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UNDERSTANDING THE AUCTION RATE SECURITIES SETTLEMENTS

By Simon S. Kogan, J.D. LLM.

In February, 2008, the market for auction rate securities froze. Virtually overnight securities which had been marketed as cash alternatives became illiquid leaving issuers and investors holding the bag. Auction rate securities are municipal bonds, corporate bonds, and preferred stocks with interest rates or dividend yields that are periodically re-set through auctions, typically every 7, 14, 28, or 35 days. Auction rate bonds are usually issued with maturities of 30 years, but the maturities can range from 5 years to perpetuity. Auction rate securities were often marketed to issuers as an alternative variable rate financing vehicle, and to investors as an alternative to money market funds. Auction rate securities were first developed in 1984, and by early 2008 the auction rate securities market had grown to well over $300 billion. When Auction Rate Securities were first introduced, mostly institutional investors participated in the auction rate securities markets. As the ARS market developed smaller investors began participating . Typically, the minimum investment for the retail investor is $25,000.

Auction rate securities are auctioned at par so the return on the investment to the investor and the cost of financing to the issuer between auction dates is determined by the interest rate or dividend yield set through the auctions. According to the disclosure documents (the prospectus or official statement) for each security, the interest rate or dividend yield is set through an auction (commonly referred to as a "Dutch" auction) in which bids with successively higher rates are accepted until all of the securities in the auction are sold. Investors can only submit the following types of orders: 1) a "hold" order, which is the default order for current investors (i.e., the order that is entered for a current holder if the holder takes no action), where a current investor will keep the securities at the rate at which the auction clears; 2) a "hold-at-rate" bid, where a current investor will only keep the securities if the clearing rate is at or above the specified rate; 3) a "sell" order, where a current investor will sell the securities regardless of the clearing rate; or 4) a "buy" bid, where a prospective investor, or a current investor who wants more securities, will buy securities if the clearing rate is at or above the specified rate. Disclosure documents often state that an investor's order is an irrevocable offer.

The final rate at which all of the securities are sold is the "clearing rate" that applies to all of the securities in the auction until the next auction. Bids with the lowest rate and then successively higher rates are accepted until all of the sell orders are filled. The clearing rate is the lowest rate bid sufficient to cover all of

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the securities for sale in the auction.4 If there are not enough bids to cover the securities for sale, then the auction fails, the issuer pays an above-market rate set by a pre-determined formula described in the disclosure documents, and all of the current holders continue to hold the securities, with minor exceptions. If all of the current holders of the security elect to hold their positions without bidding a particular rate, then the clearing rate is the all-hold rate, a below-market rate set by a formula described in the disclosure documents.

The final rate at which all of the securities are sold is the "clearing rate" that applies to all of the securities in the auction until the next auction. Bids with the lowest rate and then successively higher rates are accepted until all of the sell orders are filled. The clearing rate is the lowest rate bid sufficient to cover all of the securities for sale in the auction. If there are not enough bids to cover the securities for sale, then the auction fails, the issuer pays an above-market rate set by a pre-determined formula described in the disclosure documents, and all of the current holders continue to hold the securities, with minor exceptions. This rate is often similar to a default rate and in some cases can be as high as 20 percent. In between auctions or in the event of a failed auction an ARS holder may might be able to sell auction rate securities in the secondary market at prices greater than, equal to, or less than par. If all of the current holders of the security elect to hold their positions without bidding a particular rate, then the clearing rate is the all-hold rate, a below-market rate set by a formula described in the disclosure documents. Until early 2008, auction failures were rare. A large part of the reason why these auctions were successful was the undisclosed fact that the broker-dealers selling the securities would enter their own bids to insure the auctions success.

In February, 2008, the major players in the ARS market recognized that they were facing excessive risks in large part because of their exposure in the sub-prime mortgage debacle. In an effort to reduce their risk exposure, the broker-dealers stopped entering bids during the auctions. As a result, in early February virtually every auction failed. The holders of the auction rate securities found that the securities that they were told represented cash equivalents were now illiquid and could not be sold at par or even at substantial discounts. Issuers of these securities often found themselves paying default interest rates. Horror stories abound. Retail investors who thought they were purchasing liquid alternatives to cash found that they had no access to their capital. There are reported cases of home buyers losing the deposits on homes when they were unable to close because they could not access their cash that was invested in now illiquid ARS instruments. On the issuer side of the equation, issuers suddenly found themselves paying

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default interest rates when they hade done nothing wrong—and were not in default of their obligations.

Faced with a flood of complaints federal and state regulators were quick to respond. By August, 2008 regulators announced preliminary settlements with several of the larger players in the ARS market. These included settlements with UBS, Merrill Lynch, Citigroup, Credit Suisse, JP Morgan and Morgan Stanley. These settlements all require that the brokerage firms that sold Auction rate securities to unsuspecting investors repurchase those securities at par. The settlements also provide that the brokerage firm cannot contest liability for investor claims seeking recovery for consequential damages. The settling Broker-dealers can, however, contest the existence and the amount of claimed consequential damages. FINRA recently announced a special arbitrator selection process for cases involving auction rate securities. Auction rate securities cases involving damages of up to $50,000 will be heard by a single public arbitrator. Cases involving damages of more than $50,000 will be heard by a three member panel. The industry representative on the panel, will be individual who has not, since January 1, 2005 either worked for a firm that sold auction rate securities or themselves sold or supervised someone who sold auction rate securities.

The ARS settlements, however, are not a panacea for all investors who now find themselves holding large positions in illiquid securities. The settlement with UBS Securities, for example, only covers current customers of the firm. Customers who moved their account away from UBS are not covered by the settlement. These claimants will be forced to litigate their entire claim – including issues of liability

Arbitration claims involving auction rate securities can be expected to run the gamut from unsuitability to negligent misrepresentation to outright securities fraud. The fraud claims will likely be based on the failure of the brokers to disclose the fact that they were supporting t he auctions that were supplying liquidity by submitting bids for their own accounts. Thus, the fraud claims will allege that the brokerage firms failed to disclose the risk that auction rate securities would become illiquid in the event that firms like UBS stopped supporting the auctions. Claimants can also be expected to allege that brokers sold the Auction Rate Securities as cash equivalents knowing full well that there was a substantial likelihood that they would become illiquid because risk managers were requiring the brokerage firms to reduce their exposure to auction rate securities. In addition to the fraud claims, claimants who trusted their brokers representation that Auction Rate securities were liquid investments will be able to allege that since the

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brokers controlled whether the auctions would succeed or fail the firms owed those investors a fiduciary duty to ensure the success of the auctions and that the February, 2008 decision to stop bidding and thereby not support the auctions breached that duty.

On the issuer's side of the equation, issuers convinced by their underwriters and investment bankers to issue auction rate securities can be expected to allege both breach of fiduciary duty and fraud. Dealers often marketed Auction-Rate Securities to issuers such as municipalities as an alternative variable rate financing vehicle that would enable issuers to obtain favorable short term interest rates. When the auctions failed, these issuers suddenly were forced to pay default rates which, in some cases were as high as 20 percent. These issuers can be expected to claim fraud, breach of fiduciary duty, and breach of contract. Since the interest rate reset can be directly attributed to the failure of the dealers to make their own bids to support the auction, expect that many issuers will be in a position to raise tortuous interference with contract claims.