REGIONAL BOND DEALERS ASSOCIATION

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The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

The Honorable Andrew Cuomo
Attorney General
The Capitol
Albany, NY 12224

Ms. Karen Tyler
North Dakota Securities Commissioner and
President, North American Securities Administrators Association
750 First Street, NE
Suite 1140
Washington, D.C. 20002

August 15, 2008

Dear Chairman Cox, Attorney General Cuomo and Commissioner Tyler,

Recently you all announced several agreements in principle to settle claims against UBS Securities LLC and UBS Financial Services, Inc. (together, "UBS"), Citigroup Global Markets, Inc. ("Citigroup"), JP Morgan Chase & Co. ("J.P. Morgan"), Morgan Stanley, and Wachovia Securities, LLC and Wachovia Capital Markets, LLC (together, "Wachovia") regarding the underwriting and sale of auction rate securities ("ARS"). Under the settlements UBS, Citigroup, J.P. Morgan, Morgan Stanley and Wachovia (together, the "settling firms") have agreed to buy back or otherwise liquidate a combined $46 billion of ARS from retail, charitable, small business and, in the cases of UBS and Wachovia, institutional investors. In addition, Citigroup has agreed to use best efforts to liquidate another $12 billion of ARS from institutional investors, and JP Morgan and Morgan Stanley have also agreed to use best efforts in liquidating institutional investors' positions. The settling firms have also agreed to take other actions to compensate and provide liquidity to investors holding ARS they no longer want. In addition to these settlement announcements, other securities firms who manage ARS programs, including, for example, Merrill Lynch & Co., Inc. ("Merrill Lynch"), have recently announced that they, too, will buy ARS back from certain investors.

The Regional Bond Dealers Association[1] ("RBDA") commends you all for your aggressive actions in helping to restore order in the ARS market. However, we fear that the settlements may exclude a significant number of investors. Specifically, although UBS, Citigroup, J.P. Morgan, Morgan Stanley, Wachovia and other firms served as lead managers for tens of billions

[1] The Regional Bond Dealers Association is the only U.S. organization that exclusively represents regional securities firms and banks active in the bond markets.

of dollars of ARS, some of those bonds were sold to investors by other securities firms who are best described as "distributing firms." Distributing firms did not participate or participated only to a limited extent in ARS auctions and had, at best, limited access to information regarding the deteriorating liquidity conditions in the ARS market in late 2007 and early 2008.

On the other hand, it is clear in part from evidence that you all have published that lead managers bid at auctions for their own accounts without disclosing that fact and gave the market a false sense of liquidity when real investor demand was disappearing. According to Attorney General Cuomo's complaint against UBS, UBS acted against investors' best interests in part by buying ARS in auctions that otherwise would have failed without disclosing that fact to the market or to its customers.[2] If the allegations in Attorney General Cuomo's complaint are true and if lead managers other than UBS engaged in similar activity, the violations at the heart of the ARS market downturn stem not from problems with distributing firms at the "point of sale" but in the relatively opaque auction process.

As you formalize and conclude settlements with UBS, Citigroup, J.P. Morgan, Morgan Stanley, Wachovia and any other firms you may be in negotiations with, we urge you to ensure that liquidity and other assistance cover not only direct customers of those firms, but any investors who bought securities associated with those firms' ARS programs. Any settlement that does not apply the same lead manager obligations to both those firms' direct customers as well as those investors who bought lead managers' ARS through other dealers would be unfair and would leave thousands of investors without a resolution.

Settlement announcements leave many ARS investors without resolution.

In the cases of Citigroup and UBS, it is unclear whether the settlement agreements encompass ARS where the settling firms were lead managers and the bonds were sold to investors by distributing firms. In the cases of J.P. Morgan, Morgan Stanley and Wachovia it appears that those settlement agreements exclude securities in those firms' ARS programs that were bought through other dealers. This is further evidenced by the fact that the total volume of securities that are to be bought by the settling firms as specified in the settlement announcements appear to be less than the total outstanding volumes of ARS for which those firms are the lead managers. In some cases, investors may hold ARS in dealer accounts even if they never bought the securities from that dealer at all if, for example, an investor transferred securities from an account at one broker-dealer—perhaps a settling firm—to another using the Depository Trust and Clearing Corporation's Automated Customer Account Transfer Service or some other means. Some distributing dealers have told us that over half their customers' ARS holdings are positions transferred from other firms, often ARS lead managers.

There are a number of compelling reasons why it is important that the final settlement agreements with Citigroup, UBS, J.P. Morgan, Morgan Stanley, Wachovia and any other firms that may settle in the future afford the same treatment to investors in all those firms' ARS regardless of whether those investors bought their securities directly from the settling firms or from other dealers.

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[2] The People of the State of New York v. UBS Securities LLC and UBS Financial Services, Inc., summons filed by Andrew M. Cuomo dated July 24, 2008.

Lead managers are generally the only parties who have complete knowledge of and control over ARS auctions.

The role of lead manager in an ARS goes beyond simply overseeing the underwriting and sale of new bonds to investors. In an ARS transaction the lead manager oversees the periodic auction process and is paid an ongoing fee for that service. This function—and the associated compensation—extends not just to those bonds that the lead manager itself sold to investors but also to bonds in the same issue sold by other securities firms.

Lead managers in an ARS transaction exercise an almost complete degree of control over information associated with auctions. Lead managers are the only dealers associated with an ARS that know, for example, the number of bidders at an auction, the individual and aggregate dollar amount of bids, the range of bid prices, whether there are sufficient bids by investors for the auction to succeed, and the clearing rates in successful auctions (before those rates are disclosed to the issuer and investors). The lead manager is also the only party (other than perhaps the auction agent, who is not a principal in the transaction) who knows whether the lead manager itself bid at an auction for its own account and whether that bid was necessary for the auction's success.

Investors and other dealers, including those dealers who may have sold ARS to investors, generally do not have access to a wide variety of important information related to auction activity. This factor is especially important in the context of how the ARS market behaved in late 2007 and early 2008. As liquidity in the ARS market deteriorated in late 2007, lead managers attempted for a while to support otherwise failing auctions by bidding for their own positions on a widespread basis, giving other market participants the false impression that the market was functioning normally when investor demand for ARS had evaporated significantly. To the extent that the market was indeed characterized by this false sense of liquidity during this period, no ARS market participants other than the lead managers—not investors nor distributing dealers—could have been aware that no substantial degree of real liquidity remained for many issues.

Excluding the customers of distributing dealers from the buy-backs or other solutions mandated by settlements would worsen their prospects for restoring liquidity to their positions.

If the ARS investor customers of distributing dealers were excluded from commitments by lead managers to liquidate ARS positions or provide other benefits or compensation to ARS investors, those investors would be worse off than if no settlements were executed at all. In the absence of settlements, all investors in failed ARS have some prospect, however remote, of finding buyers for their positions. Settlements that excluded distributing dealers' customers would dissuade anyone from buying those investors' securities, since those ARS would not be eligible for sale to the lead manager. Their securities would be treated by the market as "tainted" since they would be outside the obligations of lead managers specified in the settlements. Simply, investors who had no claim under the settlement would be less likely to find buyers than if there were no settlement at all.

<u>Lead managers who are primary dealers are in the best position to buy investors' ARS positions because primary dealers can readily finance those positions.</u>

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."[3] 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. In this regard, primary dealers are in the best position to purchase and hold investors' ARS.

<u>Some lead managers who have already committed to buying illiquid ARS from investors have stated that holding those securities would not be burdensome.</u>

Regarding its offer to purchase many outstanding ARS, Merrill Lynch said it "does not expect its redemption of auction rate securities in 2009 through 2010 to have a materially adverse impact on its capital ratios, liquidity, or consolidated financial performance."[4] Regarding its commitments under last week's announced ARS settlement, Citigroup said that "the capital impact of bringing these [ARS] assets onto Citi's balance sheet is expected to be *de minimis*."[5] Regarding its settlement, Wachovia said it "does not currently expect that the purchase of ARS under the agreement in principle will have a material effect on capital, liquidity or overall financial results."[6] Firms like Merrill Lynch, Citigroup and Wachovia can buy and hold large volumes of ARS because even though their ARS positions would be significant, they are still small relative to the firms' total assets, and those firms have sufficient financial resources to carry large securities positions. By contrast, many distributing dealers are much smaller firms with fewer financial resources, and carrying even smaller ARS positions would be excessively burdensome. Holding a significant portfolio of ARS would overwhelm the available capital of many distributing firms. There simply is not sufficient capacity among distributing firms to buy back ARS positions from investors. The only practical solution for making investors whole is to include the ARS customers of distributing firms in the settlements with large lead managers.

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

[4] Merrill Lynch & Co., Inc., "Merrill Lynch to Buy Auction Rate Securities Positions From Its Retail Clients," press release, August 7, 2008.

[5] Citigroup Inc., "Citi Statement on ARS Settlement," press release, August 7, 2008.

[6] Wachovia Corporation, "Wachovia Announces Global Agreement in Principle to Settle Auction Rate Securities," press release, August 15, 2008.

Summary

We commend and support the efforts of the SEC, the New York Attorney General and the North American Securities Administrators Association to facilitate a solution to problems in the ARS market. However, we are concerned about the breadth of the settlements. If the obligations of the settling firms do not extend to investors who bought securities issued under those firms' programs but were sold by other dealers, many investors will be no better off—and may be worst off—than if there were no settlements at all. Expecting distributing firms to buy back ARS is simply not practical; those firms do not have the capital and financing capacity to carry large volumes of ARS. It also would not be fair; distributing firms were kept just as uninformed as investors were by large lead managers as the ARS market deteriorated last fall. As you work to conclude and formalize the agreements in principle announced recently and as you negotiate similar agreements with other lead managers, we urge you to take all steps necessary to ensure that settlement agreements are broad enough to explicitly cover all investors in lead managers' ARS, regardless of which firm sold the securities.

We would welcome the opportunity to discuss these issues with you further. If we can be of any assistance as you continue your work on the ARS market, do not hesitate to contact us.

Sincerely,

/s/	/s/
Michael Decker Co-Chief Executive Officer	Mike Nicholas Co-Chief Executive Officer

cc: Rick Firestone, Securities and Exchange Commission
Russ Iuculano, North American Securities Administrators Association
David Markowitz, Office of the New York State Attorney General Andrew M. Cuomo

Appendix: 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.

Virtually all 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.[7,8]

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 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

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[7] 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.

[8] 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.

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.[9]

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.

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