CHAPTER 26

PREFERRED STOCK IV: ADVANTAGES OF REMARKETED PREFERRED

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Much has been made of the choice between auction-rate and remarketed preferred stock. Unfortunately, most of it has been overdone. These two types of equity securities have been pitted against one another as if they must be mutually exclusive. To support one, it is thought, is to oppose the other. But this is not the case. Auction and remarketed preferred stock are different approaches to the same goal, long sought by corporate treasurers: inexpensive equity.

In the highly competitive investment banking environment of the late 1980s, the debate has been, regrettably, so rooted in each firm's proprietary product and market share that it has become confusing and contradictory. In the heat of the debate, firms have argued one set of market principles about floating rate securities when it came to preferred stock and then a completely contradictory set of principles for other floating rate securities—even though they were to be issued by the same company and sold to the same buyers.

How does one discuss the advantages of remarketed preferred when there exists such confusion in the marketplace?

First, it is essential to understand that *not all remarketed preferred stock structures are alike*. When comparing auction and remarketed preferred, it is important to know which remarketed structure is being discussed. Currently, two types of remarketed preferred exist: (1) "7- or 49-day clearing rate" remarketed preferred, and (2) "share-adjusted" remarketed preferred. The

basic term in each security that is common to each is the dividend rate, which is set by a Remarketing Agent. Otherwise they are different structures.

Second, it is also essential to understand the basic Dutch auction structure. The comparative advantage remarketed has in flexibility is derived from the rigid nature of the auction security. Auction securities set a single dividend rate, for a 49-day period,[1] on an entire issue, on a single day. *Critics of the remarketed method assume that remarketed preferred attempts to do exactly what an auction security does but through a Remarketing Agent. This is not the case.* Remarketed preferred allows an issuer to seek and achieve goals other than the lowest 49-day rate in the market on a given day.

When evaluating which security to issue or purchase, one needs to consider more than the repricing method. One should focus on the terms of the preferred stock's structure as well as how those terms address different corporate financing or investing objectives *over time*.

REMARKETED PREFERRED'S PRIMARY ADVANTAGE: FLEXIBILITY

There is one fundamental advantage to remarketed preferred stock from which all other advantages follow—flexibility. Such flexibility offers investors a wide range of investment terms and rates. Flexibility allows issuers to manage their exposure to floating rates, to average down their costs. Flexibility for both investor and issuer allows them to cope with market and event risks, to diversify repricings. Flexibility for the broker-dealer community gives them the tools to negotiate the best terms in the market for both buyer and seller. Flexibility *increases liquidity* under diverse market conditions.

Why Should One Care about Flexibility in the Floating Rate Preferred Market?

Floating-rate securities are risky for both issuer and investor. Since the rate adjusts periodically, the long-term cost of the security to the issuer and, conversely, the long-term yield to the investor are uncertain.

[1] Forty-nine days is the standard length of the auction dividend period because federal tax law requires a corporate investor to hold preferred stock for a minimum of 46 days in order to claim the 70 percent tax deduction for income received from dividends. Forty-nine days is the next period equally divided by seven days, which allows the security to have a fixed, consistent repricing cycle occurring on the same day of the week throughout the year (i.e., every seven weeks) and guarantees that an investor will meet the minimum holding period between repricings.

These risks are particularly troublesome in the floating rate preferred market. First, for issuers, dividends are paid with after-tax dollars. This makes fluctuations in dividend costs more expensive than floating rate debt products, which are tax deductible. Second, for investors, preferred stock is a perpetual equity security. There are no redemption rights. The changes in yield combined with equity risk make investors focus on preserving their capital investment and on the ability to resell the security at the price they paid (generally known as liquidity).

The collapse of the adjustable rate preferred stock (ARPS) market in 1983 vividly demonstrates the need for flexibility in the preferred market. ARPS was hailed as an innovation over fixed preferred when it was introduced in 1982. Since the dividend rate adjusted periodically based on broad market indices, it was thought that the security would keep its stated value in secondary market trading over time because the yield would float with the market. But even though the rate floated, the security could not adjust for the changing credit quality of the issuer, supply factors, or required spreads off market indices for corporate securities. After more than $10 billion in issues, liquidity was destroyed, deep-discount ARPS trading became commonplace, and investor confidence in the security was lost.

Dutch auction securities solved the ARPS disaster. By allowing the rate to be reset by investors and not by a preset formula, the security could respond to all the market factors for a particular credit on a given day. Liquidity was brought back to floating rate preferreds. But in solving one set of problems, the structure did not address broader but equally important market and event factors that affect the cost of the security, not on a given day, but over time.

Because auction and remarketed securities compete for buyers in the volatile short-term market, the need for maximum flexibility is greater. Market conditions can vary significantly from day to day, moment to moment. Unlike some other markets, short-term market conditions are also influenced by seasonal flows of capital into and out of the market. For example, the month of December is usually a horrendous marketing period. Since it is the end of the fiscal year for many investors, balance sheet considerations override other investment policies. In addition, since preferred stocks are a tax-advantaged instrument, they compete with other tax-advantaged securities. The tax-advantaged market is particularly sensitive to tax payment dates such as the month of April, when demand for other tax-advantaged floating rate products is particularly weak.

Some treasurers may take a passive approach, such as investing or issuing at one point on the yield curve. This is the strategy Dutch auction securities

follow. They continually reprice on a fixed cycle at the 49-point on the yield curve. Others may wish to be actively involved in managing market and event risk. They may seek to diversify their exposure to repricing risk, or they may make market judgments as to when and how much to price or invest in.

Whatever the corporate objectives, flexibility gives choice to corporate treasurers or their agents. They have the tools to make intelligent business decisions and respond to different asset/liability management objectives or corporate financing needs over time. They will be able to manage market and event risk.

How Is Flexibility Defined in a Preferred Stock?

Flexibility refers to the options available within the terms of the equity security and who can exercise those options. The goal of flexibility is to increase liquidity at the stated value for the investor and lower the costs of the security to the issuer. For example, a perpetual preferred security with a fixed rate has no flexibility. The dividend rate is usually very high and the investor takes all the risk of resale at its stated value. A perpetual preferred security whose dividend rate adjusts every 90 days by formula has some flexibility. Dividend rates are lower as liquidity is increased. A perpetual preferred security whose dividend rate and duration can change periodically and whose frequency of change is also adjustable has more flexibility.

Preferred stock flexibility focuses on the dividend rate and dividend period. Specifically, the structuring issues are

1. When the dividend rate is set.
2. How many shares it applies, that is how much of an issue or series.
3. How long it lasts before being reset, that is, the length of the dividend period.
4. Whether the dividend period can be extended or shortened.
5. How the rate is determined (i.e., by auction or remarketing).

WHAT IS A REMARKETING?

A remarketing is an organized secondary market activity. The *activity* refers to the buying and selling of securities through the establishment of dividend rates and dividend periods that maintain the stock's value at a fixed amount (i.e., the stock's liquidation preference). The "organizer" is an investment banking firm, broker-dealer, or several such firms selected by the issuer of the securities to serve as Remarketing Agent(s). This selection is done the same way an issuer selects the broker-dealers on its auction.[2]

A remarketing is conducted in a manner similar to an initial offering of securities. The Remarketing Agent acts as the issuer's *advocate* with the market of potential investors. This market includes other broker-dealers representing investors as well as investors directly. The Remarketing Agent engages in a dialogue with these investors as to the rate and investment term at which they would be buyers or sellers of the securities. The Remarketing Agent then matches buy and sell orders and confirms sales directly with investors or through other broker-dealers.

Remarketing Agents are not required to act as principals in a remarketing. They act as agent for the sellers of the securities and advocate for the issuer with investors. They can purchase securities for their own accounts but are under no obligation to do so.

THE TWO CURRENT TYPES OF REMARKETED PREFERRED STOCK STRUCTURES: SUMMARY OF TERMS

All remarketed preferreds are not alike. Currently, there are two types of remarketed preferred. Each is a flexible preferred, but the degree of flexibility varies. The share-adjusted method is the most flexible and has been used by a variety of Wall Street firms. The 7- or 49-day clearing rate method, which is favored by one firm, however, has more issues outstanding. Figures 1 and 2 present a summary of the key terms of each type of remarketed preferred structure.

COMPARISON OF TERMS WITH AUCTION SECURITIES: SHARE-ADJUSTED STRUCTURE VERSUS DUTCH AUCTION

With a share-adjusted remarketed security, the Remarketing Agent has complete flexibility to adjust both the dividend rate and the period to which it

[2]Contrary to general beliefs, auction securities do not automatically allow an unlimited number of broker-dealers to participate in auctions. Each broker-dealer has to be selected by the issuer; and the issuer can determine the number of eligible dealers. The same is true for remarketed securities.

FIGURE 1
Terms Common to Both Types of Remarketed Preferreds

Maturity	None; perpetual security
Rate setting	Remarketing agent selected by the issuer
Denominations	Shares are usually sold (individually or in units) with a liquidation preference of at least $100,000 and may be issued in one or more series
Dividends	Cumulative from the date of original issue and on each share's dividend payment date.
Redemption	Shares usually redeemable on the first day of any dividend period in whole or in part at a demeption price equal to the liquidation preference of the share plus accumulated and unpaid dividends
Minimum rate	None
Maximum rate*	Based on the prevailing rating of the issue and the length of the Dividend Period. Maximum rates have varied as the security has evolved, but generally range from 110% of 60-day Commercial Paper, as quoted by the Federal Reserve for AAA credits, to 250% of 60-day Commercial Paper for not rated or below-investment grade credits.

*These are standards for both auction and remarketed preferred stocks.

applies for each share.[3] In an auction, only the rate can vary for all shares and only on a preset schedule. Figure 3 is a comparison of the key terms of each security.

ADVANTAGES OF THE SHARE-ADJUSTED REMARKETED METHOD FOR BROKER-DEALERS

Sell Orders Are Known with Precision

The amount of remarketed stock that must be sold is always known precisely at each remarketing date. In an auction, no one knows exactly what is for sale until the auction occurs. This uncertainty increases the risk that broker-dealers will not have found enough buy orders to cover the sell orders, which would

[3]Investors must still hold shares for at least 46 days to claim the tax advantages. However, dividend periods may be added together to establish the minimum 46-day holding period (e.g., two 23-day periods, seven 7-day periods, or one 40-day and one 6-day period).

FIGURE 2
The Different Terms Common for Each Type of Remarketed Preferred

Term	*Share-Adjusted*	*7- or 49-Day Clearing Rate*
Dividend periods	Choice of two types of dividend periods for each individual share: *Short Term* 1–364 days with 1-day increments or *Long Term* 1 year to perpetuity	7-day, 49-day, or optional dividend periods with 7-day increments. Optional dividend periods may be established only by the board of directors after sufficient notification procedures.
	Change in dividend period ***at Remarketing Agent's option.***	Change in dividend period only ***at Owner's option.***
Dividend rate(s)	Each share will bear the lowest rate necessary for the Remarketing Agent to sell that share at its liquidation preference (i.e., par). Different shares within the same dividend period may bear different rates.	All shares within a 7- or 49-day dividend period will bear the lowest rate necessary for the Remarketing Agent to sell all shares at par (i.e., clear the market) for that dividend period.
Determination of shares available for remarketing	***Automatic sell order unless revoked:*** Investor is considered to have tendered his shares for sale at the end of each dividend period unless he notifies the Remarketing Agent that he wishes to hold the shares at a specific rate and period as determined by the Remarketing Agent.	***Automatic hold order unless revoked:*** Investor is considered to continue to hold his shares, as adjusted by the Remarketing Agent, unless he notifies the Agent that he wishes to sell his shares.
Effect of failure to remarket	If for any reason a share is not remarketed on its day of tender, the individual share, not the entire issue, will be retained prorata by all tendering Owners. Until successfully remarketed, such share will have successive dividend periods of one business day and a dividend, payable daily, set at the maximum rate.	If for any reason a share is not remarketed on its day of tender, all shares tendered on that day will be retained prorata by Owners. The maximum rate will apply to all shares, whether sold or unsold, continuing for both 49- and 7-day periods until successfully remarketed.

FIGURE 3
Comparison of Share-Adjusted Remarketed with Dutch Auction Rate

Term	*Share-Adjusted*	*Dutch Auction*
Dividend periods	Choice of two dividend periods for each individual share: *Short Term* 1–364 days with 1-day increments or *Long Term* 1 year to perpetuity	49 days for all shares.
Dividend rates	Individual rates; lowest rate to sell each share; each share independent of all other shares.	Clearing rate; lowest rate to sell all shares; all shares must bear same rate
Effect of failed sale	Only those shares remaining unsold will bear the maximum rate. The rate will be in effect for consecutive one-day dividend periods until successfully marketed.	The maximum rate will apply to all shares, whether sold or unsold, continuing for the next 49-day period.
Determination of shares available for sale	Automatic sell order unless revoked. Shares are deemed tendered for sale unless investor affirmatively accepts new dividend rate and period prior to 3 P.M on day preceding remarketing date.	Automatic hold order unless revoked. Investors do not have to reveal intentions to hold or sell until the auction deadline. Prior to this, all decisions are revocable.

result in a failed auction. The remarketed method eliminates this uncertainty and allows for a more orderly marketing of the shares.

Shares Are Priced throughout the Remarketing Day

Dividend rates and periods for remarketed shares available for sale occur all during the day on the remarketing date. The Remarketing Agent and broker-dealers have a 22-hour period to remarket tendered shares and make firm sales. During this period each share is priced as it is sold, resulting in an average cost to the issuer on the day of sale. This is significantly different from an auction, where all shares are priced at a single time. As such, rates reflect market conditions only at that point.

FIGURE 3—Continued

Term	Share-Adjusted	Dutch Auction
Length of marketing period	22 hours, from 3 PM on last business day of the dividend period to 1 PM of the following day. During this time firm sales of tendered shares, with the ability to set both the dividend rate and dividend period on each share independent of each other share, may be made by the Remarketing Agent.	12 PM on auction date. Bids are received and the winning (clearing) rate is calculated. Broker-dealers may solicit orders prior to this time, but no firm sales can be made until the auction occurs.
Ongoing administrative costs	0.25% of principal amount per annum remarketing fee; 0.035% of principal amount per annum for combined services of Tender Agent, Transfer Agent, Registrar, and Paying Agent.	0.25% of principal amount per annum broker-dealer fee; 0.03% of principal amount per annum for combined services of Auction Agent, Transfer Agent, Registrar, and Paying Agent.

Offering Scale Can Move with the Market

Since it can set rates and periods on shares throughout the remarketing period, the Remarketing Agent can constantly update the offering scale of dividend rates and periods to changing market conditions. With precise knowledge of sell orders and by being market sensitive throughout the remarketing day, the Remarketing Agent is better positioned to ensure a par sale and prevent any failure to remarket.

ADVANTAGES OF THE SHARE-ADJUSTED REMARKETED METHOD IN MANAGING RISKS

Term Selection

The share-adjusted remarketing method allows the Remarketing Agent to tailor repricing terms (like maturities) of specific shares to satisfy investors; for example, 10 shares with a 90-day dividend period, 63 shares with a 57-day dividend period, or 40 shares with a 2-year dividend period. In addition, conflicts with other outstanding preferred issues or troublesome dates (such as year-end) can be avoided by remarketing shares past these periods. Unlike

auction securities, there is no one cycle; rather, there are flexible investment terms.

Pricing along the Demand Curve

Since remarketed shares can be tailored to suit individual investor preferences, many investors will accept more aggressive rates if specific "maturity" needs are met. Auction shares, on the other hand, have all investors compete for a level at a fixed pricing period and cycle.

Dollar Cost Averaging

Remarketed shares may be remarketed over multiple dividend periods, thus achieving an effective average rate of the issue. Auction securities bear a single rate. Over a period of time, an average rate will likely produce lower all-in-costs than those associated with a standard, single-term Dutch auction.

Market Timing

Shares may be remarketed with specific terms depending on the shape of, or anticipated changes in, the yield curve. This market-sensitive feature allows the Remarketing Agent to respond to a changing interest rate environment on the entire issue, thus reducing the issue's exposure to volatile short-term market movements.

Increased Likelihood of a Par Sale

Since the Remarketing Agent can, during the remarketing process, adjust both the dividend rate and the dividend period to almost any level on an individual share basis, the likelihood of achieving a par sale is increased substantially. Investor interest can be increased with a variety of terms rather than a single term.

Ongoing Control

The issuer may choose to register additional shares, so that remarketed shares may be increased on an ongoing basis if warranted. Shares may also be retired at the end of each dividend period at the option of the issuer. This flexibility enables the issuer to have direct control over the amount of stock outstanding at any given time.

Shares Subject to Penalty Rate

The maximum rate for any failed sale of remarketed stock is applied only to those shares not sold, rather than the entire issue. In addition, the minimum penalty period to which this rate applies is only 1 day instead of 49 days. Auction shares require the maximum rate to apply to all shares, whether sold or not, for 49 days, even if there is investor demand for shares prior to the end of the period.

HOW A SHARE-ADJUSTED REMARKETED PROGRAM WORKS: THE EXXON EXAMPLE

Exxon Corporation, through its subsidiary Exxon Capital Holdings, is the largest single issuer of remarketed preferred stock. As of mid-1989, Exxon had $330 million outstanding, with $420 million remaining on its SEC shelf filing. The choice of remarketed preferred had to overcome some strong historical biases in favor of the Dutch auction method within Exxon, which in 1976 was the first company to sell securities through the Dutch auction process.

Exxon's share-adjusted securities are sold through a portfolio approach. The company issued two classes of securities with identical terms but with different Remarketing Agents. Each Remarketing Agent has approximately the same amount of stock to remarket. Through this approach, Exxon has established a competitive remarketing process with its agents. Five other firms serve as broker-dealers on the program.

Exxon's portfolio approach means that a small percentage of the entire issue is available for repricing on any given day. Unlike an auction issue, where 100 percent is repriced once every seven weeks, Exxon reprices from $3–15 million of stock (1–5 percent of the issue) in each remarketing.

The number of dividend periods in the portfolio is the diversification of the repricing risk. It also reflects tailoring dividend periods to individual investor demand and Exxon's liability management objectives (see Figures 4, 5, and 6).

DEBUNKING THE MYTHS OF THE AUCTION/REMARKETED PREFERRED MARKET

Myth #1: One Preferred Stock Pricing Method Always Gets Lower Rates than the Other Method

If one were to price a remarketed security and an auction security for the same credit quality on the same day for the same 49-day term, the dividend rate for each would also be about the same. The advantage of remarketed preferred

FIGURE 4
Share-Adjusted Remarketed Stock-Sample Remarketing Portfolio Exxon: October 3, 1988

Position	*Rate*	*Dividend Period Begin*	*Dividend Period End*	*Number of Days in Period*[1]
$7,200,000	6.100%	03-Oct-88	03-Oct-88	1
$1,000,000	5.950%	27-Jul-88	04-Oct-88	70
$12,000,000	6.400%	16-Aug-88	06-Oct-88	52
$1,000,000	5.770%	16-Jun-88	13-Oct-88	120
$1,500,000	6.400%	16-Aug-88	16-Oct-88	62
$1,000,000	6.450%	01-Sep-88	16-Oct-88	46
$5,000,000	5.850%	18-Jul-88	23-Oct-88	96
$10,000,000	6.350%	07-Sep-88	25-Oct-88	49
$1,000,000	6.250%	16-Sep-88	31-Oct-88	46
$5,000,000	6.250%	19-Sep-88	06-Nov-88	49
$2,000,000	6.250%	19-Sep-88	07-Nov-88	50
$5,000,000	6.360%	20-Sep-88	07-Nov-88	49
$10,000,000	6.350%	13-Sep-88	09-Nov-88	58
$2,000,000	6.300%	22-Sep-88	09-Nov-88	49
$4,000,000	6.310%	15-Aug-88	13-Nov-88	91
$2,000,000	6.250%	28-Sep-88	13-Nov-88	47
$7,000,000	6.300%	19-Sep-88	14-Nov-88	57
$3,000,000	6.220%	26-Sep-88	14-Nov-88	50
$3,000,000	6.230%	22-Sep-88	20-Nov-88	60
$1,300,000	6.260%	03-Oct-88	21-Nov-88	50
$5,500,000	6.200%	21-Sep-88	27-Nov-88	68
$2,000,000	6.240%	29-Sep-88	29-Nov-88	62
$3,000,000	6.250%	20-Sep-88	04-Dec-88	76
$3,500,000	6.280%	03-Oct-88	04-Dec-88	63
$3,000,000	6.520%	01-Sep-88	14-Dec-88	105
$1,000,000	6.520%	02-Sep-88	14-Dec-88	104
	Weighted Average			*Average Days*
$102,000,000,000	6.273%			54.40

[1] Includes both beginning and end dates of each specified dividend period.

Exxon's repricing portfolio is diversified. No more than $3–15 million of stock is repriced on any given day. And, on each repricing date, the Remarketing Agent can offer a wide range of investment terms to stimulate and satisfy market demand. In this example, shares were sold with dividend periods from 1 day to 120 days.

does not lie in its similarity to an auction but in its unique capabilities. Investment terms can be lengthened or shortened. Offering rates can move with the market. *Significant savings can be achieved only by applying the same liability management principles to a floating rate preferred stock program that one would apply to any other floating rate program.* A remarketed preferred can cost an issuer less because repricings are diversified and terms are tailored to buyer interest, not because it uses one pricing method over another.

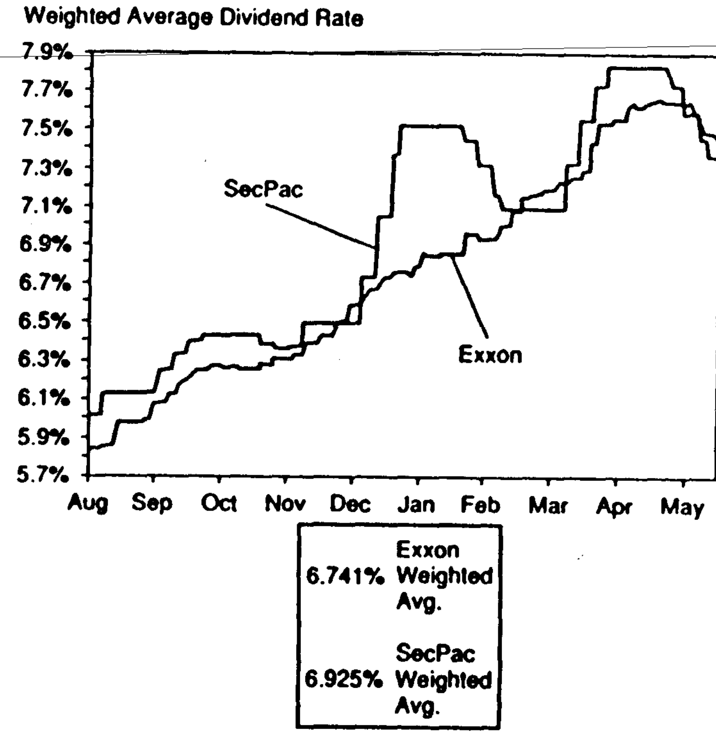
FIGURE 5
Exxon Remarketing Portfolio as of December 27, 1988

Position	*Rate*	*Dividend Period Begin*	*Dividend Period End*	*Number of Days in Period*[1]
$2,000,000	7 400%	21-Dec-88	02-Jan-89	13
$9,500,000	7 500%	27-Dec-88	02-Jan-89	7
$1,500,000	7 000%	05-Dec-88	03-Jan-89	30
$2,500,000	6 450%	10-Nov-88	04-Jan-89	56
$8 000,000	6 680%	15-Nov-88	04-Jan-89	51
$1,000,000	6 700%	15-Nov-88	04-Jan-89	51
$1 000,000	6 700%	16-Nov-88	04-Jan-89	50
$1,000,000	6 330%	04-Oct-88	04-Jan-89	93
$2,700,000	6 290%	04-Oct-88	08-Jan-89	97
$2,500,000	6 450%	09-Nov-88	08-Jan-89	61
$3,000,000	6 850%	21-Nov-88	08-Jan-89	49
$10,000,000	6 500%	10-Nov-88	09-Jan-89	61
$2,000,000	6 480%	10-Nov-88	10-Jan-89	62
$2,000,000	7 080%	13-Dec-88	11-Jan-89	30
$1,500,000	6 350%	17-Oct-88	12-Jan-89	88
$1,000,000	7 050%	28-Nov-88	16-Jan-89	50
$4,500,000	7.000%	28-Nov-88	16-Jan-89	50
$3,000,000	7.125%	30-Nov-88	16-Jan-89	48
$4,000,000	6 270%	24-Oct-88	17-Jan-89	86
$1,000,000	7.000%	05-Dec-88	22-Jan-89	49
$25,000,000	6.400%	31-Oct-88	29-Jan-89	91
$2,500,000	6.400%	01-Nov-88	29-Jan-89	90
$2,000,000	7.150%	14-Dec-88	31-Jan-89	49
$1,000,000	7.050%	09-Dec-88	01-Feb-89	55
$5,000,000	7 130%	15-Dec-88	05-Feb-89	53
$7,000,000	7.150%	19-Dec-88	05-Feb-89	49
$2,000,000	7.280%	22-Dec-88	08-Feb-89	49
$1,000,000	7.150%	16-Dec-88	13-Feb-89	60
$4,000,000	6 490%	14-Nov-88	14-Feb-89	93
$5,000,000	6 380%	24-Oct-88	20-Feb-89	120
$1,300,000	6 800%	22-Nov-88	20-Feb-89	91
$1,000,000	6 800%	29-Nov-88	26-Feb-89	90
$4,000,000	6 720%	15-Dec-88	15-Mar-89	91
$1,000,000	7.050%	02-Dec-88	02-Apr-89	122
$5,000,000	7 000%	06-Dec-88	03-Apr-89	119
$130,000,000,000	*Weighted Average* 6 746%			*Average Days* 51 20

[1]Includes both beginning and end dates of each specified dividend period.

The end of December is usually a horrendous time in the short-term market. Whereas an auction security would be forced to reprice because of its fixed schedule, Exxon's share-adjusted program could avoid this period. Shares were repriced past this period on an opportunistic basis, over several weeks, not a forced schedule.

FIGURE 6
Exxon Rate Comparison



Over a 10-month sample period Exxon's Share-Adjusted Weighted Average Cost outperformed the best-performing Dutch auction issuer by over 18 basis points

Myth #2: Remarketings Are Not Even-Handed

It is odd for action preferred makers to criticize remarketed preferred because it doesn't appear "even-handed," given the way the auction process works. The Dutch auction process slants the competitive process in favor of the buyers. Since a Dutch auction (unlike the most common auction process, the one used by the U.S. Treasury) guarantees that a bidder will receive the higher of his bid rate or the bid rate that sells the last share (the clearing rate), auction securities do not treat buyer and seller, issuer and investor alike.

The most efficient markets, however, are negotiated and competitive. In an environment of full disclosure, remarketings exemplify the fundamentals of the capital markets. Buyers and sellers with different objectives, different needs, different views on interest rates, and different views on the value of the credit meet in setting the rate and term on the security. A successful remarketing is a willing buyer and a willing seller. There is no value judgment assigned to the negotiation because it is "the market."

In the negotiated setting of a remarketing, the Remarketing Agent is clearly the advocate for the company. Its objective is to get the lowest possible cost of capital for the issuer. Investors, on the other hand, seek the highest possible return for their investment. *The Remarketing Agent, though an advocate, cannot set any terms on the security unless the owner or purchaser affirmatively agrees with such terms.*[4] Each side gets only what is agreed to when they make the trade. If the current owner disagrees with the Remarketing Agent, the agent sells the stock to someone else. The guiding principle in a remarketing is willing buyer, willing seller.

The remarketing process is similar to the way broker-dealers set the rate and repricing terms on billions of dollars of debt annually. Broker-dealers and buyers are not hesitant in this $130 billion plus market. Although this is equity and not debt, the repricing duties of the broker-dealer are no different. The differences between debt and equity are differences affecting risk and return, that is, the rate and term the securities can be sold. They have nothing to do with the remarketing process. The distinctions between debt and equity do not disqualify the broker-dealer from advocating, negotiating, and trading the preferred stock security in a remarketing just as in any other secondary market activity.

Myth #3: Remarketings Rely on a Single Broker-Dealer and a Single Sales Force; Auction Securities Have the Entire Street Working for the Issuer at Every Auction

Participation in a remarketing can be, and is, as broad as participation in Dutch auction securities. Neither pricing mechanism limits participation or guarantees it. Rather, participation is dependent on how issuers and their underwriters decide to operate the auction or remarketing process.

Neither auctions nor remarketings guarantee liquidity. To date, auctions for five issuers have failed; there have been no failed remarketings. But the

[4]Critics of remarketed preferred often miss this point. Remarketing Agents cannot force a rate and term on an investor just as an auction broker-dealer cannot require an investor to bid a certain rate. Remarketing Agents make the determination, but it is not effective unless it is accepted by a current owner or, in case an owner rejects it and tenders his shares, by a new purchaser of the shares.

notion of automatic broad market participation, and therefore greater liquidity, in one repricing mechanism versus another is not supported by the facts. Indeed, the failed auctions to date demonstrate that the auction mechanism is no better than auction advocates believe remarketing to be.

Failed Auctions through September, 1989

August, 1987	$125,000,000	MCorp (B/ba)
February, 1988	$75,000,000	First Arkansas Funding (AAA/aaa)
September, 1988	$250,000,000	The Kroger Company (A/a[2])
August, 1989	$150,000,000	American Airlines (A/a[2])
September, 1989	$77,000,000	Tuscon Electric (BBB–/ba[2])

In each failed auction, market participants held a single broker-dealer responsible for not marketing the issue aggressively. This contradicts the basic assertion that "the entire street is working for the issuer at every auction," and illustrates how Dutch auction securities actually work. Liquidity is not provided by the auction but by the initial underwriters of the issue—the ones who shared in the large up-front commissions.[5] The secondary after-market is dependent on these firms. Usually 80 percent of an auction is consistently won by the initial underwriters, and the remaining 20 percent is scattered among other dealers.

Although MCorp was more a case of credit quality than auction mechanism, the cases of First Arkansas Funding and The Kroger Company illustrate this point dramatically. Each issuer was investment grade; First Arkansas, in fact, was an AAA/aaa–rated single-purpose finance subsidiary with largely U.S. government-backed mortgages as assets. Each was a standard 49-day Dutch auction. And each had 15 to 20 broker-dealers signed up and eligible to bid the auctions. Prudential-Bache, one of the least experienced professionals in the auction market, underwrote First Arkansas, and Goldman Sachs, one of the largest and most sophisticated auction underwriters, brought Kroger to market.

Neither Goldman Sachs nor Prudential-Bache submitted bids in the auctions for their own accounts, but for different reasons.[6] When the two under-

[5]Indeed, most auction underwriters hold back 50–75 percent of the selling commissions on the initial sale to compensate their salespersons in subsequent auctions. Other broker-dealers in the auction are compensated by the issuer at only a fraction of what the initial underwriters receive. This means that each broker-dealer concentrates on distributing the issues that it originally brought to market.

[6]Goldman was prevented because of a conflict of interest issue resulting from its role as financial advisor to the issuer in a potential restructuring. Prudential-Bache made a policy decision not to inventory shares unless there was independent buyer demand from its sales force.

writers did not purchase, and since no one knows how many sell orders there will be in any auction, there was not enough demand from the rest of the street and each auction failed. As a result of a single broker-dealer's actions, the auction mechanism failed to ensure liquidity.

In practice, Dutch auction preferreds operate like remarketings *but without the benefits that the flexible remarketing structure can bring to the pricing, sale, and setting of the terms of the issue.* Even though there is an independent auction agent who receives bids and does the mathematical calculation of the rate, the reality of the Dutch auction structure is that the initial lead manager of the issue acts as the informal remarketing agent for the security on an ongoing basis.

An examination of the day-to-day workings of the auction market shows how liquidity is dependant upon a small number of firms. Prior to each auction, the lead manager canvasses the street for bid orders and to determine whether current owners intend to sell their securities at the auction or continue to hold them. This exercise, known as "price talk," is published by Telerate each day.[7]

Once price talk is established, the lead manager will usually submit a "clearing bid"; that is, a bid (or series of bids) for its own account without an independent investor behind it. The clearing bid is designed to "stop out" the auction by setting a maximum rate that clears the market. While the broker-dealer is working to generate demand, the reality of the auction preferred process forces the same broker-dealer to set the rate (and therefore provide the liquidity) on the preferred based on its estimate of buy and sell orders.

Consider also that of all the Dutch auction preferred issues brought to market to date (mid-1989), not one of them conducted its initial sale as a Dutch auction. Placement of the securities for the first 49-day term is conducted similar to a remarketing. Yet when it is argued that a Dutch auction conducted just 49 days after the initial offering is essential for broad market participation, one has to ask why is it not true for the initial sale of the securities 49 days earlier? The most common response is that distribution and placement of the securities are important elements of a continuing stable secondary market. But if this is true at the initial offering, it is certainly true at each repricing.

After one understands the practice of the Dutch auction, it is easier to

[7]Price talk is unique to auction preferred securities. Nothing like it is done on any other type of auction in the capital markets. Competitive pressures do not allow it in those auctions.

see that the other terms of the security—the flexibility issues (the length of the dividend period, the amount to which it applies, the rate, etc.)—are as important as the pricing mechanism. Neither pricing mechanism has a lock on broad investor participation or liquidity.

Myth #4: There Is Not Enough Market Demand for a Flexible Remarketed Security

In a widely circulated publication, an auction advocate argued against remarketed preferred by developing an argument based on a concept called "coverage." The difference in the amount of estimated bids for auction securities (demand) in a selected week versus the amount of securities at auction (supply) in that same week is the so-called "coverage." A ratio of 3:1 (demand to supply) is assumed necessary for a smoothly functioning market. It was argued that remarketed securities decrease coverage because of a dividend period less than the standard 49-day cycle. One week's data were used to represent the entire preferred market.[8]

In considering coverage, it is important to remember that investors have a multitude of objectives and portfolio requirements. *Remarketing advocates believe that the issuer who appeals to the diversity of investor needs (i.e., not just 49 days) has the broadest and deepest market to sell its shares.* Flexibility in the remarketing process recognizes that demand is not static. Supply and demand (another way of saying "coverage") are interactive.

Accordingly, the simplest way to ensure adequate coverage for a given issuer is to offer the market a variety of investment choices at each repricing date. Remarketed securities focus on coverage of an issue of securities, not coverage of the entire preferred market. By introducing multiple dividend periods and market rates for each period (not just a so-called 7-day cycle, but the full spectrum of money market terms—for example, 1–364 days), the likelihood of a successful remarketing is increased exponentially. Less of an issue is repriced at any given time. More dollars are left chasing less *of a given issue*. And if shorter repricing periods (less than 49 days) are thought to decrease coverage, then longer dividend periods (greater than 49 days), by the

[8]This estimate could not be independently verified since it was based on one unnamed auction agent's count for one week and presumably contains the cover bids of broker-dealers. It is likely false to also assume that demand in one week is the same as demand in the 51 other weeks of the year. If there is anything certain about the short-term marketplace, it is that demand varies. There are seasonal flows of capital into and out of the market.

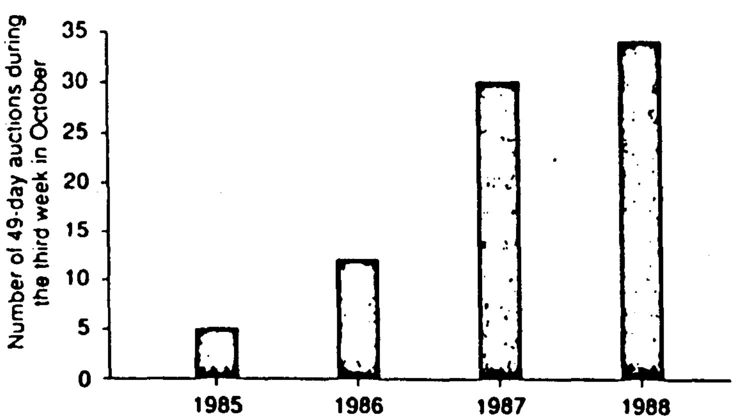
logic of coverage theory proponents, must increase coverage. For example, 50 percent of share-adjusted remarketed repricings are for dividend periods greater than 49 days.

Conversely, as the number of 49-day Dutch auction issues grows, the amount of auction supply repricing each week grows, which increases the risk of insufficient coverage (i.e., of a failed auction). Unless one assumes that every new auction security automatically increases demand for that security threefold, then issuers and investors will face greater risk of failed auctions as each week's demand is spread among many more auctions, all offering the same 49-day investment term (see Figure 7). Remember that the entire principal amount of an auction security must be repriced on a single day for a single fixed term. It is no wonder that auction proponents worry about coverage.

REPRESENTATIVE ISSUERS

Issuers of remarketed preferred stock have included Citicorp, Exxon Corporation, Chrysler Financial, General Electric Capital Corporation, Ultramar America, Pacific Enterprises, and a variety of savings and loans and thrifts.

FIGURE 7
Dutch Auctions' Increasingly Crowded Calendar Chart



Dutch auction securities offer only a single 49-day term, so as supply increases, each issuer is subjected to increasing competition for buyers. This competition cannot be foreseen or managed because of the rigid structure of the security.

As of June, 1989 every auction underwriter has underwritten a remarketed issue and participates in remarketings. This includes the notable firm that made its "choice" and vowed in 1987 that it would never underwrite a remarketed security.

CONCLUSION

The evolution of floating rate preferred stock demonstrates the ingenuity and sophistication of investment bankers. Issuers have received low-cost equity and investors a higher return than comparable investments in commercial paper and other short-term securities. Over a period of less than five years, a $20 billion market was created and a once sleepy product area became a source of innovation and an arena of intense competition.

The remarketing process can maximize the flexibility of both issuer and investor and supplement the already developed market for 49-day preferred stock investments. Liquidity is enhanced because the security can access different markets continually. It has a broader and deeper market in which to sell shares because it is so flexible.

But even among remarketed preferred stocks there are differences that must be recognized. For example, 7- or 49-day preferred offers investors only two choices at each repricing, whereas share-adjusted has few restrictions on what it can offer investors.

Like all markets and all products, few things are static. Remarketed preferred stock, in particular the share-adjusted method, represents a refinement and improvement of an excellent product. Yet remarketed preferred may not be appropriate for all issuers, just as an auction security may also be inappropriate. Undoubtedly, however, corporate treasurers need to have options to tailor their sale of securities to their needs. As this product area has evolved, treasurers have been given more options.

It is best to remember Benjamin Franklin's warning: neither Blame All nor Praise All[9]. Instead, fit the terms of an equity offering to the needs of the issuer and the demands of the market. Remarketed preferred need not be in conflict with auction preferred. It is a useful supplement to the tools a corporate treasurer must have to achieve the often elusive goal of cheap equity.

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[9] "Blame All and Praise All are two blockheads." Benjamin Franklin, *Poor Richard's Almanac* (1734).

APPENDIX 26-A
7- or 49-Day Clearing Rate Remarketing Timetable

Second to Last Business Day of 7- or 49-Day Dividend Period: Tender Date	
By noon E.S.T.	The Remarketing Agent makes available to current and prospective shareholders nonbinding indications of the dividend rate for the subsequent 7- or 49-day dividend periods.
By 1 P.M.	Current 7-day shareholders (and 49-day shareholders whose dividend periods are ending) must give irrevocable notice to the Remarketing Agent if they wish their shares to be (1) sold at the remarketing, or (2) retained for a different 7- or 49-day dividend period from what they currently own. Shareholders who do not make any affirmative selection are deemed to have rolled their investment for another dividend period of equal length.
After 1 P.M.	Remarketing of shares tendered for sale begins.
Next Business Day: Dividend Reset Rate	
Opening of Business	Remarketing continues, if necessary.
By 4 P.M.	Remarketing Agent completes remarketing and determines the applicable dividend rates for the next succeeding 7- or 49-day dividend period.
By 4:30 P.M.	Remarketing Agent notifies all holders and purchasers of the results of the remarketing.
Next Business Day: Settlement and Beginning of Each Dividend Period	
By 10 A.M.	Settlement through Depositary Trust Company and payment of accumulated dividends to current and former owners whose dividend period has just ended.

Dutch auction securities offer only a single 49-day term so as supply increases, each issuer is subjected to increasing competition for buyers. This competition cannot be foreseen or managed because to the rigid structure of the security.

APPENDIX 26-B
Share-Adjusted Remarketing Timetable

Last Business Day of Any Dividend Period	
By 1 P.M. E.S.T.	Upon request, the Remarketing Agent determines and makes available nonbinding dividend rates for their respective dividend periods based on then-current remarketing conditions.
By 3 P.M.	Current shareholders whose dividend periods are ending must notify the Remarketing Agent if they wish to retain their shares. The Remarketing Agent is required, if requested, to give a binding commitment as to the subsequent dividend rate and period applicable to a current owner's shares should they be retained. Shareholders who do not affirmatively decide to retain their investments by agreeing to a specific dividend period and rate, or simply do not communicate their intentions, and deemed to have tendered their shares for sale.
After 3 P.M.	Remarketing of tendered shares begins. A purchaser at the time of agreement to purchase may obtain a binding commitment as to the specific dividend period and dividend rate on the investment.
Next Business Day: First Day of Next Dividend Period	
Opening of business	Remarketing continues, if necessary. Dividend rates and periods offered may be adjusted to then-current remarketing conditions.
By 1 P.M.	Deadline for completing remarketing of tendered shares and establishing respective dividend rates and dividend periods.
By 2:30 P.M.	New owners settle their purchases in immediately available funds. Former owners are paid the proceeds of the remarketing plus accumulated dividends. Continuing owners are paid accumulated dividends for the previous dividend period.