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Santander Becomes Target of Puerto Rican Anger Over Bond Losses.

Carlos Burgos Alvarado sank the \$50,000 he inherited from his father into “bonos.” He believed they were safe, high-yielding, tax-exempt bonds issued by Puerto Rico. He was wrong.

According to Burgos, the Santander Securities LLC broker who sold him the investment in April 2013 didn’t tell him its credit rating had been downgraded the previous December, making it riskier to own. She didn’t tell him that Santander had underwritten the debt, sharing \$15.6 million in fees. She didn’t tell him that the bank was in the process of selling its own inventory of the bonds.

Burgos said he didn’t discover any of this until late last year, when he hired a lawyer, who’s trying to figure out whether what Burgos bought came from Santander’s own portfolio. Santander Holdings USA Inc. said it was common for broker-dealers to both underwrite and sell the bonds and the bank obeyed all laws and regulations.

“Very bad, very bad,” Burgos said in an interview. “It made me very angry.”

Puerto Rico’s \$74 billion debt crisis has been cast as a wrestling match between the government and the hedge funds that bought distressed debt on the cheap. But tens of thousands of bondholders are people like Burgos, Puerto Rico residents who invested a total of \$7 billion in bonds, much of them low-rated, to fund their retirements.

“A lot of the stuff that went on in Puerto Rico would not have been allowed on the mainland,” said Craig McCann, founder of Securities Litigation & Consulting Group in Fairfax, Virginia, and a former economist at the Securities and Exchange Commission.

Closed-End Funds

McCann points to the absence in Puerto Rico of what investors in the 50 states take for granted: a conflict-of-interest prohibition for banks. Democratic Representative Nydia Velazquez of New York called this discrepancy “unconscionable treatment of Puerto Ricans as second-class citizens.” She sponsored legislation, which passed the House this month, to close the loophole. Senate approval would make it law.

Unlike Burgos, who owned the bonds directly, many locals bought government debt through closed-end funds — products similar to mutual funds which were purchased by locals who wanted to own government debt. Santander and UBS Group AG’s Puerto Rico unit, among the island’s biggest brokerages, sold closed-end funds. Unlike most mutual funds, however, the funds used as much as 50 percent borrowed money, meaning a downturn would cause amplified losses.

Santander’s funds “complied with all applicable laws, regulations and requirements, including those established by Puerto Rico’s securities regulator, and these requirements were fully disclosed in the funds’ prospectuses,” Ann Davis, a bank spokeswoman, said in a statement. “Each fund’s prospectus

also included an extensive discussion of risk factors associated with investing in the fund.”

Peter Stack, a UBS spokesman, said in a statement that despite the island’s economic woes, “these funds have to date paid out over \$4 billion in dividends to Puerto Rico investors.”

As much as the island’s situation differs from the mainland’s, there are parallels, too. There’s the timing of ratings companies’ downgrades and the role of retail investors, whose sleep-at-night money fueled a profit machine that benefited everyone — until the island’s dismal economic condition ground it to a halt.

On the island, the May 3 municipal bankruptcy filing, the biggest in American history, pits a half-dozen or so investor classes against Puerto Rico and against one another for a piece of a pie that’s too small to satisfy everyone. The commonwealth says it can only cover about \$8 billion of \$33.4 billion in bond payments due through 2026.

Bad Advice

There are two types of local bond investors, said Sergio Marxuach, policy director at the Center for the New Economy in San Juan. “There’s a group of people that got bad advice from their financial adviser or their broker,” he said. And then there are those who “decided to go all in on Puerto Rico bonds just to reduce significantly their tax liabilities,” he said. Those people “knew that was a very risky strategy.”

For local bond investors, the wheels began to come off in 2013, soon after Burgos invested the money, which was more than he’d ever made in a year. In August, a Barron’s cover story on the risks of the island’s securities sent prices tumbling. By the end of that year, many of UBS’s closed-end funds lost half or nearly half their value, according to research conducted by McCann.

Something Wrong

Burgos said his broker told him not to worry even as his principal shrank, that he would get his investment back when the bonds matured. According to McCann, Santander should have known the bonds were effectively junk when it sold them to Burgos.

“By the time you get to the end of 2012, sophisticated market professionals, including the ones at Santander, knew that Puerto Rican municipal bonds should be considered junk,” he said. “Even though they hadn’t been downgraded to junk status yet, they were trading at credit spreads consistent with them being junk bonds.”

Between late 2012 and October 2013, Santander marketed more than \$280 million in Puerto Rico municipal bonds and its closed-end funds to clients while unloading its holdings of the securities, according to Financial Industry Regulatory Authority documents. UBS and Santander would eventually agree to pay fines through settlements with Finra for inadequately monitoring the risks of closed-end funds. Santander’s Davis had no comment on the settlements.

‘Protected Themselves’

“They protected themselves and sold their positions but left their clients holding the bag,” said Peter Mougey, a Florida-based attorney at Levin Papantonio who represents local investors filing Finra claims against the banks.

Arbitration claims are mounting. More than 1,870 have been filed, according to Securities Litigation & Consulting Group, and more than \$200 million doled out as awards. McCann said he expects that

the number of claims will rise now that the island has begun a bankruptcy proceeding. Mougey's law firm says it's set to represent 400 clients.

One of them is Burgos, now 65. After the bonds he held stopped paying interest, he said he's had to turn to his partner's children to help pay medical bills.

"I'm always paying the bills late," Burgos said. "We take it day by day, and we're always behind on things each month."

He said he's seen his Santander broker when she appears in newspaper society pages. The bank settled eight arbitration claims filed against her for fraud and breach of fiduciary duty, Finra data show. At least 14 other claims are pending.

"Call me a cynic, but the firms had to find a home for the bonds they were underwriting," said Mougey, the plaintiffs' attorney. "They had to move them out the back door and the funds and the clients were the mechanisms to do that."

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