

At A Glance

## Deep Freeze in Auction-Rate Securities

### Overview

Auction-rate securities (ARS) are long-term variable rate securities with interest rates set at periodic and frequent auctions. Investors have historically been able to liquidate ARS positions at face value at these auctions, leading many to consider the securities cash-like. There are two primary types of ARS: long-term debt instruments issued by municipalities or other public sector institutions (approximately 75% of the market) and preferred equity instruments issued by closed-end mutual funds (approximately 20% of the market). The ARS market is estimated at about \$330 billion outstanding and is a major source of leverage for closed-end funds, but represents only a small portion of the municipal debt market. Buyers are generally wealthy individuals or corporate treasuries.

Rather than yielding a set spread over a benchmark rate, such as 50 basis points above Fed Funds, the rates on ARS are periodically determined through modified “Dutch auctions,” which are facilitated by underwriting brokerage firms and generally held every 7, 28, 35, or 49 days. The auction “clearing rate” will be the lowest rate at which all securities offered for sale are matched with a purchase bid. The clearing rate becomes the new rate paid until it is reset again at the next auction.

If total buyer interest is less than the amount existing investors wish to sell at the highest rate, the auction fails. In the case of failure, the rate reverts to a “penalty” or “maximum rate” set in the issuing prospectus. Also, the ARS may have to remain with current holders, who may or may not have wanted to sell at the auction, but who will all now receive the higher penalty rate. Penalty rates for municipal ARS tend to be much higher than those for closed-end funds. For example, the Port Authority of New York and New Jersey had one penalty rate of 20%, costing \$300,000 in extra interest payments per week; closed-end funds might see increases of only 20 or 30 basis points.

### Market Crisis and Auction Failures

Over 80% of auction-rate notes have bond insurance or some other credit enhancement. However, with the recent distress of monoline insurers, investors have become concerned about the quality of their credit enhancement. This, in turn, has triggered significant and rapid distress in the ARS market. In fact, although fewer than 100 auctions failed between 1984 and 2007, there were hundreds of

auction failures in February 2008 alone, as the market “virtually collapsed” according to the *Wall Street Journal*.

In the past, if demand fell short then sometimes the brokerage firms running the auctions would themselves step in as buyers. However, many underwriting brokers are currently experiencing their own difficulties and



have generally chosen not to purchase ARS for their own balance sheets. Thus, many investors are surprised to find themselves holding illiquid securities and several corporations have written down the value of their ARS holdings due to “other than temporary” impairments in value.

## Dispute and Litigation Scenarios

Several actions have already been filed against brokerage firms on behalf of ARS investors, including one that claims over \$1 billion in damages. It is likely that additional broker-customer disputes will soon follow, claiming a similar combination of inadequate risk disclosure and misleading marketing. Additionally, we are already seeing shareholder class actions claiming improper disclosure or inappropriate investment in this market. The CEO of PricewaterhouseCoopers recently highlighted that these securities sit “in cash equivalent accounts of... thousands of companies, not just a handful of big banks.”

## Our Expertise

While historical auction failures had been rare prior to 2008, NERA experts were involved with several arbitration proceedings resulting from failures in the 1990s. In addition, our securities experts have been involved in hundreds of broker-customer disputes examining issues related to suitability, risk, and valuation, and are well-positioned to assist clients in litigation and disputes relating to ARS and other fixed-income securities matters. Our expertise includes:

### Broker-Customer Disputes

- Evaluating suitability and risk
- Assessing portfolio performance

### Accounting and Financial Analysis

- Determining GAAP compliance
- Analyzing balance sheet health (assessing the liquidity and leverage position of the company)
- Gauging the impact of investments on important financial ratios

## Valuation

- Valuing exotic fixed-income securities
- Determining the value of insurance policies for insurers affected by the credit crisis

## Securities Fraud Class Actions

- Analyzing the efficiency of the ARS market and the extent of conflicts among class members
- Estimating the exposure and amount that defendants are likely to pay if the case settles
- Determining economic arguments in favor of or against defendant liability
- Analyzing damages for use in settlement negotiations or at trial
- Critiquing opposing expert reports and analyses

## About NERA

NERA Economic Consulting ([www.nera.com](http://www.nera.com)) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real-world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

## Contact

For more information or to contact our experts, please visit [www.nera.com/sec-auctionrate](http://www.nera.com/sec-auctionrate).