DIGGING OUT OF THE RUBBLE

Commenting on the latest Auction Rate Settlements

EXECUTIVE SUMMARY:

1. Institutional cash investors continue to face uncertainties and difficult choices in ultimately obtaining liquidity despite the latest liquidity announcements. Interests of institutional investors have taken a back seat in these settlements.
2. The distinction between retail and institutional investors seems arbitrary and illogical.
3. To avoid their own reputational risk, we think that the secondary brokers are better off in following the lead of the primary dealers and working to provide liquidity to their investors.
4. It is our assessment that many institutional investors are not likely to receive interim liquidity equivalent to their securities' par value while they wait (and hope) for their liquidity dates.
5. The latest announcements may turn out to be bad news for secondary market participants.
6. We expect issuer-led liquidity solutions to kick into a (relatively) higher gear.
7. As the focus of the market shifts from "whether", to "how" and "how soon" one obtains liquidity, dealer engagement and advisory services will likely become more critical in the somewhat flexible and discretionary process.

August 26, 2008

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

DIGGING OUT OF THE RUBBLE

Commenting on the latest Auction Rate Settlements

After six months of deep freeze, the auction rate securities (ARS) market felt the first thaw in August when eight major dealers reached settlements with securities regulators to purchase the bonds at par from their retail investors. The total amount of the dealer-announced liquidity, $58 billion as of August 15, accounts for roughly 28% of the $207 billion auction rate securities market. While the latest news represents the largest liquidity breakthrough to date, we think that institutional cash investors continue to face uncertainties and difficult choices in ultimately obtaining liquidity.

The announcements from Citigroup, Goldman Sachs, UBS, JPMorgan Chase, Merrill Lynch, Morgan Stanley, and Wachovia will put $40 billion of cash in the hands of retail investors as soon as September 2008 and no later than January 2009. Deutsche Bank did not provide details of its settlement as of August 22nd. Additionally, UBS and Wachovia pledged to bring about $13.4 billion of liquidity to institutional investors no later than June 2009. Merrill Lynch promised to purchase from institutional investors with assets less than $100 million by January 2009, although no specific dollar amount was released. The UBS announcement was in addition to the $3.5 billion of closed-end funds it offered to purchase in July. All of the dealers involved agreed to provide zero net-cost loans to retail investors and will reimburse them for any losses on investments sold below par prior to the settlement dates.

NO IMMEDIATE RELIEF TO INSTITUTIONAL INVESTORS

These latest announcements came as the result of increasing legal and reputational risks the dealers have faced in recent months. As of July 30, NERA, an economic consulting firm, had documented 22 ARS related class-action lawsuits against broker-dealers and projected more suits to come[1]. In recent weeks, New York State Attorney General Andrew Cuomo intensified his investigations of 25 broker-dealers involved in the auction market. The North American Securities Administrators Association (NASAA), an alliance of state securities regulators, and the Securities and Exchange Commission (SEC) were conducting their own investigations. In July, Congress also joined in the growing probes[2].

Interests of institutional investors have taken a back seat in these settlements.

We do not think it is coincidental that many of the firms mentioned have very large and significant wealth management operations. Even though the parent companies suffered substantial capital depletion as the result of the larger credit market crisis and were shrinking their balance sheets, a refusal to work with investors and regulators would have been more devastating to their businesses in the long-run. The limited wiggle room the dealers had to accommodate retail investors unfortunately means that interests of institutional investors have taken a back seat in these settlements.

While we are glad that the pains of individual investors will soon be gone, we are disappointed by the "best efforts" pledge in settlements contained in Citigroup, Goldman Sachs, JPMorgan and Morgan Stanley documents. Again, data are unavailable from Deutsche Bank. We also feel the late start dates for redemptions to institutional investors noted in the UBS and Wachovia settlements also place those investors in a disadvantageous position.

INSTITUTIONAL INVESTOR DISTINCTION VAGUE AND ILLOGICAL

We find the definition of a "*retail*" account vague.

Much to our amazement, the distinction between retail and institutional investors seems very much deliberate. Suddenly, what constitutes "retail" or "institutional" becomes a critical touchstone. The heart of the problem with this approach seems to be arbitrary and illogical.

First of all, we find the definition of a "*retail*" account vague when the settlement parties use the reference of "investments under $10 million" at a dealer firm, and not with measures of the investors' total assets, book value etc. For example, a multi-billion dollar corporation with $9 million with a particular dealer would, in this case, be eligible for liquidity, while a small life sciences company with $11 million, essentially all of its assets, at the same dealer would not. Said differently, the dealers may simply be using the "retail" label to limit their liquidity liability to $10 million per investor, regardless of the corporate identity of the investors. If that's the case, should not all investors be eligible for liquidity on the first $10 million?

The different *types of investors* were not relevant on how the securities were marketed.

Secondly, the different *types of investors* were not relevant on how the securities were marketed, which was a main focus of investor criticism. For example, had the ARS investments been restricted to hedge funds or private placements, investors would have been required to be "accredited investors ($5 million in minimum assets)", or "qualified institutional buyers ($100 million)", respectively, to participate. But the ARS were not restricted securities by any legal definition that could have limited their participation. If there wasn't different treatment of investor types as they came in, then there shouldn't be this differentiation now that they're able to leave, we think.

We do not see how investors should have been treated differently (institutional vs. retail) in a direct purchase brokerage relationship.

Lastly, the two groups of investors do not necessarily represent different *types of accounts* at the brokerage firms that would therefore warrant this different treatment. In our experience, retail and institutional investors were part of the same "private wealth management (i.e. brokerage)" divisions. They were under the same account agreements, given the same marketing materials, and sold and serviced by the same brokerage representatives. Had they bought the securities through SEC-registered investment advisors or bank trust departments, the distinction might have been valid, as the intermediaries would have been accountable for the purchase decision decisions. In a direct purchase brokerage relationship however, we do not see how institutional investors should have been treated differently from retail investors.

SECONDARY BROKERS MAY BE ON THE HOOK

Press reports of the firms' positions since the settlements suggest that the dealers would not be responsible for positions originated by them but sold through a secondary-broker. Neither, it seems, would the liquidity be provided to investors who hold assets at a financial institution other than the primary dealer, such as investment advisors and custody banks.

The resellers, including Raymond James, Stifel Nicolaus & Co., Oppenheimer & Co. and Fidelity Investments said they shouldn't be on the hook to buy back the securities they sold as they were kept in the dark as much as their customers about the problems brewing prior to the market's collapse[3] . In an August 18 letter to securities regulators, the Regional Bond Dealers Association (RBDA), a body representing secondary brokers, suggested the auction dealers be required to buy back all the securities for which they conducted auctions[4]. The RBDA estimated that more than $60 billion of the remaining roughly $160 billion of outstanding ARS is owned by investors who bought from secondary brokers[5].

Some of the low yield student-loan backed ARS may, at some point, begin to look attractive when compared to available short-term instruments.

We concur with the RBDA's position that investors who purchased ARS through secondary-brokers should not be treated differently and that there needs to be a quick action taken to support their liquidity needs. We would propose, however, that the secondary brokers provide liquidity to their clients and sort out their differences with the primary dealers without harming their own clients. Contrary to their claims of being victims led astray by the primary dealers, the remarketers were supposed to have conducted their own due diligence before placing their clients' money in these securities. We think there were enough telltale signs to indicate increased market distress for them to adequately warn their clients, as several investment advisors had done, before the market collapsed in February 2008. To avoid their own reputational risk, the secondary brokers are better off following the lead of the primary dealers and working to provide liquidity to the original investors, we think.

AVAILABILITY OF NO-COST LOANS TO INSTITUTIONAL INVESTORS UNCLEAR

The latest announcements may turn out to be bad news for secondary market participants.

Except for clients of Wachovia, institutional investors are not likely to receive interim liquidity equivalent to their securities' par value while they wait (and hope) for their liquidity dates. UBS imposed an internal credit-ratings test on institutional investors. Firms rated "investment grade" or deemed to be so by the investment bank will receive liquidity equal to the 100% of the *par value* of their securities, while those rated below investment grade will receive 75% of the *market value* of their ARS. It is our assessment that most firms currently in net operating loss situations would not attain investment grade, and therefore may not be getting 100% interim liquidity.

For institutional investors of other dealers, we've seen that many of them have already received temporary margin or "margin-free" loans from their dealers using the ARS holdings as collateral. We doubt that their existing loan terms will change much, as making no net-cost loans available to institutional investors is not part of the dealers' commitment. However, we do think that the SEC's decision to delay instituting fines serves as an incentive for the dealers to consider doing more than they did for the institutional investors, such as partial or full waiver of past or existing loan interest, higher borrowing amounts and less stringent collateral requirements.

DECISION TO BORROW REQUIRES THOUGHTFUL CONSIDERATION

We expect issuer-led liquidity solutions to kick into a (relatively) higher gear.

No net-cost loans mean that the interest dealers charge on the loans will match the coupon interest investors receive on their auction rate holdings. For investors without an immediate cash need, we think the decision on whether to apply for the loans hinges on their ARS coupon interest, or maximum interest rates in most cases, and the going short term investment yield. For securities earning zero to very low yield, say below 1%, the decision to borrow and invest elsewhere is an easy one to make to compensate the opportunity costs. If the ARS yield is higher than what an investor can get elsewhere, the decision may be to forego the loan offer. However, the process can be tricky as the maximum interest rates are often unobservable for the current month and are harder to project for future periods.

As the securities pass the one-year anniversary of the high coupon period between August 2007 and February 2008, some of the low yield student-loan backed ARS may begin to look attractive when compared to available short-term instruments. Fundamental analysis of issuers' ability to fulfill the coupon obligations remains a key factor.

SECONDARY MARKET IMPACT LIKELY TO BE PROFOUND

Since the market collapsed last February, there have been sporadic purchases of ARS investments at levels below par by opportunistic investors including hedge funds and foreign investors. Ironically, the latest announcements may turn out to be bad news for secondary market participants. The redemption offers from the big firms so far almost always exclude investors who purchased ARS since February 13, 2008. Since a major motive for opportunistic investors picking up ARS on the cheap was the hope of cashing out at par from the dealers at some point, the exclusion clause offers a major disincentive for new secondary market buyers to step up to the plate, in our opinion. From the sellers' perspective, we think few investors will accept a below-par offer price now, as their losses are not likely to be reimbursed post-settlement dates.

This non-transferability of the right to redeem will also have an impact on the existing holders who may want to move on from the ARS chapter but whose liquidity will not come until 2010 and beyond. Their only viable solution may be to take out a loan and wait for their term to come.

ISSUER-LED LIQUIDITY SOLUTIONS MAY GET A BOOST

On the other hand, we expect issuer-led liquidity solutions to kick into a (relatively) higher gear. Other than investor complaints and moderate write-downs on the dealers' own ARS inventory, the failed auctions market has not been the dealers' biggest headache to date. Most securities continued to carry AAA credit ratings and the dealers continued to collect remarketing fees on the auctions, albeit failing, and refinancing fees on the subsequent debt conversions.

We suspect that the vague language in settlement documents leaves room for interpretation.

The settlements changed the dynamics for at least four reasons: 1) dealers must now reimburse issuers for ARS-related banking fees since August 2007 and may not earn those fees going forward, 2) larger inventory after the buybacks creates a stronger incentive for the dealers to move them off their books through refinancing; 3) the consolidation of ARS holdings from investors gives the dealers stronger collective persuasive power to pressure the issuers to accept new refinancing terms; and 4) the SEC's decision to delay levying its fines until liquidity becomes available to institutional investors may serve as a hanging sword.

Based on developments in the municipal and closed-end funds refinancing activities, we envision the dealers' growing roles in issuer-led liquidation solutions in the post-settlement era. They may be more likely to provide "put" insurance to make the securities eligible for money market fund purchases. Their vast asset management arms may provide a much needed distribution channel for the securities to get into money funds or any other commingled funds. The various bank and dealer liquidity facilities created by the Federal Reserve continue to accept AAA-rated ARS securities as eligible collateral. Lastly, Wall Street's structured finance machines are currently working overtime to create ways for the ARS investments to be housed away from the dealers' balance sheets. Think along the lines of Master ABCPs or Super SIVs.

We think that, if the momentum plays out, it will be beneficial for the institutional investors even though they were not among the first wave of investors who benefited from the settlements.

A TEMPLATE FOR OTHER DEALERS, BUT STILL A LONG ROAD AHEAD

We think the significance of the recent settlements to all ARS investors is that other dealers will likely follow the general template in reaching similar solutions in the weeks to come. (See Appendix B for details.) Although details will likely vary from dealer to dealer, we believer there will be more liquidity available to the investors, not less. According to statistics from a 2007 ARS league table, the other major ARS dealers *yet to settle* include Bank of America, Royal Bank of Canada, and Lehman Brothers[6].

We conclude that although the latest developments have been positive for the overall market, the liquidity prospect for institutional investors remains quite uncertain, at least in the interim period. Few details of implementation are available to outsiders beyond press releases. We suspect that the vague language in settlement documents leaves room for interpretation in the implementation phase. As the focus of the market shifts from "whether", to "how" and "how soon" one obtains liquidity, dealer engagement and advisory services will likely become more critical in the somewhat flexible and discretionary process. We look forward to assisting our clients in this regard in the weeks and months to come.

Note: Due to the lack of transparency in the illiquid auction-rate market, the analysis in this report may include anecdotal information that may not be representative of the general market. Opinions expressed may be derived from the analysts' observations and private conversations with outside parties, that, although we believe to be reliable, may lack factual substantiation.

---

[1] Nicholas Rummell, ARS Collapse giving rise to class-action lawsuits, Financial Week, July 30, 2008.

[2] Neil Roland, Congress to push to recoup more money for ARS investors, Financial Week, July 31, 2008.

[3] Liz Rappaport and Shefali Anand, 'Downstream' Sellers of Auction-Rate Securities Balk at Prospect of Buybacks, the Wall Street Journal, August 19, 2008.

[4] Same as No. 3.

[5] Andrew Ackerman, Response to RBDA Claim is Mixed, The Bond Buyer, August 19, 2008.
[6] Amir Efrati, Kara Scannell and Liz Rappaport, Citigroup may pressure other Firms with deal on auction-rate securities, the Wall Street Journal, August 7, 2008.

APPENDIX A: AUCTION RATE SECURITIES SETTLEMENT SUMMARY **As of 8/21/2008**

(Amounts in millions)

Dealer	Est. Assets	Size of Settlement	Retail	Begins	Ends	Instl.	Begin	Ends	Total Fines	Est. Charges	Authorities	Dated
Citigroup Inc.		**$19,300**	**$7,300**		**11/5/2008**	**$12,000**		**12/31/2009**	**$100**	**$500**	**NY, NASAA, SEC, FINRA**	**8/7/2008**
Applies to positions prior to 2/11/08						Best Efforts						
NYS retains the rights to take action on institutional accounts beginning 11/4/08												
Firm refunds fee to municipal ARS issuers between 8/1/07-2/11/08 + beyond												
Firm takes appx.$500 million pre-tax loss. (Could top $2 bln per WB Securities)												
The bank's own inventory was $6.5 billion in March, and down to $5.6 billion MV after booking $197 million of gains												
Deutsche Bank				**11/19/2008**					**$15**		**NY, NASAA**	**8/21/2008**
No press release												
Goldman Sachs		**$1,000**	**$1,000**	**8/21/2008**	**11/12/2008**	Best Efforts		**n/a**	**$22.5**		**NY, NASAA**	**8/21/2008**
Applies to positions prior to 2/11/08												
JPMorgan Chase	**$5,000**	**$3,000**	**$3,000**		**11/12/2008**	Best Efforts		**12/31/2009**	**$25**	**$400**	**NY, NASAA**	**8/14/2008**
Firm will reimbursement loss between 2/12/08 and 8/14/08												
SEC's investigation is ongoing												
Firm refunds fee to municipal ARS issues between 8/1/07-2/12/08 + beyond												
Merrill Lynch	**$12,000**	**$10,000**	**$10,000**	**10/1/2008**	**1/15/2010**		**1/2/2009**	**1/15/2010**	**$125**		**NY, NASAA**	**8/21/2008**
Offer announced on 8/7, settlement announced on 8/21												
Merrill reached a settlement with MA earlier on 8/21/08, agreeing to buy from retail customs with <$3mm starting 10/15/08, and 1/158/08 from all others <$100 million.												
The press release did not reiterate its $12bln/$10bln figures, only that it has $4bln/$3.25bln among those eligible beginning in October 2008.												
Firm said over 40% of clients' holdings have been liquidated, and 90% will have been redeemed by January 2009												
SEC investigation is ongoing												
Morgan Stanley		**$4,500**	**$4,500**	**9/30/2008**	**12/11/2008**				**$35**		**NY, NASAA**	**8/14/2008**
Offer announced on 8/11, settlement with NYS announced on 8/14												
Applies to positions prior to 2/13/08.												
SEC's investigation is ongoing.												
Purchases after 2/13/08 are explicitly excluded												
UBS	**24000**	**$18,600**	**$8,300**	**10/31/2008** **1/1/2009**	**1/1/2011** **1/1/2011**	**$10,300**	**1/1/2009** **6/30/2010**	**1/1/2011** **6/30/2012**	**$150**	**$900**	**NY, MA, SEC, NASAA**	**8/8/2008**
All clients will have immediate liquidity beginning in mid-September at no net cost												
Last day of eligibility is February 13, 2008												
Investors may choose to hold securities in the timeframes. UBS may purchase from clients at any time.												
Begins to offer net no-cost loans in mid-Sept. 2008. Those under the terms are required to sell ARS to UBS on the first available "put" date.												
Clients may decide to stay on the 50% loan or standard loan terms during the two-year period.												
Owners of student-loan ARCs rated A or below are entitled to borrow up to 75% of the MV of the securities												
For business and institutions, 100% loans are available to "investment grade" companies, while 75% are available to firms below "investment grade"												
The term of the settlement is in addition to the $3.5 billion repurchase program of tax-exempt Auction ARPS, to be completed by 10/31/2008												
Firm will reimbursement losses between 2/13/08 and 8/8/08.												
Wachovia Corp.	**$9,500**	**$8,800**	**$5,700**	**11/10/2008**	**11/28/2008**	**$3,100**	**6/10/2009**	**6/30/2009**	**$50**	**$500**	**NY, NASAA, SEC, FINRA**	**8/15/2008**
No net cost loans to **all** until full repurchase												
Total	**$50,500**	**$65,200**	**$39,800**			**$25,400**			**$360**	**$2,300**		

APPENDIX B: ARS Dealer Settlement Template

Buy back at par all ARS sold to retail investors (individuals, charities and those SME <$10 million)
Make all retail investors whole on any realized losses sustained on ARS sold between February and settlement date
Provide no net-cost loans to reimbursement clients until the buyback program begins and reimburse prior interest costs
Agree to a FINRA arbitration process to settle any consequential damages
Provide liquidity solutions to institutional investors on a "best efforts" basis
Reimburse remarketing fees to issuers between Aug. 07 and Feb. 08, and refinancing fees between Feb. 08 the settlement date
Pay fines to NY and NASAA. SEC fines to be assessed after the implementations

