True Colors of an "Auction" Market: What the SEC Unveiled in the Auction Rate Securities Market

EXECUTIVE SUMMARY:

The recent SEC investigation into the auction rate securities market found "industry-wide" violations by 15 major brokerage firms of the Securities Act of 1933.

We think that the violations uncovered by the SEC lend evidence to the opinion that the auction rate securities (ARS) market did not have the competitive bidding element.

We also think that, although the SEC action may make auctions more competitive, enforcement did not go far enough in addressing structural liquidity risk to investors.

Some of the proposed industry measures may make certain auctions more susceptible to failures, thus warranting additional in-depth scrutiny by prospective investors.

Without further substantive improvements, we remain cautious of the securities' risk-adjusted benefits for the prospective cash investor.

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

INTRODUCTION

On May 31 2006, 15 prominent broker-dealers agreed to pay a total of $13 million to the Securities and Exchange Commission (SEC) to settle claims of securities violations in the auction rate securities market. News of the SEC censure in this $200 billion-plus bond market drew little media exposure; however, closer examination of the settlement document reveals a fascinating tale of intricate behind-the-scenes dealings in the auction market.

Since 2003, we have grown increasingly skeptical of the burgeoning ARS market, mostly because of unpredictable liquidity risk, insufficient offering disclosure, and lax regulatory oversight. The SEC findings helped to validate our suspicion that the so-called "auctions" in the variable rate auction market are little more than a creative market-making mechanism which enables broker-dealers to help bond issuers pay short-term interest rates on long-term borrowings. Although the practice may have an aura of legitimacy, the allegation that broker-dealers fail to fully disclose their "invisible" hands in the auctions is what prompted the SEC to start its investigation in June 2004.

In this credit commentary, we share with readers the SEC's findings regarding the tactics that enabled broker-dealers to preserve a "zero" auction failure rate. We also assess the impact of the disciplinary action and proposed regulatory changes for

investors in this market, who may hold or are considering holding these "cash" investments in their core portfolio holdings.

VIOLATIONS AND REMEDIES

Auction-rate securities are preferred stocks and bonds with long-dated maturities and variable interest rates set by short-interval market auctions (such as 28 days). Because many believe that a prospective seller may redeem its positions simply by choosing not to participate in the next auction, some investors consider auction securities as substitutes for money market funds with higher yield potential.

The SEC ruling found "industry-wide" violations.

This thinking is valid, as long as the auctions are successful and legitimate. Two years ago, the SEC asked brokerage firms to provide reports "detailing any potentially deceptive, dishonest or unfair practices," according to a memo sent to members of the Bond Market Association (BMA), a securities industry trade group, and two other organizations. The just-released SEC ruling found "industry-wide" violations of the Securities Act of 1933, which prohibits material misstatements and omissions in any offer or sale of securities. Each firm was found to have committed at least one of the following abuses. (See the *SEC administrative proceeding* for more detailed descriptions.)

- Taking over customers' bid orders by filling in the blanks on open or market orders after viewing other bidders' orders. This practice favors certain customers over others and leaves the auction price open to manipulation.
- Without adequate disclosure, bidding for the dealers' own accounts or asking their customers to change orders; this, in an attempt to:
  - prevent failed auctions, thereby supporting the "no failed auction" marketing claim.
  - set artificial "market" rates, at levels chosen by dealers themselves.
- Rearranging bids through "netting" of in-house buy-and-sell orders ahead of actual auctions in order to change the priority of bids.
- Submitting or changing orders or allowing customers to do the same after auction deadlines without disclosure.
- Collaborating with certain customers by asking them to bid at auctions and then compensating them with higher-than-clearing rates in the secondary market.
- Providing different price talks to different customers, placing certain customers at an advantage over others.

Each of the 15 firms was censured by the SEC and was ordered to "cease and desist" from committing future violations.

In addition to monetary fines, each of the 15 firms was censured by the SEC and ordered to "cease and desist" from committing future violations. The firms were required to provide better disclosure of their current auction practices and procedures. Additionally, the CEO or general counsel of each company must certify within six months that reasonable procedures have been put in place to prevent future violations. On the day of the settlement, the BMA issued an exposure draft of "best practices" for ARS broker-dealers. The draft outlines the firms' obligations to issuers and investors when they conduct the bidding and reselling of securities.

WHAT THE FINDINGS REVEALED

We think that the SEC findings supported the opinion that the ARS market did not have the competitive bidding element.

We think that the violations uncovered by the SEC lend evidence to the opinion that the ARS market did not have the competitive bidding element. On the surface, both issuers and investors benefit from this arrangement: issuers are able to pay short-term interest rates on long-term borrowings; and investors often receive returns higher than money market fund yields. The problem is, as the investigation revealed, that this "supported" auction market is subject to abuses due to conflicts of interest which arise from the dealers' multiple roles in auctions.

In an ARS transaction, a broker-dealer acts as a representative for prospective buyers, as the facilitator of the auction, and also as a representative of the issuer as its customer. There is clear potential for each of the three roles to conflict with the

A broker-dealer may have a conflict of interest situation between buyers and sellers, and among prospective buyers.

interests of the others. As market-makers, broker-dealers are charged with conducting an orderly market to arrive at a "clearing" rate. In some cases, the clearing rates may not be available without intervention. The SEC investigation found that each of the 15 firms engaged in prohibited activities to "enhance" the "clearing" rate either at the expense of the issuer, or the investors.

Broker-dealers borrowed a failed auction concept from the 1980s and reincarnated it in the bond market with a keen interest in "managing" the auction risk.

Without a clearing rate, an auction fails because there are not enough potential buyers to take over the positions of interested sellers. A failed auction requires interested sellers to hold current positions until the next auction date. Learning from the experience of the auction rate preferred stock (ARPS) market in the 1980's, which ended in frequent auction failures, broker-dealers reincarnated the auction product in the bond market in the late 1990's. This time they have a keen interest in "managing" auction risk. This is because of a market view that failed auctions may be a sign of an issuer in a liquidity crisis. A similar view exists in the commercial paper market when issuers draw down their bank credit lines.

A common theme in almost all of the violations found by the SEC involved attempts to avoid such "death warrants", often in violation of securities laws and without disclosure. Additionally, the existence of internally failed auctions, or auctions that would have failed had the broker-dealers not intervened was never disclosed to the investing public.

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Here are a few examples of how motive met means: bidding on behalf of the dealer's own account after the deadline allowed the dealer to save an internally failed auction by making up the order shortfall. In a single, as opposed to a multiple, dealer structure, a single dealer has a greater ability to influence the auction process and its outcome without detection.

THE BMA BEST PRACTICES DRAFT:

In conjunction with the SEC settlement, the BMA exposure draft proposes several best-practice guidelines for broker-dealers to follow, specifically:

- The house bid should be "a fair and reasonable rate", which means neither too low to benefit the issuer, nor too high to prevent a failed auction.
- Brokers must provide price talks before the start of an auction, not during or after it. The talk must reflect the prevailing market conditions. Brokers may not provide price talks to other broker-dealers.
- Brokers may no longer accept "market orders", or orders without specific rates, from prospective bidders.
- A broker may no longer change, or allow its customers to change, bids after an auction closes.
- Brokers may not give holders or prospective holders information about the actual bidding during an auction. They also should not inform bidders that there are no bids.
- There should be no information sharing between the auction desk and the sales desk at the broker-dealer.
- "Cover" bids, or bids by the broker-dealers to prevent a failed auction, are allowed, but the bid rates must be reasonable market rates and the bids cannot be modified after they become irrevocable.
- A broker must exercise a good faith judgment of ARS prices in the secondary market, which means dealer prices will probably not be at par value.

THE POST-SETTLEMENT AUCTION MARKET

The SEC censure and the related BMA proposal aim to provide the auction market with price discovery that reflects the actual supply-and-demand dynamics of the market. However, adoption of these changes will not result in a "blind" market, as dealers are still allowed to monitor the bidding and to submit house bids to prevent auction failures.

We were somewhat disappointed with the SEC decision to let an industry trade group set its own rules, given the BMA's lax record of self governance in this rapidly growing

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market sector. The cursory monetary fines came in stark contrast to the stern language used in the SEC administrative findings. In addition, the new measures did not address investor concerns regarding inadequate auction disclosures and the lack of secondary market liquidity.

As broker flexibility decreases, auctions may be more likely to fail.

To be fair, we think that the proposed BMA procedures, if adopted, may bring more openness to the auction process and may discourage firm-wide abusive behavior. Ironically, with a potential decrease in broker flexibility, auctions may be more likely to fail in the future.

In terms of financial impact, going forward, an investor's return from the auction yield may be more comparable to other short-term rates. For issuers, funding costs may increase if investors demand a yield premium for the higher probability of auction failures and for the lower probability of all-holds rates, which are below-market rates when none of the existing holders decides the sell. Costs to broker-dealers may also increase, as it will likely be more difficult for dealers to manipulate bid prices.

We view the future growth potential of the variable rate auction market as limited.

We view the future growth potential of the variable rate auction market as limited. New accounting interpretations, more cash investment opportunities, and increased regulatory scrutiny should play a role in limiting the upside potential of this market. The discovery of abusive dealer conduct may curtail issuers' willingness to use auctions for funding obligations when having multiple market choices. In fact, a slow-down in new auction-rate transactions was evident even before the settlement. Auction-rate bond sales declined 22% in 2005 to $33.1 billion from a record $42.3 billion in 2004, according to Thomson Financial. Auction securities as a percentage of variable rate municipal issuance also fell from 50% in 2003 to 20% in 2006, according to Merrill Lynch. We project that this trend will continue in the wake of the SEC findings.

CONCLUSIONS:

In reviewing the SEC administrative proceeding and the BMA draft, we find that although new measures may make market auctions more similar to blind auctions, enforcement still does not go far enough in addressing the structural liquidity risk of ARS to investors. On the contrary, some of the suggested measures may make certain auctions more susceptible to failures due to decreased dealer flexibility and thus warrant additional in-depth scrutiny by prospective investors.

We believe that failed auctions will continue to be a marketing stigma that broker-dealers will try hard to avoid to the best of their efforts. Although we think the risk of failed auctions will increase, we may not see this result materialize. More likely, some dealers may decide to exit the market instead.

We are cautious on the securities' risk-adjusted benefits to the perspective cash investor.

We remain hopeful that increased self-discipline and investor demands will lead to improved disclosure, secondary market liquidity and investor education on the risk-reward tradeoff of the auction market. Without further concrete improvements in these areas, we remain cautious regarding the securities' risk-adjusted benefits to the prospective cash investor.

Meanwhile, the SEC investigation is ongoing. In June 2004, as many as 25 brokerage firms were named to be in talks with the SEC. The May 31 settlement announcement states that the Commission continues to investigate other entitles that participate in the ARS market. Notably, one dealer missing from the settlement is UBS Financial Services, the second largest auction market manager in 2004 (Bond Buyer, June 24 2004).

WEB LINKS:

SEC Settlement with 15 Broker-Dealers

Administrative Proceeding of Settlement

BMA's Exposure Drat on Broker-Dealer Best Practices

BROKER-DEALERS SETTLING WITH THE SEC:

Bear Stearns, Citigroup Global Markets, Goldman Sachs, J.P. Morgan Securities, Lehman Brothers Holdings, Merrill Lynch, Morgan Stanley (including the former Dean Witter unit) and RBC Dain Rauscher each were fined $1.5 million. Banc of America Securities was ordered to pay $750,000, a reduced amount for having self-monitoring capabilities in

place. A.G. Edwards, Morgan Keegan, Piper Jaffray, SunTrust Capital Markets and Wachovia Capital Markets each were each fined $125,000.

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