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MARKET ANALYSIS

Auction Rate Securities Need Reform, Not Just Redemption[1]

By Joseph S. Fichera[2]

Three years – that's how long ago much of the $330 billion auction rate securities (ARS) market stalled. Yet stranded investors still await significant signs of life, let alone genuine recovery. Just half the size of the troubled asset relief program and a year before was that program was conceived and one month *before* the fire sale of Bear Stearns, the ARS market was one of the first markets to fail.

Three years is beginning to feel like thirty. Despite widespread assurances by broker-dealers, including the former CEO of Merrill Lynch, John Thain[3], that all those securities would be long gone and investors made whole, Bloomberg data shows that more than $150 billion of auction rate securities remained outstanding as of December 2010. Hundreds of auctions are still held each week, but most fail to attract enough investors in their bidding range. As a result, from Maine to Maui thousands of investors are still stuck with investments they can't sell, or can sell only at a deep loss.

Post crisis market reform should not ignore this market, its investors, market makers or issuers.

Some auctions, however, never failed, and some are now succeeding though the surrounding facts remain obscure in this opaque market. In other cases, issuers are offering tenders at a discount to restructure the securities. Nevertheless, little if anything comprehensive is being done to address the core market issues of investor confidence in the auction process or liquidity for often highly credit-rated securities using an auction mechanism.

Moreover, amid the flaws now clearly exposed in the prior regime, astonishingly regulators have failed to develop a single set of rules governing disclosure, transparency and conduct in auction securities. The ARS market was not and is still not a level playing field.

A ray of hope has occurred. It has also been three years after Saber Partners in response to a rulemaking process (initiated by the Municipal Rulemaking Board (MSRB)[4] only *after* the crisis occurred) proposed sweeping reforms to the disclosure regime in municipal securities auction rate securities. On May 16, 2011 the MSRB finally implemented most of Saber's proposals in a new system for investors, issuers and brokers to see critical information about auctions. It was a major development. Unfortunately, more than 2/3 of the market still remains in the dark. And other regulators remain uninvolved.

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[3] John Satish Kumar, "Merrill's Thain Backs Auction-Rate Securities,"... *The Wall Street Journal*, May 8, 2008.

[4] [4] See http://saberpartners.com/oped/saber_letter_msrb.html and http://saberpartners.com/press/articlepages/ARS_04_12_10.html

Nor are auctions open and competitive processes, where any and all willing investors have equal access to relevant information. This is key to independent investor liquidity. ARS auctions have remained largely closed, proprietary bidding systems, where direct participants in auctions (including authorized broker-dealers and auction agents) have significantly more knowledge than those – such as investors and issuer –who are not direct participants. Since the massive disruption in 2008, most broker-dealers have retreated from trying to restore investor confidence and build independent investor demand for the securities. Regulators have sought quick solutions for some investors and left the majority to help themselves. Many issuers either have been forced to restructure at high costs or done little or nothing to get auction markets to work in reliance on advice from the broker-dealers who first designed, then abandoned, the security.

Three things can be done to promote liquidity in the ARS market and create the basis for using an auction mechanism in the future:

1. *The Securities & Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA) and other regulators should establish a single set of rules, practices and disclosures for how auctions are conducted. The MSRB rules should be extended to all ARS product as a first step. This should also include how investors can access the market and receive important related information– whether the securities are corporate, municipal or structured products, and whether they are sold in private placements or public offerings.*

2. *ARS issuers should open their auctions to all potential investors interested in competing, not just those bidding through one or a few select broker-dealers. In doing so they should provide performance-based compensation to broker-dealers for their sales efforts. Pay for "sales not fails." Increased marketing should be rewarded, just as those broker-dealers were who resolved failed auction securities programs in the 1990s.*

3. *An auction securities exchange platform should be established to facilitate a return to liquidity in the market, with clear ground rules established for the current and next generation of auction securities. Broker-dealers should employ the latest technology to make auctions accessible to all customers, broader, more transparent competition and allow the full issuer fees to go to whichever broker-dealer sells the security.*

Regulators have Responsibility; Broker-Dealers a Duty; Investors a Need

In the absence of a clear regulatory response, investors, issuers and now the courts are asking important questions about what it means to conduct, to hold an "auction," whether the ARS markets were manipulated, and whether other securities rules and regulations were violated. Unfortunately, those questions are often difficult and clear answers sometimes elusive (though many are not) – in large part because the ARS market was plagued by conflicting interests and a tremendous degree of information opacity.

The best way to foster the investor confidence necessary for any market to succeed is to provide meaningful market transparency. This means the ability to see and evaluate the rates and prices at which other *independent* investors are willing to buy or sell the security. In the jargon of the profession, this is known as "price discovery." Among other things, it requires more complete and uniform access to verifiable market information. This is how investors can effectively evaluate risks and ensure that the securities' interest or dividend rates reflect true market forces, rather than returns structured and "managed" by broker-dealers.

Liquidity involves more investors than available supply within the permitted bidding range. Auctions should also be open to investors bidding through *any* broker-dealer rather than, as was often the practice, just a select few – or even one. Fewer potential bidders lead to less liquidity and therefore the need for higher interest or dividend rates. Yet, the technology exists today to substantially broaden the market for high-grade securities and create a truly broad and competitive and liquid secondary market using the auction process. Will it be enough? Without these steps, it is unlikely, with them it is possible. The role of regulators and brokers is to let markets work.

However, key participants have been slow to adopt practical liquidity solutions, even in the wake of some regulatory sanctions and litigation. The focus has been on getting issuers to restructure the securities they sold, and investors to accept reduced prices for their investments. This needs to change, and it can. Successful examples of technology and effort exist, if a group of regulators, investors and/or brokers would only lead the way.

Background

Auction rate securities are perpetual preferred stock or long-term debt investments for which the interest or dividend rates are periodically reset through an auction process. In a genuine auction, bidders compete freely and with all available information to determine what they are willing to pay or receive for an asset or investment. Given a critical mass of buyers and sellers, auctions can provide effective and meaningful price discovery – the "market value" at that moment in time. Indeed, the U.S. Treasury successfully conducts efficient and transparent auctions in both easy and tight credit market conditions. Each auction can be analyzed and market participants can evaluate the results to determine the true liquidity of those auctions, and then consider that information when making investment decisions in future auctions.

But unlike Treasury auctions, ARS "auctions" were plagued by information asymmetries and deficits that restricted participation. Broker-dealers always had superior knowledge, however. In many cases, they exercised de facto control over the auctions.

Liquidity also suffered as the auctions became "closed" systems, in which insiders kept control of important information and the auction process. Among other things, this ensured the steady flow of deals and fees to a few select firms. The lack of meaningful liquidity and transparency proved nearly fatal when ARS came under significant stress in 2007 and 2008. Many ARS auctions failed. Today, many continue in futility, leaving too many investors unable to sell their positions for anything but a deep loss. Even more opaque secondary markets have developed where "bottom fishing" investors with money can take advantage of other investors' stress and lack of transparency.

Although specific facts differ, many regulators and investors have since reached a common conclusion: investors often did not know important facts or may have been told misleading things about the securities they were buying. The SEC has taken action against underwriters, auction dealers and auction agents, and reached settlements with a number of them.[5] FINRA, too, has censured and/or settled with member firms over their ARS practices, including BNY Capital Markets, Jefferies, Nuveen and others. Investors and issuers have also alleged that the market was manipulated by the firms dealing in many of these securities. Courts, arbitrators and regulators continue to grapple with whether those firms' disclosures of how they "might" or "could" participate in the auctions square with what they actually did, and with the requirements of U.S. securities laws and regulations.

How did that happen? By no coincidence, a patchwork of disclosure and transparency rules applied to different segments of the ARS market at each of the federal and state levels. Even now the SEC has different departments setting the rules – all in addition to FINRA and MSRB. Some securities had

[5] *See* www.sec.gov/investor/ars.htm.

almost no disclosure requirements at all. Only one regulator, the Municipal Securities Rulemaking Board (overseen by the SEC), has developed a transparency system for investors. And even that system is just being implemented three years later.

An initial burst of regulatory action did help many small, "Main Street" investors recover their investments. But official policy has since left the remaining investors (holding $150 billion in securities) stuck on the vine. The New York Times recently reported that the Federal Reserve may have intervened with regulators probing the auction market when the second round of settlements concerning ARS in about 2 years was done.[6] The Fed official who influenced the SEC did not seem to understand the nature of the auction securities market and or the types of credits involved. Most ARS were not the toxic securitizations that the Fed was concerned about with most banks... and the banks had no reason to educate the regulator. Most ARS were "money good" in that the credits would continue to pay principal and interest when due – so the banks would have had to hold these securities until maturity or until a market was re-established. The real issues were structural issues affecting yield and therefore liquidity in the secondary market between and among investors.

The unlucky holders include many small- and medium-sized investors and companies, as well as those who invested (knowingly or not) in some of the more dubious and least-liquid types of auction rate securities. "Don't worry, the problem will go away on its own," seems to be an enduring bromide of the ARS crisis – one proclaimed almost as often as the pre-crisis mantra that ARS were "liquid and safe."

So, ARS litigation grinds on. But litigation is a symptom of a problem, not an answer to them – particularly when the problems are fundamental and systemic. If developments over the last four months are any guide, signs may point to more even litigation, not less. In a federal securities case involving Dow Corning and Merrill Lynch, in which Saber Partners serves as an expert advisor, Judge Loretta Preska denied a motion to dismiss an ARS claim, marking a sharp departure from prior cases before her and potentially signaling a roadmap for other plaintiffs. In another large, ARS-related case, the U.S. Second Circuit Court of Appeals has gone one step further. It recently asked the SEC to answer questions about whether that agency's 2006 settlement with ARS broker-dealers should prevent investors from recovering on certain ARS claims brought against the broker-dealers, as some cases seem to have held. The Appeals Court's action has been widely interpreted as asking the investor-protection agency, in essence, "Did you really mean that?" The SEC is expected to respond to the request by the end of June 2011 after notably asking for, and being granted, two extensions to respond.

Open Auctions: Transparency, Technology and Performance-Based Compensation

The current crisis shows that there is an urgent need for a coherent policy response, in which regulators enforce a level playing field and ensure that market terms like "auction" are not abused. All markets work best (and by "best" we mean efficiently, effectively and fairly) when everyone has the same, verifiable information when making investment decisions. It's called full disclosure. And when that information involves seeing what others have done it is called transparency.

Currently, the only players that see all bids and orders are the broker-dealers who may also be participating in the auction. Furthermore, there is (until Saber proposed MSRB system for municipals was implemented) no disclosure of the true extent and need for support bids submitted by broker-dealers. By definition, this creates an uneven playing field and an inability to evaluate liquidity risks. Just like in US Treasury auctions, comprehensive information on the bidding and auction results (bid-

[6]Gretchen Morgenson and Louise Story, "In Financial Crisis, No Prosecution of Top Figures," *The New York Times*, April 14, 2011. The named Fed official "suggested that the S.E.C. soften the proposed terms of the auction-rate settlements. His staff followed up with more calls to the S.E.C., cautioning that banks might run short on capital if they had to pay the many billions of dollars needed to make all auction-rate clients whole, the people briefed on the conversations said."

to-cover ratios, etc.) should be released to all investors after every ARS auction. Separating program dealer bids from others in U.S. Treasury auctions is unnecessary since no one dealer can affect the success of failure of an auction. When one dealer (Salomon Brothers) tried to affect the outcome in the 1990's, swift action was taken. Unfortunately, in the non-Treasury auction market, individual program dealers could and did affect outcomes so their bids should be permitted and identified.

Information Released	US Treasury	Municipal [7]/Corporate and Structured ARS
Winning Yield	✓	✓
Amount of Competitive Bids[8]	✓	
Amount of Competitive Bids Accepted	✓	
Amount of Non-Competitive Bids[9]	✓	
Amount of Non-Competitive Bids Accepted	✓	
Amount of Bids at the Winning Yield	✓	
Median Yield	✓	
Lowest Yield	✓	
Amount of Competitive Tenders at or below Median Yield	✓	
Amount of Tenders at Lowest Yield	✓	
Bid to Cover Ratio	✓	

Precedents

Moreover, that information should be readily available on a consistent, comprehensive electronic platform, accessible to the public – not just market insiders. Today's technology makes it feasible to quickly build, deploy and operate such a system, as was recently done by the New Orleans Exchange to create a live, online auction platform in support of asset-based lending operations. It has also been done by Google in a receivables exchange.

Alternatively, it might be possible to build upon or enhance the existing, but disparate, EDGAR and EMMA systems of the SEC and the MSRB, respectively. That way, issuers, investors, broker-dealers, auction agents and regulators could have access to comprehensive information about the issuance, auctioning and trading of ARS.

[7] Prior to MSRB action on May 16, 2011 (based on Saber's Joseph Fichera's proposals).
[8] Competitive Bids are bids that specify the minimum rate at which the investor is willing to purchase the stated amount of securities. They are similar to a Hold at or Buy at rate order in ARS.
[9] Non-Competitive Bids are bids that do not specify a rate, only an amount of securities. They indicate the investor is willing to accept whatever the winning rate of the auction is, similar to a Hold order in ARS within the terms of the security's acceptable bidding range.

An Auction Securities Exchange

Finally, an open auction system – similar to an exchange which creates the core "auction" mechanism for equities and other assets – could also help bring needed liquidity to the different ARS instruments. An exchange-type platform for ARS would enable all qualifying investors to submit bids and orders in ARS auctions through any broker-dealer, rather than, as was often the practice, just a select few – or even one. Although broader potential participation could make more work for individual broker-dealers, it would serve to enhance potential liquidity and price discovery. And even if it makes auction results more volatile, that would provide important risk/return information to the market – information of a type that was sorely lacking in the long run-up to the ARS crisis that peaked in 2007-2008. This is the essence of "price discovery," a concept that is critical to the efficient functioning of the capital markets.

Before the crisis, investors and issuers were almost universally unaware of the full extent to which broker-dealers' practice of submitting so-called "support" bids may have affected the outcome of auctions. As the SEC and others have noted this masked not just insufficient but sometimes non-existent demand from independent investors. Had that information instead been widely known outside of the broker-dealer community – and perhaps more auctions actually failed publicly – participants would have had a much more accurate sense of the risks and value of their ARS investments. The market may have been more volatile, but that volatility could have been considered by both issuers and investors in deciding whether to issue and for investors in deciding at what price to buy or hold within the issuer's offering range.

If none of this is done, then perhaps the illusion of an auction should be ended and auctions converted to remarketings which are more transparent and accountable as was done in the 1980's and described in Dow Jones Irwin, *The Library of Investment Banking*, "The Advantages of Remarketed Preferred Stock" [10]

Conclusion

Investors, issuers and brokers have all been harmed because a third of a trillion dollar market grew without anyone defining the basic ground rules governing these "auctions." It's not surprising, then, that broker-dealers, issuers and investors operated with different understandings and expectations, and that the securities laws may have been violated.

Policymakers should now step up and set clear and consistent disclosure and transparency rules for auction securities, and see what market innovations may bloom. Brokers should use their ingenuity and invention to restore liquidity. Successful bidding within the range permitted could resume if reforms are enacted; without it the chances are slim. Fundamentally, all market participants stand to benefit. Transparency and competition can help ensure confidence and coverage so that each time the auction gavel falls, it is on a successful auction.

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[10] See http://saberpartners.com/oped/preferred-stock-4.pdf