Jefferies scores in $178 mln auction-rate battle

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By Suzanne Barlyn

July 9 (Reuters) - A New York-based hedge fund has lost a bid to recoup $178 million from Jefferies & Co Inc over its claim that Jefferies acted negligently in its sale of auction-rate securities, according to an arbitration ruling.

SCO Capital Partners LLC, a hedge fund that invests in discounted life sciences companies, alleged that Jefferies was negligent and sold it unsuitable securities, among other things, according to the ruling by a Financial Industry Regulatory Authority arbitration panel.

The July 5 ruling did not specify the type of auction-rate securities at issue. As is customary, the FINRA panel did not explain the reasons for its decision.

The panel ruled that Jefferies & Co, a unit of Jefferies Group, Inc, does not have to buy back nearly $18 million in auction-rate securities from New York-based SCO Capital. Jefferies is also not liable for $160 million in additional damages that SCO said occurred because of the failed securities, the panel ruled.

An SCO executive and a Jefferies spokesman both did not return phone calls requesting comment.

The case is an example of the ongoing fallout from the 2008 auction-rate securities debacle that continues to affect many institutional investors. Auction rates were sold as highly liquid short-term instruments similar to money-market funds, but with slightly higher returns. When the $330 billion auction-rate market failed in 2008, as large investment banks that held the auctions ran into liquidity crunches, thousands of investors were left with securities that could not be sold.

Those investors included certain hedge funds, which relied on auction-rates to hedge against risk, depending on their investment strategy, said Myles Edwards, general counsel and chief compliance officer for Constellation Wealth Advisors LLC in New York. Funds that relied on auction-rates to boost their yields are now stuck with securities that are worth far less than their investment, said Edwards, who is not involved with the case.

It is unclear from the arbitration ruling or SCO's website how auction-rate securities were used in SCO's investment strategy. Also unclear is whether Jefferies sold or underwrote the securities, a factor that could affect the outcome in such a case, say lawyers.

FINRA fined Jefferies $1.5 million in 2011 for failing to disclose certain conflicts of interest and additional compensation it received in connection with the sale of auction-rate securities to a group of corporate customers. The company neither admitted nor denied FINRA's charges. It is not known whether SCO was among those customers.

Jefferies, in December 2008, voluntarily spent about $68 million to partially buy back auction-rate securities from retail investors. Institutional investors were typically excluded from agreements and settlements by brokerages to buy back auction-rates from investors following the crisis.

Some hedge funds, as a result, are still fighting to recoup their money, said Ross Intelisano, a lawyer for Rich, Intelisano & Katz, LLP in New York, who handles hedge fund litigation. Hedge funds are filing those cases in both court and as arbitrations, he said.

While courts have typically been tougher on hedge funds than arbitration panels, the battle in both forums is an uphill climb, Intelisano said. That is because judges and arbitrators consider hedge fund advisers to be extremely sophisticated and knowledgeable investors, he said.

In addition, offering documents for certain auction-rate securities clearly pointed out that the auctions could fail, he said.