Auction Rate Securities

Part 2

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To understand what has happened in the marketplace with Auction Rate Securities [ARS], it is useful to review their origin, and how they have proliferated in recent years.

Municipalities commonly issued long term bonds to finance projects. The projects tend to be capital intensive with long lives. Payment terms on the bonds need to match to the municipality's ability to pay from the incoming tax revenues. Getting the business was very competitive, as many investment banking firms were clamoring for it. Investment bankers, looking for a competitive edge, came up with a structured product called "Auction Rate Securities." It allowed the municipality to issue long term securities thereby matching the revenue stream at a reduced cost. Eventually other non-municipal entities, mostly colleges and universities, hospitals, and student loan related programs, started to issue ARS. The investments were sometimes referred to as Auction Rate Certificates.

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To reduce costs, the security had to reduce time risk. This was accomplished by having the municipality, for example, vary the interest rate periodically to market demands (every "reset date," usually every 7, 28 or 35 days) to ensure the investor will be able to sell the security and be made whole. If the investor was not able to sell the security, the municipalities were required to pay an interest rate penalty to compensate the investor for now having in effect an illiquid long term security (and hence additional time risk). At the same time, this clause provided incentive for the issuer to make the investor whole as soon as possible and call the issue back, cashing out the investor.

The Creation of Auction Rate Preferred Securities ("ARPS")

As "Auction Rate Securities" proliferated through the market place, any short term competitive edge the original investment bankers had, evaporated. It was not easy to write the business. One had to find a real municipality that had a real project which needed funding. They did not come around every day. They could not simply be manufactured.

But if the ARS structure could be deployed in other investment markets, investment firms could introduce the closed end funds that issued preferred shares and structure and market them as ARPS. There are many types and flavors to the family of funds. Many of these closed end funds are simply entities that house long term financial assets which earn long term rates.

ARPS were not market based funds, that is to say they had no basis in market reality. The closed end funds issuing ARPS were basically warehouses for long term financial assets earning long term rates. But, the issuers in no way wanted to pay out anything near long term market rates for the ARPS. That would defeat the purpose of issuing them. The purpose of issuing ARPS was to make additional income between what they can earn on their long term assets and what they can have the brokerage houses get their clients to accept. In other words, since the interest rates on the ARPS were short term rates, sometimes paying as little as 4.3% to 4.7%, the present value of security would actually be worth 40% to 50% of par value if long term interest rates on a long term illiquid investment were paying just 8% to 10%.

Wall Street made billions from the process of underwriting, administrating, acting as principal, acting as a market maker, and/or earning a continuing interest over and above what the client received. After a new ARPS was first issued, it could subsequently be re-marketed in the ARS market to clients of the broker-dealer. As such, a prospectus would not be required before offering it to clients on a secondary market basis. Hence, the clients got no prospectus nor were they told where it could be viewed, nor that they should review it, or that it even existed.

As we know, in the second week of February 2008, most brokerage firms suddenly stopped making a market in these securities. The ARS market collapsed when failing auctions largely outnumbered auctions that succeeded, leaving ARS investors stranded with illiquid investments. As a result, suspiciously, all the brokerage firms involved in the mirage of deception simultaneously decided to abandon their clients and brokers alike, allowing them to fail.

As early as May, 2006, the SEC issued Cease and Desist Orders to most of the brokerage firms for improper sales practices in connection with auction rate securities. However, it seems again that the SEC had gone for the capillary instead of the jugular vein in its misguided and half-hearted attempts to regulate the marketplace.

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