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Auction-Rate Questions

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SEC's Haines Skeptical of Market Practices

by [Lynn Hume](#)

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Questioning whether "auction-rate securities" actually involve an auction or benefit issuers and investors, the SEC's municipal bond chief today pressed broker-dealers to disclose to the market that they often intervene in such auctions, bid with the knowledge of other bids, submit bids after issuer deadlines, and either influence or set the clearing rate.

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"I am not saying that this is necessarily good or bad, but it should be disclosed in plain language," Martha Mahan Haines, chief of the Securities and Exchange Commission's Office of Municipal Securities, said in a speech today in Chicago.

"To simply say that a broker-dealer may submit orders in auctions for its own account, in which case it might have an advantage over other bidders because it would have knowledge of other orders placed through it for that auction, just does not give an accurate picture of the reality of how this market functions," Haines said in a speech at the 10th annual conference of Women in Public Finance.

"Do not dance around this issue: describe what really happens flat out," she said, stressing these were personal remarks and not necessarily those of the SEC. "If this is the way that investors and issuers prefer for the market to function, so be it. If not, perhaps practices should change to reflect their true preferences?"

Haines urged issuers and investors to "ask for information regarding the frequency of broker-dealer bidding and its policies and procedures ... regarding the submission of bids and other activities that may affect the clearing rate."

Market participants, she said, should "insist that the rates set in these auctions and other critical information be made public."

"You have all heard me talk about the importance of market integrity and investor confidence before," she told the group. "I suggest that the lack of transparency regarding the actual rates set in these auctions undermines both."

Haines raised troubling questions about the municipal auction-rate securities market, which she likened to a "black box." The muni auction-rate securities market accounted for about 46% of municipal, corporate, and preferred stock auction-rate securities markets, which had grown to more than \$263 billion at the end of 2005, according to statistics cited by The Bond Market Association.

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"It may not be accurate to call this an auction at all," Haines said. "In a true Dutch auction [such as those in the Treasury market], no bidder has knowledge of the bids submitted by others. This protects the process from manipulation and ensures that the price set is truly reflective of the market."

"Unlike the large, homogenous Treasury market, the [auction-rate securities] market, at least for municipal securities, is fragmented by a high number of dissimilar offerings, a decentralized over-the-counter market structure, and lack of transparency," she said. "Each of these features inhibit market efficiency."

It may be more accurate to call auction-rate securities a "managed auction process" or a "bidding system ... recogniz[ing] that 'BS Securities' is not an appealing acronym," she said.

Haines' remarks come after 15 broker-dealer firms in the auction-rate securities market agreed in June to pay a total of \$13 million to globally settle SEC charges they acted negligently in violation of the securities laws by engaging in undisclosed practices that, among other things, favored some investors over others, favored some issuers over investors, and manipulated clearing rates.

The SEC charged that the disclosures in the offering documents for most auction-rate securities bear little resemblance to actual dealer practices. The documents did not disclose to issuers or investors that the broker-dealers often bid in these "auctions" for their proprietary accounts or ask customers to make or change orders to prevent auctions from failing, to set an auction rate, or to prevent all-hold auctions. The dealers also sometimes prioritize certain customers' bids to increase the likelihood that their bids will be filled and engage in "price talk" with them to give them an advantage over other customers in determining what rate to bid, the commission said.

The action prompted The Bond Market Association to issue a set of "best practices" for dealers in the market as well as to begin publishing a series of weekly indexes covering different kinds of auction-rate securities to give issuers and investors benchmarks to determine the appropriateness of the rates they are getting on securities sold through the auction-rate process.

"If you read between the lines of the commission's recent settlements involving auction-rate securities and the 'Best Practices' released by TBMA, it appears that the way rates are actually set on auction-rate securities often may bear little resemblance to the way the process has typically been described in offering statements," Haines said.

Under the settlement, the SEC did not prohibit broker-dealers from engaging in these various practices, but insisted that they provide issuers and first-time purchasers of auction-rate securities with written descriptions of them. The firms have contended that these practices generally help the market, such as by preventing "failed" auctions from occurring.

But Haines raised questions about whether these practices are good for the market.

"We should acknowledge that, although broker-dealers involved in this market generally claim that their intervention is for the good of the market as a whole, this has not been studied," she said. "In fact, the outcome of even a completely independent study would be dependent on one's view of what is best for the market."

"It is true that, due in large part to broker-dealer intervention, there have been few 'failed' auctions," resulting in windfall interest rates for investors until the next auction, or 'all-hold' auctions, resulting in below market rates briefly benefiting issuers," Haines said. "Broker-dealers also

intervened when the rate that would be set was not, in that broker-dealer's opinion, an appropriate market rate."

"But wasn't a determination of the market rate the very purpose of [the] auction?" she asked. "We are told that this is in the best interests of both issuers and investors. But is it? It has disguised the true liquidity risk, volatility, and fragmented nature of this market from both issuers and investors. Furthermore, broker-dealer intervention does not necessarily set the rate at the same point as would be set in a successful multi-bidder auction."

Meanwhile, TBMA Friday disagreed with some of Haines' points and said that broker-dealers are already providing increased disclosures to the market as a result of the global settlement with the SEC.

"We think she is unduly pessimistic," said Marjorie Gross, TBMA's senior vice president and regulatory counsel. "We believe the market has already developed new disclosure practices, that it is providing increased information on current clearing rates, and that it continues to provide very cost-effective financing to issuers and attractive short-term rates to investors."

"TBMA is more than willing to discuss changes that the SEC believes should be made to the market," Gross said. But she said it is difficult to tell the extent to which Haines' remarks reflected her own views or those of the SEC, despite Haines' standard disclaimer that these were personal remarks.

"Some of the points she made were not raised in the SEC settlement with member firms," Gross said. No one at the commission ever suggested it would be inappropriate to use the term "auction" for auction-rate securities, she said. "While Martha's line about BS may have been cute, I just don't think that's the SEC's position."

Gross pointed out that the SEC, in its settlement, did not prohibit dealers from participating in auction-rate securities programs, but rather said they must disclose the extent to which they participate.

"I'm not sure she's right about clearing rates," Gross said. Some auction-rates are giving issuers very detailed reports about the bids that come in their auctions, she said, adding, "We think they have a lot of information about bids and clearing rates for auction rate securities."

Gross said also that TBMA is working on other projects in this area, including providing dealers with model disclosure language that can be put into offering documents as well as model language on auction procedures that can be put into bond indentures, resolutions, and other bond documents.

In the municipal market, auction rate securities are municipal bonds whose interest rates are periodically reset through auctions, typically every 7, 14, 28, or 35 days. They have maturities that range from five years to perpetuity, but are usually 30 years. Issuers often use these securities as an alternative to variable rate bond financing and investors view them as an alternative to money market funds, according to the SEC.

In an auction, investors can submit "hold" orders to keep their securities at the rate at which the auction clears; "hold-at-rate" orders to keep the securities at or above a specified level; "sell" orders to sell the securities regardless of the clear rate; or "buy" bids to buy the securities at the clearing rate or some other specific rate.

The clearing rate is the lowest rate bid sufficient to cover all of the securities for sale in the auction, according to the SEC. If there are not enough bids to cover the securities for sale, then the auction fails and the issuer must pay an above-market rate set by a pre-determined formula. If all of the holders of the securities chose to hold their positions without

bidding a particular rate, then the clear rate is the all-hold rate, a below-market rate set by a pre-determined formula.

Haines also talked about the “lessons learned” from San Diego’s pension debacle, under which officials of the city and its pension system failed to disclose to investors that the system was seriously under-funded because of concessions made to labor unions. The disclosure problems forced the city to stop issuing financial statements and prevented it from accessing the municipal debt market for the past three years.

The SEC muni chief said that the city could have avoided this and saved millions of dollars in legal fees and remediation efforts simply by checking the disclosures in its financial statements and bond offering documents.

The lessons learned for issuers and market participants include, “Don’t ignore the elephant in the living room,” Haines said. “Don’t leave it for the next guy to shovel up after.”

Issuers must have systems and internal controls to ensure their financial reports and disclosure documents are accurate and complete, she said.

Haines also urged underwriters, their counsel, and disclosure counsel to verify that the official statements and other disclosure documents for municipal securities are actually delivered to state and local governmental officials and that these officials read at least the “relevant portions” of the documents.

“Over 10 years after the commission’s report regarding the conduct of the behavior of Orange County’s Board of Supervisors, I cannot imagine why, in this day and age, anyone would be comfortable with their due diligence without verification,” she said.

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