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Auction Rate Securities – Know the Risks and Rewards

In the world of corporate cash management investments, there is the \$260 billion¹ auction rate securities (ARS) market, and there is everything else.

What is unique about ARS makes them appealing, but has also brought controversy. Few AAA-rated securities offer such valuation simplicity and enhanced yield over Treasuries that ARS provide, making them a popular cash management tool. Conversely, few investment grade securities have faced as much scrutiny by independent observers, while simultaneously having their virtues extolled by brokerage firms who earn fees for selling them. Reasons for the debate are understandable, as no other investment grade security type can claim the following attributes:

- Sold in an auction-style market
- Has been the subject of SEC allegations of auction manipulation, alleging that brokers intervened in sales and allowed favored customers to submit or revise bids after auction deadlines to ensure auctions didn't fail²
- Is sold in a single broker-dealer structure where the same broker underwrites, runs, and sells the majority of the auction, significantly concentrating risk and investment bias. The collective pool of money earned for managing each auction creates a unique incentive for brokers to market these securities relative to other capital preservation tools.
- Has seen Big Four accounting firms require their clients to reclassify from cash equivalent to short-term, and in some cases long-term holdings per FAS 95.
- Is marketed differently to clients, as either a long-term, short-term, or a cash equivalent security, depending on the target client's sensitivity to FAS 95.

RISKS TO THE SINGLE-DEALER STRUCTURE

Purchasers of these securities often look at the credit rating of the issuer. Most of the issuers carry a high credit rating (AAA-rating from at least two ratings agencies). However, the risk should not be determined solely on the issuer's credit rating. It is important to know and understand the dealer's credit rating or capitalization. This risk is often overlooked. If the broker-dealer is a single-A rated entity and the performance of the investment is tied to that dealer, the purchaser must also take into account that there is some A-rated risk, specifically that the dealer may not be able to support the auction at some date in the future.

There are two other risks to consider. Depending on the agreement, the auction agent may resign by giving a specific number of days notice and may not necessarily be required to wait until another auction agent is in place if their fees have not been paid. If the broker-dealer resigns, the security may not be required to have a replacement broker-dealer in place. If either of these events occurs, and there is not an auction agent or broker-dealer, it will not be possible to hold an auction. As a result, the interest rate assigned will be determined in another manner, which may or may not be favorable to investors.

Another risk is that the broker-dealer decides it is no longer worth the capital necessary to support a particular auction in the event that many investors shy away from this security type or a particular issue. If the total number of bids received for an auction does not cover the entire issue, the dealer has the right, but not the obligation, to bid on the remaining securities, thereby clearing the auction. If the auction agent does not receive bids lower than the maximum rate for the total amount of securities, the

HOW THE AUCTION PROCESS WORKS

Auction rate securities are long-term in nature (up to 50 years to maturity) with interest rates that reset monthly or weekly according to a scheduled auction process. The collateral structure that backs coupon and principal payments can vary significantly from issue to issue and requires significant amounts of time to assess fully.

The broker-dealers appointed by the issuer receive fees from the issuer — usually a percentage of the principal amount sold or successfully placed through them. However, the broker-dealer's obligation is both to the issuer and the investor, but on different levels. The obligation to the issuer is to solicit bids on the regularly scheduled auction dates, and the obligation to the investors of the securities is to manage the auction process per the security's prospectus.

An auction agent is hired by the issuer or trustee (usually a bank), which receives orders and determines the clearing rate and the allocation of the securities among the dealers. In a multiple-dealer program, each of the broker-dealers must act independently and may not share any information with the others. This is designed to keep the auction process objective and non-discriminatory.

On the auction date, ARS holders indicate their desire to hold, purchase or sell and, if buying or holding, which price they wish to hold. If the clearing rate comes in lower than their respective bid, they are obligated to sell the security. In this Dutch auction process, the orders are filled from the lowest bid rate on up until the full size of the auction has been allocated. The rate is then set at the highest bid that clears the auction and all investors receive that rate for the next term.

auction fails. This occurred in 2002 with a busted Zurich auction rate issue. In that example, the broker did not feel obligated to cover the issue and the investors did not have the option to sell through the auction process and were obligated to hold it longer to avoid principal loss.

TRADING OF OTHER MONEY MARKET SECURITIES

Liquidity features of traditional money market securities such as commercial paper, negotiable certificates of deposits, agency discount notes, short corporate bonds and asset-backed securities differ greatly from ARS.

For example, investors in the aforementioned securities can reach out to multiple dealers (typically five or more) to solicit bids from each dealer to ensure best execution. By contrast, investors in ARS hold an illiquid security away

from the weekly or monthly auction window. Should a corporate investor run into a liquidity crunch, the investor is held captive by the specific dealer managing the auction. Even though this may be a short window of time, it is typically too long for investors like our clients who demand a high degree of liquidity as stated in their investment policies.

ACCOUNTING BACKGROUND

PricewaterhouseCoopers (PwC) issued an advisory in February 2005 which called for ARS to be classified as short-term securities rather than the cash equivalent classification enjoyed by corporations that use them to manage their cash. The result was a marked decline in their use as a cash management tool. PwC's rationale was that the legal maturity of ARS was typically 20 to 30

years, despite the auction mechanism, and that the auction liquidity was provided by third parties not factored into the ARS credit ratings. In response, the Association for Financial Professionals (AFP) submitted a letter to the Financial Accounting Standard Board (FASB) seeking an update and additional clarification of cash and cash equivalents. At their March 21, 2007 meeting, FASB announced that it intends to eliminate the classification of “cash equivalent”, while providing little detail as to how ARS would be treated under the new definitions. The Big Four accounting firms have similarly been quiet on how they will look to classify ARS if the proposed rule changes take effect. Further guidance from FASB is expected between now and the end of the year.

CONCLUSION

We continue to recommend that investors be fully aware of the auction process and its reliance on a restrictive trading structure. Because investors in the short-term space generally require a high degree of liquidity as a prerequisite for any investment, it is important to invest in securities where a broad array of brokers can provide liquidity. Under the typical auction rate structure, there is a great degree of dependency upon a single broker who oversees the auction process. Until this asset class provides more complete trading options and less accounting risk, we believe the slight yield advantage available today does not merit the inherent risks described above.

¹ Bloomberg.com, January 9, 2007.

² U.S. Securities and Exchange Commission. May 31, 2006. Specific to the auction rate market, Bear Stearns & Co., JP Morgan Securities Inc., Deutsche Bank AG, Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner, & Smith, Inc., RBC Dain Rauscher, AG Edwards & Sons, Morgan Keegan & Co., Piper Jaffray & Co, SunTrust Capital Markets, Wachovia Capital Markets, two units of Morgan Stanley, Citigroup Inc., Bank of America Corp, and Goldman Sachs Group, all settled claims they broke laws that forbid omissions or misstatements in the sale of the securities. The firms accepted a cease and desist order from the SEC on such activities without admitting or denying the Commission's findings.