09 CV 5172

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	ECF Case
v.	:	Civil Action No.
RBC CAPITAL MARKETS CORPORATION,	:	
Defendant.	:	

COMPLAINT

Plaintiff Securities and Exchange Commission ("Commission") alleges the following against defendant RBC Capital Markets Corporation ("RBC" or "Defendant"):

NATURE OF THE ACTION

1. This is a case in which RBC failed properly to disclose in communications with customers the increasing risks associated with auction rate securities ("ARS") that RBC underwrote, marketed and sold. ARS are long-term bonds or preferred stock with interest rates or dividend yields that are periodically reset through auctions that typically occur on a weekly or monthly basis. A significant portion of RBC's business was underwriting ARS issues and managing ARS auctions as remarketing agent. Through its employees and marketing materials, RBC misrepresented to many of its customers that ARS were safe, highly-liquid investments that were substitutes for cash or money-market funds. As a result, numerous customers invested funds in ARS through RBC that they needed or expected to have available on a short-term basis.

2. Historically, in order to prevent the failure of ARS auctions that RBC managed, RBC routinely invested its own capital to make bids in auctions where there was insufficient demand. During the fall of 2007 and early 2008, deteriorating market conditions and falling customer demand caused RBC, in order to prevent auction failures, to acquire much greater amounts of ARS in the auctions it managed, which in turn caused RBC's proprietary inventory of ARS to increase significantly. Consequently, during this time period, RBC considered declining to place bids for its own account at ARS auctions it managed and knew that the risk of failed auctions had materially increased. Despite RBC being aware of these material facts, RBC did not disclose them to customers.

3. On February 11, 2008, for the first time in the twelve-year history of its ARS business, RBC declined to place bids in most of the ARS auctions for which it served as remarketing agent and in which the bids of other market participants were insufficient to satisfy all sell orders. At or around the same time, other broker-dealers also discontinued their practice of placing bids in auctions. As a result, most auctions failed and RBC's customers were left holding billions of dollars worth of illiquid ARS, instead of the liquid short-term investments RBC had represented ARS to be. RBC's individual and non-institutional customers were left holding more than $800 million in illiquid ARS, while its institutional customers held more than $8 billion in illiquid ARS.

4. By engaging in the conduct described in the 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 Defendant from further violations of the relevant provisions of the

Exchange Act; (b) the imposition of a civil penalty against the Defendant; and (c) any other relief this Court deems necessary and appropriate under the circumstances.

JURISDICTION AND VENUE

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

6. RBC, directly or indirectly, used the mails and means and instrumentalities of interstate commerce in connection with the acts, practices and courses of business alleged herein.

7. Venue is appropriate in this District pursuant to Section 27 of the Exchange Act [15 U.S.C. § 78aa] because RBC is found, has offices and transacts business in this District.

DEFENDANT

8. RBC is a Minnesota corporation and a wholly-owned subsidiary of Royal Bank of Canada. RBC is registered with the Commission as a broker-dealer and as an investment adviser, and is a member of the Financial Industry Regulatory Authority (FINRA). RBC maintains its principal executive offices, as well as its trading desk responsible for ARS, in New York, New York. Among other services, RBC provides underwriting and remarketing agent services for issuers of ARS, and, during the relevant period, marketed ARS to many of its customers throughout the United States.

FACTUAL ALLEGATIONS

Description of ARS and RBC's ARS Business

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

10. During the relevant period, ARS were attractive financing vehicles for some issuers because ARS are long-term obligations that re-price frequently using short-term interest rates, which are typically lower than long-term rates. From the customer's perspective, ARS appeared to be an attractive investment, during the relevant period, because they were marketed as a highly safe and liquid investment product that offered a higher interest rate than various forms of cash alternative products. ARS typically were liquidated at auction, but there was a secondary market for ARS between auctions.

11. For most ARS, during the relevant period, the issuer of ARS selected one or more broker-dealers to underwrite the offering and/or manage the auction process. Customers were only permitted to submit orders for that ARS through the selected broker-dealers. If the issuer selected more than one broker-dealer to manage the auction process, then one of the broker-dealers — customarily the lead underwriter of the issue — took the lead doing so, typically by not only soliciting bids from customers but also placing bids for its own account in order to ensure that there was a buyer for all ARS sought to be sold at the auction.

12. RBC acted as underwriter and remarketing agent for public and private issuers who used ARS to finance their operations. Approximately 90% of RBC's ARS business was in ARS issued by student loan lenders, with the remaining 10% evenly divided between municipalities and closed-end mutual funds. ARS typically generated revenue to RBC from the issuer in two ways: (i) underwriting fees, and (ii) broker-dealer fees.

13. In its role as remarketing agent during the relevant period, RBC solicited bids from customers, directly or through other broker-dealers, who typically placed bids at the lowest interest rate they were willing to accept for the particular ARS. RBC then transmitted those bids to an auction agent. If there were enough bids to purchase all of the ARS for sale in the auction, then the interest rate or dividend yield, known as the clearing rate, was set as the lowest rate among all the bids that could purchase all the offered ARS.

14. If there were not enough bids to purchase all of the offered ARS, then the auction failed and customers who sought to sell their ARS in the auction for cash were unable to sell their securities. In the event of a failed auction during the relevant period, the terms of the ARS provided that the interest or dividend rate on the ARS converted to a specified rate, typically called the maximum rate. The maximum rate applied until the next successful auction, if any. The maximum rate might be fixed or determined by some formula, and could be higher or lower than the prior auction clearing rate or the rates available on other securities of similar credit quality and maturity.

15. To prevent failed auctions during the relevant period, RBC, in cases where it chose to act as the leading remarketing agent, routinely placed bids for its own account to buy any ARS that had not been bid on by other customers, thus causing the auction to clear ("Clearing Bids"). While RBC was not obligated to use its own capital to support auctions, in practice RBC routinely did so for many years in order to ensure orderly and successful auctions. Until February 2008, in fact, there had never been a failed auction for any ARS managed by RBC. Due to its role as remarketing agent and its routine submission of Clearing Bids, RBC carried an inventory of ARS between auctions that it attempted to sell on a daily basis in the secondary market.

RBC Knew of the Significant and Increasing Risks Associated with ARS

16. As early as October 2007, RBC's management was aware of a significant and growing imbalance in the ARS market whereby supply was exceeding demand. Because of this imbalance, RBC's practice of placing Clearing Bids resulted in the firm acquiring an increasing amount of ARS inventory. In this period, RBC's ARS inventory grew to never-before-seen levels, requiring the firm to increase its internally-set inventory limits. RBC's ARS inventory grew (in approximate numbers) from $250 million in January 2007 to $2 billion by the end of July, and to $3.8 billion by year-end 2007. After dropping in early January 2008, RBC's inventory grew to $5.4 billion on February 11, 2008, when RBC stopped placing Clearing Bids at most auctions for which it had acted as lead remarketing agent and these auctions began failing.

17. RBC knew that its growing inventory posed an increasingly significant risk that RBC would be unable or unwilling to place Clearing Bids in future ARS auctions it

managed — to prevent further inventory growth — and that, if it failed to do so, many auctions would likely fail. This significant and increasing risk of auction failure was exacerbated by the fact that RBC's ARS business, and thus its inventory of ARS, was predominately concentrated in student loan ARS. While failed auctions in ARS issued by municipalities or closed-end mutual funds might result in a maximum rate as high as 15% or 20% during the relevant period — well above market rates for instruments of similar credit quality — failed auctions for student loan ARS generally resulted in a relatively low maximum rate, in some cases well below market rates for instruments of similar credit quality and maturity. RBC was a leading firm in the student loan ARS market. Of the $80 billion of outstanding student loan ARS at the end of 2007, RBC was the underwriter and remarketing agent for approximately one quarter of them, or about $20.2 billion. Thus, student loan ARS was the most common type of ARS that RBC sold and marketed to its institutional customers, and was the largest class in RBC's own ARS inventory, representing over 95% of ARS owned by RBC. As RBC's inventory of student loan ARS grew, so did the potential negative financial consequences of holding securities from failed auctions onto its already capital-constrained books. Consequently, RBC's ballooning inventory of student loan ARS further increased the likelihood that RBC would cease making support bids for ARS auctions for which it was lead remarketing agent, and thus materially increased the risk of auction failure.

18. As a result of these circumstances, in November 2007, RBC assembled a group of senior managers ("Management Group"), including representatives from its parent bank, to discuss the Firm's credit, risk, and business strategy and overall business plan in the ARS market, particularly with respect to student loan ARS. The Management

Group monitored the ARS market and RBC's inventory on a daily or near-daily basis. Throughout the rest of 2007 until the February 2008 ARS auction failures, RBC's Management Group recognized that if the Firm could not stem the rise in its ARS inventory, then RBC would eventually have to cease making Clearing Bids for its auctions. The Management Group also recognized that discontinuing its practice of placing Clearing Bids would result in the failure of many RBC-managed auctions, which had never before occurred in the more than twelve years that RBC had acted as remarketing agent for ARS. Certain members of the Group further expected that a failure of ARS auctions managed by RBC or another sizeable ARS remarketing agent would lead to widespread failure across the ARS market. This expectation proved to be correct once auction failures began in early February 2008, as firms in rapid succession ceased placing Clearing Bids for the ARS auctions they managed. Among the matters discussed by the Management Group were whether RBC should be the first broker-dealer to discontinue the longstanding market practice of placing Clearing Bids at auctions for which it acted as lead remarketing agent; the impact that auction failure would have, both on its business and its customers; what liability RBC might have to customers; and even whether RBC should exit the ARS business entirely. The Management Group also planned for the aftermath of auction failure by devising external communications strategies and drafting internal talking points to be used if failure occurred for ARS auctions managed by RBC or another firm.

RBC Misrepresented or Failed to Disclose the Significant and Increasing Risks Associated with ARS to its Customers

19. During the relevant period, RBC had ARS disclosures that were posted on its website and sent to its customers. Among other things, this disclosure included a section

entitled "Existing Holders' Ability to Resell Auction Rate Securities May Be Limited." It stated in part:

> RBC may submit a Bid in an Auction to keep it from failing, but it is not obligated to do so. There may not always be enough Bidders to prevent an Auction from failing in the absence of RBC bidding in the Auction for its own account or encouraging others to bid. Therefore, Auction Failure Events are possible, especially if the issuer's credit were to deteriorate, a market disruption were to occur or if, for any reason, RBC were unable or unwilling to bid.

20. In contrast to this disclosure, however, RBC – through its sales force and in written marketing materials – misrepresented ARS to numerous customers as safe and highly liquid investments that could easily be sold on a short-term basis. In late 2007 through the auction failures beginning in early February 2008, and despite the Management Group's focus on the ARS market, RBC failed to disclose to many customers the significant and increasing risks associated with ARS.

21. Even in response to its customers' specific inquiries and concerns, RBC misrepresented to some customers the significant and increasing risks associated with their ARS. For example, one retail customer specifically raised concerns to his broker in January 2008 about ARS market conditions. His broker, after getting assurances from the RBC trading desk that handled ARS, told him that his money was safe and at no risk at all. On the institutional side, as late as January and early February 2008, various RBC institutional customers asked RBC's institutional sales desk directly about the likelihood of auction failure in ARS managed by RBC. RBC sales personnel could not advise their customers about the increasing likelihood of auction failures because they were not participants in the Management Group's ongoing deliberations about whether and when

RBC should cease to utilize its own capital to submit Clearing Bids, and were not made aware of the substance of those discussions.

22. Although various retail customers had expressed to their brokers their need for liquidity in their ARS investments, RBC failed to disclose the substantial liquidity risk associated with ARS. These customers suffered harm as a result of the loss of liquidity of their investments, such as delayed estate distributions, lost real estate opportunities, difficulty in obtaining funds to pay income taxes and various corporate financial impacts. Customer illiquidity caused by ARS auction failure is evident in the numerous RBC accounts that used illiquid ARS as collateral for loans from RBC after the February 2008 auction failures. Had the ARS auctions not failed, these customers could have sold their ARS holdings, rather than having to borrow money to pay their expenses.

RBC Failed to Disclose Internally the Significant and Increasing Risks Associated with ARS

23. The significant and increasing risks associated with RBC's own growing inventory, and the Management Group's consideration of whether to discontinue its historical practice of placing a Clearing Bid for each RBC-managed auction, were not made known to RBC's brokers and salespeople in late 2007 through the auction failures that began in early February 2008. In fact, while RBC's Management Group met in late 2007 and early 2008, RBC did not provide any ARS training or other updates to its retail brokers — many of whom otherwise had little if any understanding about the ARS market in general or how RBC in particular managed its auctions. Brokers and salespeople working on the firm's trading desk for ARS were excluded from meetings of the Management Group and were not otherwise informed of the substance of the Group's

deliberations. As late as January 23, 2008, the Firm even assured employees involved in ARS that, despite problems in the market, RBC was continuing to strongly support the market and maintain as orderly a market as possible. In an email to a group of employees involved in ARS and other products handled by RBC's short-term trading desk, a member of RBC's Management Group, who was also a manager of the short-term desk, advised that RBC senior management was carefully reviewing the situation on the trading desk multiple times each day and that the Firm's inventory was very high by historical standards. "Nonetheless," he wrote, "the firm continues to stand strongly behind the market, and maintain as orderly a market as possible under the circumstances in the many issues for which we serve as remarketing agent."

RBC Attempted to Limit Its Own Inventory of ARS

24. Rather than advising its customers, retail brokers and institutional salespeople of the significant and increasing risks associated with ARS, RBC tried by various means to reduce its own ARS inventory, which in late 2007 and early 2008 had reached and surpassed historically high levels. One of the ways RBC unsuccessfully attempted to reduce its inventory was to try to expand its institutional customer base for ARS. In November and December 2007, RBC repeatedly encouraged its institutional sales forces in other areas of the firm, both in the U.S. and abroad, to sell ARS to their customers who traditionally did not own them. Another way RBC attempted to reduce its inventory was to offer regular discounts on the ARS that RBC offered daily from its inventory in the secondary market between auctions. Finally, in an effort to sustain sales of ARS during a period in the fall of 2007, RBC temporarily increased its commissions to other broker-

dealers whose customers participated in auctions for which RBC was the remarketing agent.

CLAIM FOR RELIEF

[Violation of Section 15(c) of the Exchange Act]

25. Paragraphs 1-24 are realleged and incorporated by reference as if set forth fully herein.

26. 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.

27. By engaging in the foregoing conduct, 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 Defendant and its respective agents, servants, employees, attorneys, assigns and all those persons in active concert or participation with Defendant 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.

Respectfully submitted,

Mark A. Adler

Mark A. Adler (MA-8703)

Securities and Exchange Commission
100 F Street, NE, Mail Stop 4030
Washington, DC 20549
(202) 551-4402 [Adler]
(202) 772-9245 [Adler FAX]
AdlerMA@sec.gov

JAT

Jordan A. Thomas

Fredric D. Firestone
Gregory G. Faragasso
David A. Neuman
Eugene H. Bull
Thomas M. Gargan
Heidi H. Mayor
Thomas B. Rogers
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 200549-4030
(202) 551-4475 [Thomas]
(202) 772-9245 [Thomas FAX]
ThomasJA@sec.gov

Attorneys for Plaintiff

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