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# Statement of the Regional Bond Dealers Association

## Committee of Financial Services United States House of Representatives

## Hearing on the Auction Rate Securities Market: A Review of Problems and Potential Resolutions

## September 18, 2008

## Submitted for the hearing record

The Regional Bond Dealers Association (RBDA) appreciates the opportunity to submit this statement for the record in conjunction with the Committee on Financial Service's hearing on "Auction Rate Securities Market: A Review of Problems and Potential Resolutions." The RBDA is the only U.S. trade organization dedicated exclusively to representing regional securities firms active in the bond markets.

The auction rate securities (ARS) market has experienced considerable disruption in the last year. At one time, ARS were widely considered to be as safe and liquid as money market investments. In the minds of many investors, ARS were substitutes for commercial paper, money-market funds and similar highly liquid, short term investments. Today, however, liquidity has all but disappeared for tens of billions of dollars of outstanding ARS. Thousands of investors own securities they no longer want and cannot sell. The anxiety of ARS investors has been magnified by bankruptcies and consolidations among auction dealer firms. In that context, the issues addressed in the Committee's hearing on ARS are vital, and we commend Chairman Frank, Ranking Member Bachus and other committee members for your attention to these concerns.

In recent weeks federal and state enforcement agencies have been aggressive in securing agreements in principle with major securities firms to settle potential enforcement actions related to their activities in the ARS market. A key element of many of these agreements is an obligation on the part of settling securities firms to buy ARS positions back from certain of their investor customers at full face value. The RBDA supports these actions by regulators. Through

agreements secured by the SEC, state attorneys general, state securities regulators and others, many thousands of ARS investors will be made whole.

However, thousands more ARS investors are not covered by most of the agreements reached thus far by enforcement agencies. Many investors bought their ARS not from securities firms who underwrote the transactions and managed and controlled periodic auctions, but from "downstream" dealers who served principally as distributors of ARS. Investors who bought ARS from these "distributing" firms are mostly left out of the settlement agreements reached thus far. While we support the actions of enforcement agencies to help stranded ARS investors, we also urge policy makers to explore fair and practical solutions that will help all ARS investors become whole.

Some of the firms that have entered into agreements in principle related to ARS have been accused of violating sales practice rules associated with selling ARS by engaging in practices such as misrepresenting securities to their customers or selling securities that were unsuitable for a particular customer's objectives and risk tolerances.[1] RBDA believes that any firm that violated sales practice rules or any other applicable regulations in underwriting or distributing ARS or in managing ARS auctions should be subject to full regulatory enforcement. With that said, there are additional steps that market participants and regulators can take to help investors liquidate ARS they no longer want to own.

### ***Reestablishing Liquidity***

Many downstream brokers have been hamstrung in their ability to help their investor customers sell or borrow against their ARS holdings. Auction rate preferred stock (ARPS), sold by closed end mutual funds, is not marginable, which makes it prohibitively expensive for broker dealers to make margin loans to their customers using ARPS as collateral. While the SEC and FINRA have taken some steps to allow dealers to lend to customers against their ARPS holdings—and some firms do provide loans against customer positions—it is still prohibitively expensive for most dealers to provide this service.

Some closed end mutual funds have begun the process of restructuring their outstanding ARPS into other instruments that would be more attractive to investors. Regulators have been somewhat accommodating in providing approvals necessary to effect these transactions. We encourage regulators to expedite their consideration of filings by closed end funds designed to take ARPS out of the market and replace them with securities that offer more liquidity protection.

One key method for restoring liquidity to the holders of the ARS securities has been mostly ignored thus far by state and federal enforcement agencies. While the regulators have been vigorous and aggressive in insisting that the major institutions that were the lead managers in the auction process repurchase these securities, they have not taken any action against issuers of ARPS, closed end mutual funds and their managers. Yet at least some closed end fund managers likely were aware last winter of the same problems in the auction process confronting the lead

[1] See, for example, Office of the Attorney General, State of New York, "Attorney General Cuomo Brings National Multi-Billion Dollar Lawsuit Against UBS for Auction Rate Securities Scandal," press release, July 24, 2008.

managers and cooperated with the managers or turned a blind eye in order to maintain this source of inexpensive financing. We urge enforcement agencies to examine the conduct of the ARPS issuers and their possible knowledge of and responsibility for the wholesale failure of the ARPS market. Like the lead managers with whom they worked, ARPS issuers should be required to take action to assist ARPS investors by redeeming outstanding ARPS. Action by the closed end fund issuers can go a long way toward resolving much of this problem. After all, fund managers have the resources to unwind immediately their present use of the cheap financing they are now using for their funds' own leverage purposes.

Some fund managers have, on their own, moved to address their ARPS investors' problems by redeeming the securities. We commend these actions. However, many have not done so, and we urge regulators to encourage closed end fund managers to take appropriate steps to assist their ARPS investors.

Also, liquidity for ARS backed by student loans could be helped by a greater degree of disclosure by issuers of the characteristics and performance of the pools of loans that back outstanding ARS. Student loan ARS issuers, both state agencies and private companies, generally have ready access to data related to, for example, auction performance and interest rate changes, waivers, default rates and forbearances for the underlying loan pools, and geographic and demographic characteristics of pool loan borrowers. These data are necessary in evaluating and pricing student loan backed ARS but are often only to current holders of securities, not to potential buyers. Making these data more readily available to the market at large could attract new investors to the sector. Appendix 1 of this statement discusses this issue more fully.

One of the focuses of federal and state enforcement agencies in resolving the ARS problem for investors has been to negotiate agreements with dealers who have sold ARS that obligate those firms to buy back the ARS they sold from their retail and some institutional customers. While those agreements will likely be successful in providing a potential resolution for many investors, negotiated buy backs may not be the best approach in all circumstances because they may not be fair or practical. Negotiated buy backs may make sense if the dealer who sold ARS violated laws or rules in its role as auction dealer or ARS distributor and if it is practical to expect that the settling dealer has the financial capacity to take customers' ARS back onto its own balance sheet. In cases where dealers did not violate rules or does not have the capacity to buy back customers' ARS positions, buy backs are not a good tool for enforcement agencies.

In many cases, distributing, or downstream, dealers did not violate sales practice or other rules related to selling ARS. In many cases, downstream dealers did not know that the ARS market was collapsing last fall and was being supported only by auction dealers taking large volumes of ARS onto their own balance sheets. The ARS market is opaque, and information on ARS auction performance is generally available only to the auction dealer—usually the lead underwriters of the ARS transaction. The auction dealer controls information related to the number and volume of bidders, whether an auction dealer's own bids were necessary to prevent an auction from failing, and the size of auction dealer's positions in particular ARS. Indeed, some auction dealers expressly prohibit their employees from disclosing certain information related to auctions that could affect the value of securities and investor demand.

In 2006 15 broker-dealers reached a settlement agreement with the SEC regarding violations of securities laws associated with their roles in the ARS market.[2] One element of the settlement requires the 15 settling dealers to publish "material auction practices and procedures" associated with their ARS activities as auction dealers. While we have not performed an exhaustive review of all the settling firms' auction practices and procedures, it is evident that at least some firms imposed on their employees an outright prohibition on communicating to the market certain details information related to auctions. For example, Merrill Lynch's auction practices and procedures state:

> Merrill Lynch prohibits Auction Desk employees from disclosing to any holder or prospective holder:
>
> - information about actual bidding in any auction by any other holder or prospective holder. For example, it is not permitted to disclose to anyone, other than the auction agent, the rate or quantity at which other holders or prospective holders have placed their bids or are likely to place their bids, or the status of any other holder's or prospective holder's auction order;
>
> - ***the rate or quantity at which Merrill Lynch plans to bid, or the status of any auction order for Merrill Lynch's account;*** [emphasis added]
>
> - the size of any other holder's or prospective holder's position, or ***the size of Merrill Lynch's position*** [emphasis added] (apart from information with respect to Merrill Lynch's inventory that Merrill Lynch makes available to customers);
>
> - ***whether there are sufficient bids to prevent a failed auction;*** [emphasis added]
>
> - prior to when the auction agent posts the results of an auction, what the auction's clearing rate is; and
>
> - whether an all hold auction is likely to occur.[3]

Based on the firm's own internal policies, Merrill Lynch's ARS employees are expressly prohibited from disclosing to the rest of the market the scope of Merrill Lynch's bids at auction for its own account, the size of Merrill Lynch's own positions in ARS, and whether there are sufficient bids at an auction to prevent an auction failure. Without access to this kind of information, it would have been impossible last fall and winter for other market participants, both investors and downstream dealers, to know that the ARS market was on the verge of collapsing and that auction dealers' own buying was creating a false sense of normalcy. To the extent that downstream brokers did not commit rule violations in selling ARS, they should not be

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[2] Securities and Exchange Commission, "Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934," Administrative Proceeding File Number 3-12310, May 31, 2006.

[3] Merrill Lynch, Global Markets & Investment Banking Group, "Description of Merrill Lynch's Auction Rate Securities Practices and Procedures."

subject to sanctions, including requirements to buy back positions from investors. Simply, no party should be sanctioned for violations they did not commit.

Another consideration regarding buy backs is whether downstream firms that sold ARS have the financial capacity to take securities onto their balance sheets. In many cases, downstream firms do not have the operating or regulatory capital to support a large position in ARS and cannot obtain financing for those positions.

On March 16, 2008 the Federal Reserve Bank of New York (FRBNY) announced the creation of the Primary Dealer Credit Facility (PDCF). The PDCF provides a means for primary dealers to receive overnight financing from the FRBNY using an expanded list of collateral. Although the financing is technically overnight, it can be easily rolled on a daily basis to allow for longer term financing of securities positions. The "Program Terms and Conditions" for the PDCF published by the FRBNY state that "Collateral eligible for pledge under the PDCF includes all collateral eligible for pledge in open market operations, plus investment grade corporate securities, municipal securities, mortgage-backed securities, and asset-backed securities."[4] This list of eligible collateral appears to include many examples of ARS, and the PDCF may provide an inexpensive and efficient means for primary dealers to finance ARS bought from investors. Even if certain ARS were not accepted as eligible collateral under the PDCF, primary dealers could still benefit from the PDCF in financing ARS holdings by pledging other eligible collateral to achieve similar results. Non-primary dealers, on the other hand, do not have access to the PDCF. Indeed, many non-primary dealers have found it exceedingly difficult in recent months to finance any securities positions through otherwise "normal" means such as repurchase agreements. Moreover, Federal Reserve regulations limit the ability of a bank to provide financing for borrowers whose ARS are held by a dealer affiliated with the bank and effectively limit the ability of a bank-affiliated dealer to buy back ARS from investors. In this regard, many downstream dealers do not have the capacity to buy and hold large ARS positions.

### *Summary*

The buy backs that federal and state enforcement agencies have negotiated with some sellers of ARS have provided many ARS investors with an opportunity to exit positions that have been locked up since February. We commend the regulators for their aggressive approach to problems in the ARS market and for their focus on helping investors exit their positions. However, many retail and small institutional investors have been left out of the settlements. In particular, investors who bought ARS from "downstream" brokers are not covered under most of the settlement agreements announced so far.

We believe in full enforcement of applicable securities laws and regulations. Firms that violated rules in distributing ARS should be sanctioned. However, it is not fair to impose sanctions, including buy back requirements, on firms that did not violate rules. Moreover, many downstream brokers simply do not have the financial capacity to take on large ARS positions.

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[4] Federal Reserve Bank of New York, "Primary Dealer Credit Facility Program Terms and Conditions," www.newyorkfed.org/markets/pdcf_terms.html.

There are other steps regulators can take to help alleviate troubles in the ARS market. We urge regulators to give prompt consideration to filings by closed end funds to restructure their ARPS obligations and to encourage closed end fund managers to take appropriate actions to assist their ARPS investors. We also urge regulators to carefully consider capital requirements related to dealer ARS positions; tighter capital rules have the effect of limiting the ability of dealers to take on positions in ARS or lend against customer ARS portfolios. Other actions, such as enhancing issuer disclosures for student loan-backed ARS, can help restore investor demand.

Thank you for the opportunity to present our views. Do not hesitate to contact us if we can be of any assistance.

## *Appendix 1:*
## *Disclosure Information Requested of Auction Rate Securities Issuers*

Certain segments of the auction rate securities (ARS) market are still dysfunctional. For many ARS issues, auctions still regularly fail and no secondary market outside the auction process exists. One of the sectors where ARS problems are most acute are ARS backed by student loans. The fact that these securities do not trade is in part a function of lack of access to data and information on the securities themselves or on the underlying student loans that collateralize the bonds. In many cases, information on pool and loan performance is available only to existing securities holders and to auction dealers—dealers authorized to bid at the regularly scheduled auctions, generally the dealers that originally underwrote the issues—despite the fact that issuers generally have ready access to the information. Because non-auction dealers and investors who do not currently own the securities cannot access loan and pool information, it is not possible to evaluate and price the securities. Dealers and investors who may be interested in buying the securities—and providing liquidity to current investors who may be "stuck" holding them—will not without access to data and information necessary to price the bonds. Making this information available to the market at large would help alleviate some of the distress being experienced by current student loan ARS investors.

This document outlines data and information that student loan ARS issuers should disclose to the market at large in order to spur demand among investors.

<u>Information about auctions and rate changes</u> — In general for ARS, dealers who are not auction dealers do not have access to detailed information on auction activity and rate changes. Originally, this arrangement was designed to protect proprietary information of auction dealers. However, lack of access to auction and rate information is now having the effect of preventing non-auction dealers from participating in the market or providing liquidity to investors.

<u>Information about waivers, default rates and forbearance</u> — Borrowers under federally subsidized student loans can sometimes qualify for waivers which affect the timing and amount of loan repayments and the pricing of student loan-backed securities. Defaults on student loans affect the timing of payments to holders of student loan-backed securities, even if the loans are guaranteed by the federal government. Also, many student loans are eligible for forbearance, where the borrower can defer interest payments under certain circumstances. Forbearances also affect the timing of payments to securities holders and affect pricing.

<u>Geographic and demographic information for loan pools</u> — Aggregate geographic and demographic information for borrowers whose loans are in a pool can be important in evaluating how the loans and securities will perform.

<u>Average life information</u> — The expected average life of loans in a pool is necessary to price securities backed by the pool.

<u>Rejected claims and servicer quality</u> — A rejected claim can occur when a borrower defaults on an federally guaranteed student loan but the guarantee claim is rejected for some reason. In

some cases, the rejection can be due to actions by the servicer of the loan. Data on rejected claims and servicer quality is necessary in pricing student loan-backed securities.

## *Appendix 2: Background on Auction Rate Securities*

ARS are a form of long-term, variable rate debt financing designed to emulate money-market instruments. With an ARS, a designated auction agent, typically a bank, conducts periodic auctions, usually every seven, 28 or 35 days. The auctions serve two purposes. First, the auctions determine an interest rate to be paid by the ARS issuer during the period until the next auction. Second, auctions provide a source of liquidity for investors who want to sell their securities. Investors who want to sell ARS depend on bidding at auctions by other investors who want to buy them.

Most ARS can be segregated into three categories. First are ARS issued by state and local governments and non-profit entities ("municipal ARS"). Second are ARS backed by pools of student loans issued by student loan originators or wholesalers ("student loan ARS"), in some cases state student loan financing authorities and in some cases for-profit student loan financing companies. Third are auction rate preferred stock ("ARPS") issued by closed end mutual funds. (There are other categories of ARS, but these three are the most prevalent.) Although estimates vary, at the height of the ARS market there were approximately $330 billion of ARS outstanding, with municipal ARS the most prevalent category representing approximately 75 percent of outstanding volume. Municipal ARS were marketed primarily to institutional investors; student loan ARS were sold to both institutional and retail investors; and ARPS were sold principally to retail investors.

No new ARS issues have been sold by issuers in 2008. However, when they were widely used, ARS, like most debt securities, were often underwritten by syndicates of dealers comprised of a lead manager and a group of co-mangers. In any debt issuance, the lead manager plays a dominant role in underwriting and selling the bonds to investors. With ARS, however, the role of the lead manager is magnified due to the ongoing nature of the periodic auctions held throughout the life of an issue. The lead manager of an ARS transaction generally controls the auction process for that issue and earns an ongoing fee for that service that covers not just the bonds sold directly by the lead manager but also bonds in the same issue sold by other securities firms.

In an auction, current investors in an ARS issue can submit any of several types of bidding instructions regarding the disposition of their positions. With a "hold" order, an investor signals that he will continue to hold the bond regardless of the rate set at the auction. With a "hold at rate" bid, investors signal that they will hold their securities provided that a specified minimum rate is established at the auction. Otherwise, if the clearing rate does not meet the investor's minimum, the investor loses the auction and his position is sold. With a "sell" order, an investor signals a desire to sell his position regardless of the clearing rate established at the auction. With a "buy" order, an investor signals a desire to acquire or increase a position in the security provided a minimum clearing rate is established at the auction. Prospective investors can also submit bids at auctions. The lead manager generally collects bidding instructions from investors, either directly or through other dealers, and passes those instructions to an auction agent. It is the auction agent's role to review all bids, award securities to winning bidders, and transmit interest rate information to the issuer and to the lead manager.

A failed auction occurs when the volume of "sell" orders at an auction exceeds the volume of "hold" or "buy" orders. In a failed auction, some or all investors who want to sell securities are not able to, and must hold their ARS until at least the next auction. In this case, until the next auction, the yield on the securities becomes a "penalty rate" that is pre-established at the time the securities are issued.

A large majority of ARS include third-party credit enhancement, usually in the form of bond insurance provided by a monoline bond insurer. The credit enhancement is designed to protect investors in case the ARS issuer defaults on its payment obligations. The credit enhancement does not, however, provide any protection against a loss of liquidity associated with a failed auction.

There is generally no requirement that lead managers or auction agents publicly disclose the results of auctions, and in general, such information is not available to market participants. The only auction information generally available to investors and distributing firms is the clearing rate established at the auction.[5,6]

Early in the second half of 2007, global credit markets began to weaken across many sectors as a result of a downturn in the market for subprime mortgages and a general repricing of credit risk. One of the results of the subprime downturn has been the credit deterioration of several monoline bond insurers. This deterioration eventually led to a retreat among investors from products like ARS that depend on credit enhancement.

As demand for ARS among investors disappeared, lead managers supported the market for a while by bidding themselves at auctions. While this practice happened from time to time before last fall, it was generally the case that ARS bought by lead managers could be sold quickly to other investors. Last fall, however, with investor demand for some ARS issues quickly evaporating, lead managers became more and more aggressive in supporting auctions through their own purchases. A number of lead managers accumulated large positions in ARS for which auctions would have failed if not for the lead managers' bidding. As lead managers' ARS positions swelled, pressure grew within those firms to take steps to reduce inventories. In the case of student loan ARS, for example, some lead managers may have influenced issuers to authorize temporary, higher maximum reset rates on their bonds in order to make them more attractive to investors without disclosing the fact to investors and distributing firms that these

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[5] A small number of lead managers have authorized Bloomberg LLC to make available to all BloombergProfessional information service subscribers the clearing yields for auctions. Even in these limited cases, however, no other information on auctions is generally available to market participants other than the auction dealer.
[6] On March 17, 2008, the Municipal Securities Rulemaking Board ("MSRB") proposed a "Plan for Increasing Information Available for Municipal Auction Rate Securities" (the "MSRB Plan"). Under the MSRB Plan, auction dealers would be required to submit to an information repository for public disclosure data regarding auction performance and outcomes for ARS under the MSRB's jurisdiction, including municipal ARS and student loan ARS issued by non-profit or state or local agencies. Required disclosures would include clearing rates established at auctions as well as the number of bidders, the number and aggregate dollar amount of bids, bids submitted by the auction dealer for its own account and other information. See MSRB Notice 2008-15. In July 2008, the MSRB announced that the MSRB Plan will likely be implemented in the first quarter of 2009. See Andrew Ackerman, "MSRB Eyes 2009 for New System," *The Bond Buyer*, July 21, 2008.

higher rates could lead to future reset rates that were actually zero. Some of our members have also expressed concerns that some managers of closed end mutual funds may have known that the weakening ARPS market was being artificially propped up by lead manager bidding at auctions but did not inform investors or other market participants.

Many lead managers began to recognize internally that they were accumulating imprudently large ARS inventories and that they would have to stop bidding at auctions. However, that information was never disclosed to the market at large, neither to investors nor to distributing dealers. By mid February 2008, the capacity of the ARS lead managers to continue to support the market by buying securities was exhausted and ARS auctions began to fail on a widespread basis.[7]

Since February, some steps have been taken to address problems in the ARS market, but liquidity is still severely constrained in certain subsectors. Among municipal ARS, a large number of issues have been taken out of the market as a result of refundings or conversions to other forms of variable rate financing. In other cases, the auctions for some municipal ARS are still functioning. For other municipal ARS where auctions continue to fail, investors generally have no way to sell their holdings.

Liquidity in the market for student loan backed ARS is virtually nonexistent. Almost all auctions have failed consistently since February, and investors have no opportunity to sell securities. Moreover, as a result of technical issues unique to student loan ARS, some securities are occasionally not paying interest, making them even more unattractive to investors.

The market for ARPS is highly illiquid. However, some mutual fund companies have begun to implement strategies to restore market liquidity, and some ARPS investors may be able to sell their securities in the coming months under those strategies.

Since the downturn in the ARS market in February, the market in many respects has become more opaque than ever. Many distributing dealers and their customers have had significant difficulty obtaining information from lead managers on the status of auctions, the performance of securities, and steps that dealers, issuers or others may be taking to try to resolve problems in the market.

[7] Jeremy R. Cooke, "Florida Schools, California Convert Auction-Rate Debt," Bloomberg.com, February 22, 2008.