AUCTION RATE SECURITIES: A CRISIS FORETOLD

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Auction Rate Securities ("ARS") are clever creations of investment bankers, that enable borrowers to incur long-term debt at short-term rates and lenders to obtain the safety and liquidity of money markets at a higher return. As could be expected with clever creations of investment bankers, substantial investment banking fees are earned in underwriting these instruments and continuing fees are charged by investment banks for conducting the ARS auctions, regardless of whether the auctions succeed or fail. Also, as could be expected with Wall Street's clever creations, the incredible benefits conferred on the issuers of, and investors in, these instruments turn out to be too good to be true.

After the pervasive failure of the ARS auctions during the week of February 11, 2008, it became all too clear that the borrowers had issued long-term debt of uncertain liquidity for which no efficient secondary market existed. Investors were coldly confronted with the fact that what they thought of as cash reserves were subject to the credit risks of long-term debt, and in many cases paid interest, albeit at a fail rate, well below a rate commensurate with the assumed level of risk. Faced with paying higher than anticipated rates of interest, issuers were left to scramble to refinance in a credit market that had gone into hibernation. Broker-dealers, which had sold these instruments to many of their most affluent customers as money market alternatives, sought to quell fears with the hope that this crisis would soon abate with the restoration of liquidity, and to address clients' cash needs with loans using ARS and other securities as collateral. Speculators took advantage of the fear and uncertainty in the marketplace by purchasing these instruments at a deep discount. State, federal and SRO regulators commenced investigations to figure out how this could have gone so wrong, although most of the answers to this question were addressed in articles by prescient commentators authored well before the crisis broke. And lawyers readied themselves to be of assistance to anyone involved in this mess, and jockeyed for position in response to an "auction rate securities" Google search.

I. WHAT ARE AUCTION RATES SECURITIES?

For those of you wondering how we got here, if we start with the basics and take them to their logical conclusion, it will soon become readily apparent. Auction Rate Securities are far simpler than the mysterious name suggests. ARS are nothing more than debt instruments, bonds or, in the case of closed-end funds, preferred securities. The ARS issuers are typically the state or local government agencies or corporations. Issuers of Auction Rate Preferred Securities ("ARPS") are closed-end mutual funds seeking to borrow funds at low interest rates to leverage the investments of the common shares of those closed-end funds. The ARS are long-term debt, and their maturity, or the obligation of the issuer to repay the debt, could be 20 or 30 years from the date issuance. ARPS often are perpetual securities with no maturity date

The principal difference between typical debt instruments and ARS is how interest rates are set. A typical debt instrument sets forth a fixed rate of interest or a formula by which interest will be set during the term of the debt. Because the investor in long-term fixed interest debt bears the risk of changes in the market price of the debt instrument due to fluctuations in the interest rate environment and changes in the credit risk of the issuer, interest rates paid on long-term debt are substantially higher than interest rates paid on short-term debt. As the name implies, the interest rates of Auction Rate Securities are determined by auctions at set intervals determined by the instrument. The auction intervals are usually every 7, 28 or 35 days. The auctions are conducted by investment banks, which contract to serve as auction agents for particular issues for an agreed upon fee.

II. THE AUCTION PROCESS

The auctioneer employs a Dutch Auction process, during which broker-dealers submit bids on behalf of their investors or themselves for the number of shares at $25,000 par value they are willing to buy at a given interest rate. In the ARS auction, it is, therefore, the interest rate that fluctuates, not the value of the debt instrument. If there are enough investors willing to purchase all shares offered for sale at a Minimum Acceptable Rate or higher at the Dutch Auction of a particular ARS issue, those shares are purchased at the Clearing Rate, which is the

highest rate bid at the point that there are sufficient bids to purchase all shares offered for sale. The Clearing Rate sets the rate of interest to be paid to all holders of ARS until the next auction.

If no shares of a particular ARS are offered for sale at a periodic auction, the Clearing Rate will be set at an All Hold Rate as defined in the instrument.

If there are not enough investors willing to purchase at a given auction **all** shares of a particular issue offered for sale at the Minimum Acceptable Rate or higher, the auction fails and no securities change hands. Under this circumstance, there is no liquidity in that ARS issue outside a secondary market until the sooner of 1) the next successful auction at which there are sufficient purchasers willing to buy all of the ARS offered for sale at the Minimum Acceptable Rate or higher; or 2) the maturity or earlier call of the ARS. In the event of a Failed Auction, a Fail Rate, which is the Maximum Auction Rate specified in the prospectus or debt instrument, must be paid by the issuer. The Maximum Auction Rate is often some percentage above comparable commercial paper or LIBOR (London Interbank Offered Rate) rates.

If the Fail Rate of an auction rate security is substantially above the market rate of interest offered for comparable long-term instruments, the credit rating of the issuer is very good, and the investor has no liquidity needs, such a security may be a good investment. An asset manager told me that his clients are happy to hold tax-free ARS which are paying interest at the Fail Rate of 8% or higher, although he anticipated that the benefits will be short-lived, as he expects that the issuer will seek to refinance the obligation. On the other hand, if the Fail Rate is at or below the interest rate paid on long-term bonds with comparable credit ratings, the ARS has lost the short-term liquidity at par anticipated through the periodic auctions and the investor is stuck with long-term credit risks at unacceptable interest rates.

Since liquidity at par is a function of a successful auction or redeemed issue, if the investor has immediate liquidity needs or otherwise does not wish to hold the ARS until a liquidity event, the investor is faced with the option of selling the ARS in a thin secondary market for far less than par value. To those who believed that then ARS were cash equivalents, that option is like selling a dollar for seventy-five cents.

III. THE FAILURE OF THE AUCTIONS

Investors purchased ARS believing that their principal was safe. The price of an ARS was not fixed by the Dutch Auction. The shares went for par at auction. It was the interest rate, which fluctuated. As long as the auctions did not fail, investors could cash out at par at any auction of the instrument held in short intervals of every 7, 28 or 35 days. The fly in ointment, however, was the simplest principle of supply and demand and the unnoticed supply bubble in the ARS market headed towards a turbulent credit market.

Auction Rate Securities were first developed in 1984.[1] In 1988, Goldman Sacks introduced to the first tax-exempt market an instrument, then called "periodic auction asset securities", through a $121,400,000 offering for the Industrial Development Authority of Pima County, Arizona.[2] By May 2006, the ARS market had grown to well over $200 billion.[3] Less than two years later, this market had grown by approximately 60%. By the middle of February, 2008, the ARS market was estimated to have grown to $330 billion.[4]

Supply would have long since exceeded demand had investment banks not prevented failed auctions by buying at ARS at auctions where there otherwise would not have been enough buyers to prevent auction failures or selling ARS at auctions where there were no other sellers. Investors were unaware of the extent to which dealers were propping up the ARS auctions, and were lulled into a false sense that their ARS could easily be liquidated at any auction interval and in the meantime they could enjoy a competitive return. As the credit market weakened in early 2008, the ARS supply bubble popped. Banks, under pressure from $146 billion in credit losses and writedowns from subprime mortgage securities, stopped buying ARS for their own account.[5]

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1 *In the Matter of Bear Stearns & Co., Inc., et al.*, SEC Administrative Proceeding No. 3-12310 (May 31, 2006).

2 "A Dutch Auction Security Début", New York Times, March 17, 1988.

3 *In the Matter of Bear Stearns & Co., Inc.*, supra.

4 "Muni Regulators Seek Disclosure on Auction-Rate Bonds", Bloomberg.com, February 15, 2008.

5 Id.

Failed auctions started in August 2007 for some corporate securities,[6] but by the middle of February 2008, ARS auctions came to grinding halt. As occurs with the bursting of any financial bubble, once the auctions failed, investors lost interest, the holders of the issues flooded the auctions with sell orders, and demand dried up, making failed auctions inevitable for all but the most attractive issues.

IV. FAILURE PREDICTIONS FULFILLED

Although broker-dealers had been marketing ARS to high net worth clients and corporate accounts as liquid money market alternatives paying slightly higher interest rates, commentators and research analysts had long recognized the risks of ARS, and predicted the inevitable failure of this market. On May 8, 2003, Lance Pan, Director of Credit Research at Capital Advisors Group, pointed out the now obvious credit and liquity risks of ARS. Pan concluded:

> Claims made by broker-dealers that ARS are liquid, high-quality short-term investments are often incomplete, inaccurate, and misleading. The securities are appropriate only as a small (10% to 20%) and illiquid part of an actively managed short-term portfolio. Ongoing monitoring of dealer support, secondary market liquidity, collateral quality, as well as bidding mechanism at each auction, are imperative for holders of these assets.[7]

In December 2004, Ernst & Young began to advise its corporate clients to change their classification of ARS from cash equivalents to short-term investments.[8] In March 2005, Price Waterhouse Coopers ("PWC") Structured Finance Group issued Capital Markets Accounting Developments Advisory 2005-4 entitled, "Investors' Classification of Auction Rate Securities." The Advisory addressed the propriety of the classification of ARS as cash equivalents on corporate balance sheets. PWC observed:

> The proper classification of auction rate securities should be based on the contractual maturity of the security, and not the next reset date. Most auction rate securities have

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6 Id.

7 Seven Facts...and Fiction about Auction Rate Securities, Lance Pan, Capital Advisors Group, May 8, 2003.

8 "Auction-Rate Securities: Hold that Gavel," Marie Leone, CFO.com, April 25, 2005.

> maturities that span many years, and such securities will not qualify as cash equivalents. We understand that the approached classification described above, is consistent with the views of the staff at the FASB, Securities and Exchange Commission (SEC), and Public Company Accounting Oversight Board.

By the beginning of the second quarter of 2005, strains in the ARS market became more apparent. In response to the reinterpreted standards relating to the classification of ARS by the Big Four accounting firms, corporations, such as Comverse Technology, Inc., Abercrombie & Fitch, and Borders Group, Inc., were publicly reclassifying their large ARS holdings previously treated as cash or cash equivalents. The Securities and Exchange Commission was also actively investigating allegations that dealers were propping up ARS auctions. [9]

In response to the required accounting changes and SEC investigation, Lance Pan, in a follow-up to his previous analyses of this market entitled "Forecasting a Perfect Storm: New developments aggravate the potential fall of the auction rate securities market," warned on March 1, 2005:

> We have always been concerned that the fragile liquidity and dependency on investor confidence of ARS may subject the securities to potentially violent market contagion that could lock up the entire market for days or weeks. The PwC accounting opinion and the SEC probe may create a powerful concoction that results in a potentially explosive chain of events in the not too distant future. **Investors may experience significant losses if they do not act quickly.** [emphasis in original]

A lack of transparency in the ARS auction process caused concerns about the potential effect on the market, as was noted in an article in CFO.com almost three years before the market collapsed. The article reported:

> Indeed, investors and regulators are worrying that many auction-rate issues are handled by only one dealer, noted SVB's [Jim] Anderson. "Suppose the dealer decides to stop supporting the market," he says. "The amount of

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9 Id.

> control one firm has over the auctions, the issuers and the investors are the reason the SEC is investigating the market."
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> Regardless of whether the commission orders a market makeover, SVB's Anderson asserts that liquidity issues are surfacing. Based on the huge spreads – between 40 and 50 basis points – that followed the accountability change, he deduces that the demand for the securities declined.
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> A drop and demand can't be verified quantitatively because the dealers that run auctions don't reveal final bid-to-cover ratios (a measure of auction-demand volume), he says. "No one knows how successful the auctions actually are," adds Anderson. "We know demand is going down because spreads are going up".
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> . . .
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> A pull-out by too many buyers would lead to a drastic supply – and – demand in balance. In the extreme, it could spawn failed auctions, which are technically defined as ones lacking the demand needed to sell an entire block of bonds. In that case, treasury managers would have no way of cashing in their long-term bonds except at deep discounts. In effect, buyers would be stuck holding 30-year bonds, not the short-term debt they sought.[10]

The SEC's investigation into the ARS auctions identified and addressed the deceptive and manipulative practices that had become commonplace in this market. This investigation resulted in a Cease and Desist Order with findings, and sanctions against the following 15 broker-dealer firms: Bear Stearns, Citigroup, Goldman Sachs, J.P. Morgan Securities, Lehman Brothers, Merrill Lynch, Morgan Stanley, RBC Dain Rauscher, Bank of America Securities, A.G. Edwards, Morgan Keegan, Piper Jaffrey, SunTrust Capital Markets, and Wachovia Capital Markets. The Order found that between January 2003 and June 2004, each of these firms engaged in one or more practices that were not adequately disclosed to investors and which constituted securities laws violations with respect to ARS auctions. The findings of the Order noted systemic manipulation of the ARS auction process. The Order found, among other things:

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10 Id.

b. Intervention in Auctions. Certain Respondents intervened in auctions by bidding for their proprietary accounts or asking customers to make or change orders without adequate disclosures. [footnote omitted]. In certain instances, the interventions affected the clearing rate. Certain Respondents intervened in one or more of the following three ways:

b.1 Bids To Prevent Failed Auctions. Without adequate disclosure, certain Respondents bid to prevent auctions from failing. Failed auctions occur when there are more securities for sale than there are bids for securities and result in an above-market rate described in the disclosure documents. These Respondents submitted bids to ensure that all of the securities would be purchased to avoid failed auctions and thereby, in certain instances, affected the clearing rate;

b.2 Bids to Set a "Market" Rate. Without adequate disclosure, certain Respondents submitted bids or asked investors to change their bids so that auctions cleared at rates that these Respondents considered to be appropriate "market" rates. In certain instances, this practice affected the clearing rate and/or the Respondents' or investors' bids displaced other investors' bids; and

b.3 Bids to Prevent All-Hold Auctions. Without adequate disclosure, certain Respondents submitted bids or asked investors to submit bids to prevent the all-hold rate, which is the below-market set when all current holders want to hold their positions so that there are no securities for sale in the auction. Sometimes certain Respondents did not have any or sufficient inventory to be eligible to submit the hold-at-rate bids they submitted, or changed an investor's bid without obtaining permission. In certain instances, this practice affected the clearing rate; . . .

In response to the SEC Order, in 2007, the Securities Industry and Financial Markets Associations ("SIFMA") issued the "Best Practices for Broker-Dealers of Auction Rates Securities." In conjunction therewith, SIFMA also proposed model auction procedures for use by issuers, broker-dealers and auction agents designed to be consistent with the Best Practices. The Best Practices were intended to encourage greater transparency in the auction process, provide

education to issuers and investors regarding material features of ARS, and to avoid manipulative auction practices.

As noted above, the risks in the ARS market had thoughtfully been identified and the ultimate failure of this market foreseen. As with all bubbles, however, the persuasive concerns about this market were not heeded by broker-dealers, who continued to aggressively market ARS to their customers as liquid money market alternatives that paid a competitive interest rate.

V. AUCTION RATE PREFERRED SECURITIES

Included in the ARS market failure were the ARPS. As noted above, ARPS are preferred securities issued by closed-end funds. The purpose of ARPS is to borrow funds at a low interest rate to leverage the investments of the common shares of the closed-end funds. Unlike ARS, which have a date of maturity on which the issuer is obligated to redeem the debt instruments, ARPS typically have no maturity date and have no mandatory redemption so long as certain specified asset coverage tests are met. Among the coverage tests is the requirement under the Investment Advisory Act of 1940 that the underlying fund maintain asset coverage of at least 200% of any outstanding senior securities, including the ARPS.[11] In the event of the liquidation or dissolution of the underlying fund, the holders of the ARPS are entitled to a liquidation preference before distribution to holders of the fund's common shares.

Like ARS, dividend rates are set at periodic Dutch auctions, at which the per share value of the ARPS is fixed at $25,000.00. In the event that the auction fails, the dividend rate is set at the Maximum Payable Rate specified in the prospectus.

While the credit quality of an ARS is based upon the credit rating of the issuer, the credit quality of the ARPS is based upon the quality of the underlying assets. Because ARPS are used to leverage the returns of the common shares of a closed-end fund, the assets held by the closed-end fund are often comprised of higher yielding, and, therefore, riskier securities. For instance, although one ARPS, had a Moody's Aaa credit rating, 50.20% of the assets of the underlying

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[11] 15 U.S.C. §80a-18(a).

fund were rated BBB or below. Moreover, closed-end funds may rely on bond insurance from insurers like MBIA or AMBAC, which have been under substantial financial pressure.

VI. WHERE WE STAND

The pervasive failure of the ARS market has caused a fundamental supply and demand imbalance in this market, which will take time to work through in light of outstanding issues in excess of $300 billion. While liquidity is returning to the most creditworthy ARS issues paying competitive interest rates, the less competitive ARS issues are languishing. To stimulate the ARS market, the SEC has issued guidance that permits issuers to participate in ARS auctions so long as they disclose price and quantity information about their bids.[12] The SEC has warned, however, that below market bids by issuers on their own ARS may be viewed as market manipulation, but gave no guidance as to what is meant by "below-market" bids.[13]

In the ARPS market, issuers have aggressively moved to seek alternate financing solutions to liquidate the ARPS obligations. Reports on the status and success of these efforts are found at the websites of the issuers of ARPS.

The ARS collapse has lead to regulatory investigations by the New York Attorney General, the Massachusetts Attorney General and the SEC, as well as numerous lawsuits. On May 8, 2008, UBS reached a settlement with the Massachusetts Attorney General, in which it agreed to repay $37 million to 17 cities and towns in that state that UBS allegedly misled into buying ARS as safe money market alternatives.[14] Although Merrill Lynch's John Thain has predicted that ARS held by that firm's clients will be fully refinanced within a year,[15] the end of this story is yet to be told. Nonetheless, the ARS market will never be the same, and issuers seeking low cost financing and investors who believed they had invested in a secure money market alternative have both suffered significant harm.

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12 SEC No-Action Letter dated March 14, 2008 re: Municipal Auction Rate Securities.

13 "SEC Official Warns Against Below-Market ARS Bids," The Bond Buyer, March 27, 2008.

14 "Broker to Return $37 Million to Towns," Boston Globe, May 8, 2008.

15 "Thain Sees Refinancing of Auction-Rate Securities," Wall Street Journal, May 8, 2008.