

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9200 / April 5, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64182 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14320

In the Matter of

Wells Fargo Securities LLC
(f/k/a Wachovia Capital
Markets LLC)

Respondent.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO SECTION 8A OF THE
SECURITIES ACT OF 1933 AND SECTION
15(b) OF THE SECURITIES EXCHANGE
ACT OF 1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND A
CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”) and Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”) against Wells Fargo Securities LLC (f/k/a Wachovia Capital Markets LLC) (“Respondent” or “Wells Fargo Securities”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

Summary

1. These proceedings concern two collateralized debt obligations ("CDOs") tied to the performance of residential mortgage-backed securities ("RMBS"), Grand Avenue CDO II ("Grand Avenue II") and Longshore CDO Funding 2007-3 ("Longshore 3"). Wachovia Capital Markets LLC ("Wachovia Capital Markets") structured and marketed these two RMBS CDOs in late 2006 and early 2007 when the United States housing market was beginning to show signs of distress.

2. In so doing Wachovia Capital Markets violated the antifraud provisions of the Securities Act in two respects. First, Wachovia Capital Markets charged undisclosed excessive markups in the sale of certain of the preferred shares, or equity, of Grand Avenue II to the Pueblo of Zuni and the Pension Plan and Trust for Employees of the Pueblo of Zuni (collectively the "Zuni Indian Tribe") and an individual investor. Second, Wachovia Capital Markets represented to investors in Longshore 3 that it acquired assets from affiliates "on an arm's-length basis" and "at fair market prices" when in fact certain assets were transferred from an affiliate at above-market prices.

Respondent

3. Wachovia Capital Markets was a registered broker-dealer and wholly-owned subsidiary of Wachovia Corporation during the relevant period. Wachovia Capital Markets conducted the corporate and investment banking business of Wachovia Corporation's securities business. Wachovia Capital Markets was renamed Wells Fargo Securities, LLC after Wachovia Corporation merged with Wells Fargo & Company on December 31, 2008. Wachovia Capital Markets structured and marketed Grand Avenue II and Longshore 3.

Other Relevant Entity

4. Wachovia Securities LLC ("Wachovia Securities") was a registered broker-dealer and wholly-owned subsidiary of Wachovia Corporation during the relevant period. Wachovia Securities conducted the retail brokerage business of Wachovia Corporation's securities business. Wachovia Securities was renamed Wells Fargo Advisors LLC after Wachovia Corporation merged with Wells Fargo & Company on December 31, 2008. Wachovia Securities was involved in the sale of the Grand Avenue II preferred shares.

Grand Avenue II

RMBS CDO Equity Generally

5. RMBS CDO equity is a complex, highly-leveraged structured product. RMBS are securities backed by residential mortgages. Investors receive payments out of the interest and principal payments from the underlying mortgages. RMBS CDOs are collateralized by RMBS. The RMBS are packaged and generally held by a special purpose vehicle that issues notes entitling the holders to payments derived from the underlying RMBS. The notes issued by RMBS CDOs are securities with defined risk profiles determined by a hierarchical, tranching structure. The cash flows from the RMBS are divided according to defined rights among the tranches of the CDO in a waterfall fashion.

6. The AAA-rated tranches are at the top of the waterfall with the first right to receive principal and interest if there is a shortfall. As a result, they have the highest credit quality, meaning the lowest likelihood of being affected by problems in the underlying collateral. The lower tranches are junior in priority and therefore more risky. The equity tranche is at the bottom of the capital structure and the most risky, but has the potential for the highest payout. Equity investors are generally the first to experience losses associated with a deterioration of the underlying mortgage loan portfolio.

Sale of Grand Avenue II Preferred Shares

7. Grand Avenue II was a \$1.5 billion CDO backed by a portfolio of RMBS. The deal closed on October 26, 2006. At closing, Wachovia Capital Markets had been unable to sell \$5.5 million of preferred shares, or equity, in the transaction. Wachovia Capital Markets retained those securities in its CDO syndicate desk's inventory and marked them at 52.7 on the company's books and records for purposes of financial reporting in accordance with generally accepted accounting principles ("GAAP") (preferred share prices referenced herein are represented as percentages of par).¹ GAAP required that Wachovia Capital Markets value the securities at an estimate of the price at which they could be sold in the market in a reasonably short period of time.

8. Wachovia sold the securities in February and March 2007 to the Zuni Indian Tribe and an individual investor. Both were customers of a Wachovia Securities registered representative located in El Paso, Texas. The Zuni Indian Tribe and the individual investor paid 90 and 95 as detailed below. Unbeknownst to them, this represented a markup of over 70 percent above the price at which the preferred shares were marked on Wachovia Capital Markets' books, which was 52.7. By the end of 2007, the RMBS held (or referenced) by Grand Avenue II had been downgraded substantially and the transaction went into default as of February 1, 2008.

¹ CDO equity is not listed on a U.S. exchange and trades infrequently and thus current prices are not readily discoverable. CDO equity is generally valued using models whose varying inputs produce a range of prices.

9. The mechanics by which the Grand Avenue II preferred shares were sold were as follows. On or about February 13, 2007, Wachovia Capital Markets sold \$2 million of the Grand Avenue II preferred shares to Wachovia Securities at 90.5, and then on February 14, 2007, Wachovia Securities sold those securities to the Zuni Indian Tribe at 95. On or about March 12, 2007, Wachovia Capital Markets sold another \$2 million of the Grand Avenue II preferred shares to Wachovia Securities at 85.5. On March 15, 2007, Wachovia Securities sold \$890,000 of these securities to the Zuni Indian Tribe and \$1,110,000 to the individual investor at 90. On or about March 16, 2007, Wachovia Capital Markets sold \$1.5 million of the Grand Avenue II preferred shares to Wachovia Securities at 85.5, and then on March 20, 2007, Wachovia Securities sold those securities to the individual investor at 90.

Wachovia Did Not Surveil for Markups on the CDO Syndicate Desk

10. The prices at which the Grand Avenue II preferred shares were sold to Wachovia Securities were determined by Wachovia Capital Markets. Wachovia Securities then determined the ultimate price to investors.

11. At the time of the sales of the Grand Avenue II preferred shares to Wachovia Securities, the shares were held in the inventory of the Wachovia Capital Markets' CDO syndicate desk. The CDO syndicate desk was typically involved in primary sales of securities at par or other prices negotiated with the investor, so a markup calculation was inapplicable. As a result, Wachovia Capital Markets' compliance department did not surveil markups on positions sold off of the CDO syndicate desk during the relevant period.

12. Wachovia Securities' compliance department approved the sales of the Grand Avenue II preferred shares to the Zuni Indian Tribe and the individual investor. Wachovia Securities did so with the understanding that it was marking up the securities approximately five percent from 90.5 to 95 and from 85.5 to 90. Wachovia Securities' compliance personnel were not aware that Wachovia Capital Markets had marked the securities at 52.7 and that, as a result, the ultimate markup to investors was over 70 percent.

13. Wachovia Capital Markets' CDO secondary trading desk made a market in CDOs and engaged in secondary trading thereof. The compliance department at Wachovia Capital Markets surveilled markups on the CDO secondary trading desk and flagged for review any sale at a price in excess of five percent from certain defined references; however, there was no surveillance of markups of positions sold off of the CDO syndicate desk because the CDO syndicate desk typically engaged in the primary sales of securities.

Undisclosed Excessive Markups

14. Under the so-called "shingle theory," a broker-dealer violates the antifraud provisions of the federal securities laws by charging customers excessive undisclosed markups. Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 189-94 (2d Cir. 1998). A markup is the difference between the price charged the customer and the prevailing market price. Id. at 189. A markup is excessive if it bears no reasonable relation to the prevailing market price. Id. at 190.

Negligence-based violations of Sections 17(a)(2) and (3) are appropriate where a broker-dealer should have known that the prices it charged were excessive. See, e.g., In the Matter of Mark David Anderson, Admin. Proc. File No. 3-9494, 2003 SEC LEXIS 1935 (2003); In the Matter of Marion Bass Securities Corp., Admin. Proc. File No. 3-9471, 2000 SEC LEXIS 2806 (2000); In the Matter of BT Alex Brown Incorporated, Admin. Proc. File No. 3-10097, 1999 SEC LEXIS 2443 (1999).

15. Wachovia Capital Markets charged undisclosed excessive markups in the sale of the Grand Avenue II preferred shares to Wachovia Securities for subsequent sale to the Zuni Indian Tribe and an individual investor. These investors paid 90 and 95. Unbeknownst to the investors or Wachovia Securities, this represented a markup of over 70 percent above Wachovia Capital Markets' internal mark on the Grand Avenue II preferred shares, which was 52.7. In so doing, Wachovia Capital Markets violated Sections 17(a)(2) and (3) of the Securities Act under the shingle theory because it knew or should have known that the prices it charged were excessive.

16. As a result of the negligent conduct described above, Wachovia Capital Markets willfully² violated Sections 17(a)(2) and (3) of the Securities Act, which prohibit fraudulent conduct in the offer and sale of securities.

Longshore 3

CDO Warehousing Process In The Industry Generally

17. Prior to the closing date of a CDO, it is typical for the structurer (or an affiliate of the structurer) to finance the acquisition of CDO collateral, which is often selected on the advice of the collateral manager. This pre-closing process is called "warehousing." During the warehouse phase, the collateral is consolidated on the balance sheet of the structurer, or its affiliate providing the financing. On the closing date, the CDO pays the structurer – either to buy the collateral or to repay the structurer for financing the collateral – by using the proceeds from the sale of notes to investors.

18. Prior to the closing, the CDO structurer or an affiliate bears "warehouse risk," meaning that the collateral will remain with the entity that provided the warehouse in the event the deal fails to close or is downsized and the CDO fails to purchase the collateral from the CDO structurer or its affiliate. Warehouse risk is one of the principal risks associated with the CDO structuring business. A number of large financial institutions suffered significant losses on RMBS and other debt obligations in their CDO warehouses during the recent financial crisis.

² A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Transfer Of Assets To Longshore 3 At Above-Market Prices

19. As of February 2007, Wachovia Capital Markets was in the process of warehousing collateral for two RMBS CDOs, Longshore 3 and another proposed CDO (the “Transferor Warehouse”). Longshore 3 was a \$1.3 billion CDO backed by a portfolio of RMBS and other asset-backed securities. The deal closed on April 26, 2007. Wachovia Capital Markets decided not to proceed with the other CDO due to market conditions. Wachovia Capital Markets as CDO structurer was then faced with the prospect of suffering losses on a portfolio of cash and synthetic³ RMBS that had accumulated in the Transferor Warehouse.

20. Wachovia Capital Markets avoided losses on some of these assets by transferring 40 RMBS (28 cash and 12 synthetic) with a total notional value of approximately \$250 million from the Transferor Warehouse to the warehouse for Longshore 3 at the prices at which the assets had originally been acquired (the “acquisition cost”). That acquisition cost was approximately \$4.6 million above the market prices at the time of the transfer because the market had moved in the period between the original acquisition of the assets and the time of the transfer.

21. Structured Asset Investors LLC (“SAI”), a wholly-owned subsidiary of Wachovia Corporation during the relevant period, was the collateral manager for Longshore 3. SAI personnel responsible for managing collateral for RMBS CDOs wanted to ensure that Longshore 3 acquired assets at appropriate prices and raised questions regarding the acquisition of collateral for Longshore 3 at acquisition cost given changes in the market for such collateral. The issue was brought before the ABS CDO Investment Management Committee (the “IMC”), which was responsible for managing conflicts of interest between SAI and Wachovia Capital Markets. At a meeting on or about March 16, 2007, the IMC approved the transfer of assets at their acquisition costs on the condition that Wachovia Capital Markets make certain disclosures to investors relating to the pricing issue. The IMC directed SAI to select from the Transferor Warehouse only those RMBS it deemed acceptable for Longshore 3, and SAI did so.

22. Wachovia Capital Markets made two sets of disclosures relating to the pricing issue (SAI was not involved in the disclosure process). First, Wachovia Capital Markets provided prospective investors in Longshore 3 spreadsheets with identical “purchase” and “transfer” prices for every asset in the portfolio prior to the pricing of the transaction (investors generally commit to purchase CDO securities at pricing). Wachovia Capital Markets emailed the spreadsheet to six (6) of the seven (7) investors in Longshore 3; the seventh investor received a spreadsheet identifying all of the assets in the portfolio and their “purchase” prices. Those spreadsheets failed to specifically indicate that a portion of the collateral was previously acquired

³ CDOs sometimes assume credit risk by entering into credit default swaps referencing RMBS, referred to in the documentation as “synthetic” securities, rather than by purchasing the RMBS. The CDO described herein assumed a relatively small amount of risk in this manner; however, this alternative form of assuming RMBS exposure does not change the analysis. Thus, for reasons of convenience, the analysis herein does not further discuss the concept of credit default swaps referencing RMBS.

for the Transferor Warehouse at then-current market prices and then transferred to the warehouse for Longshore 3 from an affiliate of SAI at their acquisition costs, which no longer represented market prices.

23. Second, Wachovia Capital Markets represented in the Offering Circular for Longshore 3 that collateral acquired from affiliates of SAI would be acquired in transactions representative of transactions entered into “on an arm’s-length basis” and “at fair market prices” (the “Affiliate Transaction Disclosures”). Those representations were false and misleading because assets transferred from the Transferor Warehouse were priced approximately \$4.6 million above their then-current market prices as determined by Wachovia Capital Markets’ internal marks on the assets. Wachovia Capital Markets provided similar disclosure concerning the acquisition and pricing of assets in offering circulars for other CDOs. Wachovia Capital Markets attempted to modify the representations in the Offering Circular for Longshore 3 concerning the prices at which collateral was acquired into the Longshore 3 warehouse to address the decision by the IMC to allow Longshore 3 to buy collateral from the Transferor Warehouse at above-market prices, but the standard Affiliate Transaction Disclosures in the Offering Circular were not modified to address the decision by the IMC to allow Longshore 3 to buy collateral from the Transferor Warehouse at above-market prices. Wachovia Capital Markets provided copies of the Offering Circular to all seven (7) investors in Longshore 3.

Disclosure Violations

24. Section 17(a) of the Securities Act prohibits the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Violations of Sections 17(a)(2) and (3) may be established by showing negligence. SEC v. Hughes Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992). Negligence-based violations of Sections 17(a)(2) and (3) are appropriate where material misrepresentations or omissions resulted from a lack of disclosure training and inadequate procedures relating to the drafting and review of offering documents. In the Matter of State of New Jersey, Admin. Proc. File No. 3-14009, 2010 SEC LEXIS 2705 at *39 (2010).

25. Wachovia Capital Markets represented to investors in Longshore 3 that it acquired assets from affiliates of SAI “on an arm’s-length basis” and “at fair market prices.” Those representations were false and misleading because approximately \$250 million worth of RMBS were transferred from an affiliate at prices approximately \$4.6 million above the market value at the time of the transfer into the Longshore 3 warehouse. SAI personnel responsible for managing collateral for RMBS CDOs believed it would have affected an investor’s negotiation of their purchase price of the CDO if they had known that certain assets were being transferred into the Longshore 3 warehouse at acquisition cost rather than current market price. Wachovia Capital Markets acted negligently in at least two respects. First, Wachovia Capital Markets attempted, albeit unsuccessfully, to disclose the issue by providing prospective investors spreadsheets with

certain pricing data. Second, the standard Affiliate Transaction Disclosures in the Offering Circular were not modified to address these circumstances. In both instances, Wachovia Capital Markets exercised inadequate care in making the pricing disclosures.

26. As a result of the negligent conduct described above, Wachovia Capital willfully (see footnote 2 supra) violated Sections 17(a)(2) and (3) of the Securities Act which prohibit fraudulent conduct in the offer and sale of securities.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent Wells Fargo Securities and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in the Offer of Wells Fargo Securities.

Accordingly, pursuant to Section 8A of the Securities Act and Section 15(b) of the Exchange Act, it is hereby ORDERED that:

- A. Respondent Wells Fargo Securities cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act.
- B. Respondent Wells Fargo Securities shall, within 10 days of the entry of this Order, pay disgorgement of \$6.75 million and a civil money penalty in the amount of \$4.45 million. Respondent shall satisfy this obligation by (i) disbursing \$7.4 million pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002 as distribution of losses: Respondent shall make \$1.319 million in payment(s) to and for the benefit of the Zuni Indian Tribe; Respondent shall make a \$1.064 million payment to and for the benefit of the individual investor who purchased the preferred shares in Grand Avenue II; and Respondent shall make \$5.017 million in payment(s) to and for the benefit of the investors acquiring Longshore 3 securities from the initial purchaser (Wachovia Capital Markets) on the closing date of Longshore 3, pro rata based on their original investment; and (ii) making a payment of \$3.8 million to the Securities and Exchange Commission, Office of Financial Management, Operations Center, 6432 General Green Way, Mail Stop 0-3, Alexandria, Virginia 22312. Payments shall be accompanied with a notification that identifies Wells Fargo Securities as the Respondent in these proceedings. Respondent shall simultaneously transmit a copy of such payment and notification to Reid A. Muoio, Deputy Chief, Structured and New Products Unit, Division of Enforcement, 100 F Street N.E., Washington, DC 20549-5030. Respondent will cooperate with the staff of the Commission to obtain evidence of receipt of the payments set forth herein.

C. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund is created for the disgorgement and penalties referenced in paragraph B above.

By the Commission.

Elizabeth M. Murphy
Secretary

Service List

Rule 141 of the Commission's Rules of Practice provides that the Secretary, or another duly authorized officer of the Commission, shall serve a copy of the Order Instituting Administrative and Cease-And-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934 ("Order"), on the Respondent and its legal agent.

The attached Order has been sent to the following parties and other persons entitled to notice:

Honorable Brenda P. Murray
Chief Administrative Law Judge
Securities and Exchange Commission
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