involved in the sales and trading of fixed income and equity securities, and the derivatives of those securities, to and on behalf of institutional and corporate customers.

## FACTS

### A. Description of ARS

11. ARS are bonds issued by municipalities, student loan entities, and corporations, or preferred stock issued by closed-end mutual funds, with interest rates or dividend yields that are periodically reset through auctions, typically held every seven, fourteen, twenty-eight or thirty-five days. ARS are usually issued with maturities of thirty years, but the maturities can range from five years to perpetuity.

12. The issuer of each auction rate security selects one or more broker-dealers to underwrite the offering and to manage the auction process. If the issuer selects more than one broker-dealer, then the issuer designates one of the broker-dealers as the lead broker-dealer or "manager." Other "contractual" broker-dealers may enter into

agreements with the issuer to participate in the auctions. Only sole, lead or contractual (collectively "participating") broker-dealers can submit customer orders directly to the auction agent, who runs the auction.

13. ARS are auctioned at par, i.e., they are auctioned at a price equivalent to their original issue value or value upon redemption. Before an auction, each participating broker-dealer accepts orders from its customers, as well as from non-participating broker-dealers, and then submits the orders to the auction agent. Customers bid the lowest interest rate or dividend they are willing to accept. The auction clears at the lowest rate bid that is sufficient to cover all of the securities for sale, and that rate applies to all of the securities in the auction until the next auction. If there are not enough bids to cover the securities for sale, the auction fails.

14. If an auction fails, the issuer pays a maximum "penalty" rate which is either a pre-determined flat rate or a rate set by a pre-determined formula described in the disclosure documents. The penalty rate may be higher or lower than the prior auction rates and the rates available for securities of comparable credit quality and duration.

15. Before February 2008, the sole or lead manager customarily placed "support" bids in each and every auction. If there were not enough bids placed by customers to purchase all of the securities sold in an auction, the sole or lead broker-dealer purchased the remaining ARS into its own inventory to prevent a failed auction.

**B. <u>DBSI's Role in the ARS Market</u>**

16. DBSI underwrote ARS through two of its businesses—DBAB and CIB.

17. DBAB underwrote an ARS product known as ARS preferreds, which are ARS issued by closed-end mutual funds ("ARS Preferred"). DBAB traded ARS

Preferreds primarily on behalf of retail customers as opposed to institutional customers, and DBAB facilitated these trades through the Fixed Income Desk.

18. Since 1992, DBAB underwrote eleven ARS Preferred offerings, totaling approximately $710 million. DBAB acted as the lead manager on four of these eleven ARS Preferred offerings. As of April 30, 2008, one hundred and eighteen DBAB customers held approximately $111 million of the eleven ARS Preferreds that DBAB underwrote.

19. Most of the ARS trading DBAB performed on behalf of its customers, however, occurred in the secondary market (i.e., the purchase and sale of ARS after their initial issuance). Overall, as of February 2008, 1,303 DBAB customers held approximately $2.2 billion in ARS that were managed or co-managed by broker-dealers other than DBAB. Of that $2.2 billion, DBAB's customers held $1.05 billion in student loan ARS and $1.15 billion in ARS Preferreds.

20. DBSI's CIB division underwrote two types of ARS products: (1) ARS issued by special purpose vehicles ("SPVs") that were designed to make money by investing in credit default swaps; and (2) student loan ARS, which were ARS backed by student loans.

21. Until mid-to-late 2007, CIB was the lead or co-lead manager in connection with approximately thirty-six student loan ARS offerings. As of February 29, 2008, CIB held in its proprietary account approximately $472 million in student loan ARS.

22. DBSI followed industry practice of using its own capital to place supporting bids in the auctions for which it acted as the lead manager. If DBSI's support bid was "filled," or accepted, then DBSI would purchase into its inventory the amount of

ARS necessary to prevent a failed auction.

### C. DBSI Knew or Was Reckless in Not Knowing that it Marketed ARS Preferreds to Customers as Cash Alternatives or Money Market Instruments

23. DBAB was aware that certain of its CAs made affirmative misrepresentations to customers about ARS. Certain CAs marketed ARS Preferreds to its customers as highly liquid securities that were alternatives to cash or money market funds. Certain CAs described ARS Preferreds to customers as, among other things, "safe" and "liquid," and represented that there was "no risk involved." Certain CAs also represented that ARS Preferreds were "just like money markets," but with a "better return" and that ARS Preferreds had "equivalent liquidity" in relation to money markets. Similarly, certain CAs also told customers that ARS Preferreds had "7-day liquidity," that the customer "would never be without liquidity for more than seven days" and that the "worst case scenario" was that the customer would have to wait "a few days" for the money to be liquid.

24. Certain customers told CAs that their money needed to remain readily available to meet short-term expenses, such as the purchase of a home. Certain of DBSI's CAs assured these customers that their investments in ARS Preferreds would be liquid to meet such needs.

25. The third-party marketing materials that DBSI's CAs distributed to customers also characterized the ARS Preferreds as a "cash alternative" and an "attractive alternative" to "money market funds."

26. From September 2003 to February 2008, DBSI, through a clearing broker, sent monthly account statements to its customers that categorized ARS Preferreds as an

"Other - Money Market Instruments" type of investment. In or about March 2008, after the ARS market collapsed, the format of DBSI's customers' statements was revised to categorize ARS Preferreds as "Other - Other."

27. Certain CAs also failed to disclose to customers material information regarding ARS Preferreds. Specifically, certain CAs failed to disclose that: (a) an auction's success depends on a broker-dealer placing support bids to cover a shortfall of buyers; (b) without this support, the auctions could fail, rendering customers' ARS Preferred holdings illiquid; (c) DBSI placed supporting bids in the ARS Preferred auctions for which it was a lead manager; and (d) DBSI was not obligated to place supporting bids in the auctions for which it was a lead manager to prevent them from failing.

28. By omitting this information, DBSI's representations that the ARS Preferreds were "safe" had "7-day liquidity," and were like a money market instrument were misleading.

### D. DBSI Knew or Was Reckless in Not Knowing that its CAs Marketed ARS to Its Customers As Cash Equivalents

29. DBSI was aware that certain of its CAs marketed ARS to customers as cash equivalents, yet it did not take adequate steps to educate its sales force about ARS Preferreds or to ensure that customers consistently received meaningful disclosures.

30. DBSI did not provide its CAs with any formal training in connection with ARS Preferreds. As a result, there was no way for DBSI to ensure that all of the CAs were sufficiently knowledgeable about ARS Preferreds or accurate in their marketing of the product.

31. There was a misunderstanding at DBSI as to who was responsible for

training the CAs regarding ARS. The head of the CAs believed that particular product groups were responsible for training CAs about the product they traded. The product group under which ARS Preferreds fell was the Fixed Income Desk because that desk was responsible for ARS Preferreds trading. The head of the Fixed Income Desk, however, believed that, although his group provided systems and operational training, it did not provide any training to CAs in connection with ARS Preferreds.

32. DBSI told CAs who had questions about ARS Preferreds to direct their questions to the trader responsible for ARS Preferreds on the Fixed Income Desk. The Fixed Income Desk traders did not have any specific written information or guidance generated by DBSI that they supplied to CAs about ARS Preferreds. Rather, the Fixed Income Desk traders simply answered the specific questions the CAs asked about ARS Preferreds on an ad hoc basis. As a result, DBSI did not provide all CAs with the knowledge necessary to gain an understanding of the mechanics of the auction process and the accompanying risks associated with ARS. For example, some CAs were unaware that it was customary for broker-dealers to place supporting bids in order to prevent an auction from failing, did not know that DBSI was doing so and, therefore, could not and did not pass this information to their customers.

33. In addition, the policies and procedures manual governing the Fixed Income Desk at DBAB referred to ARS whereas the policies and procedures manual that governed the CAs did not. The manual that governed the Fixed Income Desk, which was reviewed and approved annually by the head of the Fixed Income Desk, included ARS as a possible "Non-Conventional Investment," which it described as a product that "may carry comparatively greater risk than conventional products, and often have complex

terms and features that may not be easily understood or assessed by less sophisticated investors." The Fixed Income Desk's manual also explained that some of the more common traits of non-conventional investments include "unique structures, varied forms of collateral, less market liquidity, less pricing transparency and heightened credit risks."

34. The Fixed Income Desk's manual also stated that non-conventional investments may require more specialized training. According to the manual, CAs "must be knowledgeable as to the [non-conventional investment's] features, risks, rewards, and all other factors relevant to making suitability determinations and necessary to facilitate complete, accurate, fair and balanced marketing and sales presentations."

35. The policies and procedures manual that governed the CAs, which was reviewed and approved annually by the head of DBAB, also contained a section regarding non-conventional investments. Unlike the Fixed Income Desk's manual, however, it did not identify ARS as a type of non-conventional investment. The manual that governed the CAs described non-conventional investments as a type of investment that "may have complex terms, unique features relating to risks and rewards, less market liquidity, less pricing transparency, and more credit risk, all of which may not be easily understood by retail clients." The manual further states that "[g]iven the distinct, often more difficult character of [non-conventional investments] all CAs and supervisory personnel must comport their sales conduct to the following obligations: due diligence regarding the product, reasonable basis suitability analysis, customer specific suitability analysis, balanced disclosure, and training."

36. The head of the CAs was not aware that the Fixed Income Desk's manual included ARS among the types of investments that may be considered non-conventional

investments. Similarly, the head of the Fixed Income Desk was not aware that the manual that governed the CAs did not identify ARS as a possible type of non-conventional investment.

37. Moreover, DBSI had no policies or procedures that required it to distribute disclosures about ARS Preferreds to the customers who purchased them on the secondary market. Typically, DBSI distributed brochures and prospectuses regarding ARS Preferreds purchased on the secondary market only when the customer requested them. Moreover, DBSI had no system to track when such materials were distributed to its customers.

### E. DBSI Continued to Market ARS Preferreds as Highly Liquid Despite Evidence that the Risk of Auction Failures Had Become Greater than Historical Experience

38. DBSI was aware that auction failures were occurring with increasing frequency toward the latter part of 2007.

39. In August 2007, CIB was aware that other managers' SPV ARS auctions were beginning to fail due to concerns about the subprime securities underlying those particular vehicles. CIB recognized that if it allowed one of its SPV ARS auctions to fail, it would affect its ability to auction SPV ARS going forward.

40. On August 13, 2007, one of the SPV ARS auctions for which CIB was a lead manager failed.

41. At least one individual at CIB believed that the disruptions occurring in the subprime market in general would cause people to become suspicious of other asset-backed securities, including, but not limited to, student loan ARS. During the fall of 2007, however, this theory was not shared by others within CIB. Indeed, the widespread

belief at CIB was that the disruptions in the SPV ARS market would not affect the ARS Preferred market.

42. Despite this belief, however, one senior manager at CIB sold all of his personal ARS Preferred holdings on August 14, 2007—the day after CIB's first SPV ARS auction failure. Although the manager did reinvest in ARS Preferred holdings later in the fall, and held approximately $1.2 million in ARS Preferred holdings when the market collapsed in February, he explained that he sold ARS Preferred on August 14, because he thought they may run into liquidity problems.

43. Also beginning in August 2007, monoline insurance companies (which insured certain ARS and guaranteed timely repayment of bond principal and interest when an issuer defaults) began to experience credit problems. Many monoline insurers had insured subprime mortgage related bonds and with the subprime crisis, concerns grew that the insurers lacked sufficient capital to cover issuer defaults. The credit problems grew worse in December 2007 and January 2008, when ratings agencies placed certain monoline insurers on negative credit watch and eventually downgraded them, triggering a simultaneous downgrade of municipal bonds that they insured. Investor concerns about the creditworthiness of monoline insurance companies, higher than normal inventory levels in certain segments of the ARS market and auction failures in those markets indicated that the risk of auction failures had materially increased.

44. After the August 13, 2007 SPV ARS auction failure, the student loan ARS inventory CIB held in its proprietary account began to rise gradually. For example, the average amount of student loan ARS inventory that CIB typically held in that account prior to the August 13, 2007 failure was approximately $100 million. At the end of 2007,

however, the amount of student loan ARS inventory that CIB held in that account was approximately $325 million.

45. Consequently, throughout the fall of 2007, CIB became increasingly concerned about the amount of student loan ARS inventory it was carrying and was monitoring it on a daily basis. CIB was concerned about the student loan ARS inventory's effect on its net capital. Moreover, certain individuals at CIB did not want DBSI to be the first to fail a student loan ARS auction.

46. During this time, the trader at CIB who was responsible for trading student loan and SPV ARS was under constant pressure to reduce the student loan ARS inventory and was encouraged to sell the student loan ARS at par and at a discount in order to reduce CIB's inventory. CIB also decided to lessen its exposure in the student loan ARS market by stepping down as the managing broker-dealer for some of its offerings. As a result, between August 2007 and November 2007, the total amount of student loan ARS offerings for which CIB was the managing broker-dealer dropped from $2 billion to $600 million, or 70%.

47. In addition, after its August 13, 2007 SPV ARS auction failure, CIB also decided to cancel a new student loan ARS product it was planning to underwrite.

48. In or about October 2007, the head of the Fixed Income Desk and the individual to whom he reported—the head of Global Investments and Sales for the U.S.—became aware that CIB experienced a failure in one of its SPV ARS auctions in August 2007. At that time, however, they did not believe that it would affect the ARS Preferred market because they viewed the problem as one of credit quality and not liquidity.

49. As a result, the head of the Fixed Income Desk did not disclose any increased risks of owning or purchasing ARS Preferreds to DBAB's CAs, the head of DBAB's CAs or DBAB's customers. Consequently, DBSI continued to market ARS Preferreds as highly liquid securities into February 2008.

### F. DBSI Did Not Disclose That It Would Elect to Stop Supporting Auctions When It Determined that Using Its Capital to Do So Would Be "Unwise"

50. Prior to February 2008, DBSI had supported its ARS Preferred auctions, and, consequently, never had a failed auction.

51. On February 7, 2008, student loan ARS auctions managed by another broker-dealer failed.

52. On February 12, 2008, DBSI became aware that certain broker-dealers acting as lead managers for other ARS Preferred auctions had stopped supporting the auctions and allowed them to fail.

53. In response to other broker-dealers allowing ARS Preferred auctions to fail, on February 13, 2008, the head of the Fixed Income Desk decided to stop placing support bids in auctions for those ARS Preferreds for which DBSI acted as lead manager in order to preserve DBSI's capital. To further commit DBSI capital to support the auctions was deemed "unwise." As a result, those auctions failed.

54. After the February 13, 2008 failure, the head of Global Investments and Sales for the U.S. learned that DBAB was the lead manager on four ARS Preferred auctions, that DBAB maintained a $4 million inventory of ARS Preferreds, and that DBAB had previously used its own capital to place supporting bids in order to prevent the auctions from failing.

55. After communicating with other senior managers, the head of Global Investments and Sales for the U.S. and others decided that DBAB would stop placing supporting bids in ARS Preferred auctions going forward.

56. Shortly thereafter, the ARS Preferred market completely seized, and approximately 1,600 of DBSI's retail accounts were unable to liquidate approximately $1.3 billion in ARS Preferred holdings.

## CLAIM FOR RELIEF

### Violation of Section 15(c) of the Exchange Act

57. Paragraphs 1 through 56 are realleged and incorporated by reference as if set forth fully herein.

58. The Defendant made use of the mails or means or instrumentalities of interstate commerce to effect transactions in, or to induce or attempt to induce the purchase or sale of, securities: (a) by means of a manipulative, deceptive, or other fraudulent device or contrivance, and (b) in connection with which Defendant engaged in a fraudulent, deceptive, or manipulative act or practice.

59. By engaging in the foregoing conduct, the Defendant violated Section 15(c) of the Exchange Act [15 U.S.C. §78o(c)].

## PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

A. Permanently enjoin the Defendant and its respective agents, servants, employees, attorneys, assigns and all those persons in active concert or participation with them who receive actual notice of the injunction by personal service or otherwise, from directly or indirectly engaging in violations of Section 15(c) of the Exchange Act [15

U.S.C. §78o(c)];

B. Order Defendant to pay civil monetary penalties pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. §78u(d)(3)]; and

C. Grant such other and further relief as this Court deems necessary and appropriate under the circumstances.

Dated: June 1, 2009

Respectfully submitted,

Mary Etheridge Hansen


Daniel M. Hawke
Elaine C. Greenberg
Tami S. Stark (TS-8321)
Mary Etheridge Hansen (ME-9947)
Colleen K. Lynch
David W. Snyder
Attorneys for Plaintiff
U.S. SECURITIES AND
EXCHANGE COMMISSION
701 Market Street, Suite 2000
Philadelphia, PA 19106
Telephone: (215) 597-3100
Facsimile: (215) 597-5885