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UBS Faces $5 Million Class Action Claim on Puerto Rico Bond Funds.

A class action claim filed this week in federal court sheds new light on the possible conflicts of interest surrounding UBS' sale of Puerto Rico municipal bond funds.

The complaint, filed on Monday in U.S. District Court for the Southern District of New York on behalf of seven investors in Puerto Rico, is asking for damages "in excess of $5 million" on the grounds that UBS AG's wealth management group violated its fiduciary duty in selling funds with proprietary products and high commissions.

UBS marketed the tax-free investments as secure "fixed income" securities that would preserve investors' principal, when in fact the funds were highly volatile and contained a large portion of bonds that UBS had underwritten, according to the complaint.

"For defendants, however, the funds were cash cows, which defendants milked for hundreds of millions of dollars in fees and commissions," the complaint said.

UBS said the complaint is "wholly without merit," according to a statement provided by spokesman Gregg Rosenberg.

"We intend to defend ourselves vigorously against [the allegations]," the firm said.

The complaint is not the first class action claim made with regard to the bond funds. As of April, Finra had received more than 200 arbitration claims on similar grounds.

But this class action is one of the first to make claims about breach of fiduciary duty and present numbers around the fees UBS collected.

"The fee issue in the class actions, and for that matter in arbitrations, will be an extremely important issue," said Andrew Stoltmann, an attorney who is representing claimants in Finra arbitrations regarding the funds. "The onion is getting peeled in terms of what UBS did and how much they were paid."

The plaintiffs say that under Puerto Rico's securities laws, UBS was acting under a fiduciary standard of care, which would have made the conflicts of interest illegal.

UBS was the lead or co-lead underwriter in 19 municipal financings from 2008 to mid-2013 and collected more than $200 million in underwriting fees, the lawsuit said.

The firm also collected fees from its asset management unit for managing the closed-end bond funds and "generated tens of millions of dollars in advisory and transactional fees by causing the funds to purchase the Puerto Rico bonds they had underwritten," according to the claim.

UBS made around $50 million in fees per year for managing the UBS closed-end funds, the complaint alleges.

Clients then paid a 4.75% commission when investing in the bond funds, which was much higher than if UBS had sold individual securities or bonds directly to consumers, according to the complaint.

The complaint also states that UBS advisers in Puerto Rico encouraged clients to borrow against their brokerage accounts and then re-invest the money into the funds. The firm made approximately $500 million in loans to Puerto Rico customers, plaintiffs said.

Investors had been pouring money in as Puerto Rico bond funds had demonstrated strong performance prior to 2013. The Tax Free Puerto Rico Bond Fund II Inc. generated a market return of 9.95% in 2012, according to an annual report from UBS.

"For more than 20 years, investors in UBS' Puerto Rico and closed end funds received excellent returns that frequently exceeded the returns available through investments in other bonds or bond funds," Mr. Rosenberg said. "In addition, because they are exempt from Puerto Rico and US estate and gift taxes and may have provided tax-exempt or tax-advantaged income, Puerto Rico municipal bonds and closed end funds provided additional benefits to investors."

But a number of the funds tanked in 2013 as interest rates began to increase, the City of Detroit filed for bankruptcy and critics began to question Puerto Rico's ability to deliver on its budgetary reform measures.

The Tax Free Puerto Rico Bond Fund II lost 49.75% for 2013 based on the market value of the shares of the fund.

The losses were amplified by the fact that many of the funds were over concentrated, highly leveraged and therefore unsuitable for retirees, the complaint said.

UBS said, however, that the funds' holdings had to consist of at least 67% Puerto Rico assets in order to achieve the tax benefits, and that the concentration was disclosed in the prospectuses.

UBS' head of wealth management and investment solutions, Robert Mulholland, had characterized the situation as a "perfect storm" during a September 2013 trip to San Juan, the complaint said.

The complaint also names Banco Popular de Puerto Rico, and a subsidiary, Popular Securities, which had around 50 financial advisers in Puerto Rico and jointly managed some of the Puerto Rico municipal bond funds, according to the complaint.

A spokesperson for Banco Popular was unable to be reached by press time.

By Mason Braswell

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