

Auction Rate Securities Under Attack

July 9, 2008

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Auction rate securities were marketed as cash equivalents

- SEC found in 2006 that ARS were being sold as an alternative to money market funds. (1934 Act Release No. 53888, May 31, 2006)
- ARS were uniformly represented to be safe, liquid and suitable for short-term investing
- ARS were described on monthly statements as cash or cash equivalents
- Investors were often issued checkbooks to draw on their ARS and many brokers offered “overnight liquidity”

Cash & Cash Alternatives

Addressing your short-term needs

As you develop a portfolio strategy to work toward your long-term goals, the need to fund short-term financial goals may arise. For this reason, you should consider maintaining a portion of your portfolio in liquid assets. Liquidity refers to the ability to quickly convert investments into cash when you need it. Investing in cash alternatives can add this flexibility to your overall portfolio strategy. Cash alternatives are highly liquid, short-term investments. They include:

- Agency Discount Notes (GSEs)
- Auction Preferred Stock (APS)
- Auction Rate Certificates (ARCs)
- Certificates of Deposit (CDs)
- Commercial Paper
- U.S. Treasury Bills (T-Bills)
- Variable-Rate Demand Obligations (VRDOs)

A Financial Advisor can provide more information about the features, credit quality and risks of these investments, as well as guidance on how they may fit into your portfolio strategy.



For investors who prefer not to extend that far in maturity, we suggest locking in rates on better yielding two- and three-year maturities. Doing so might involve some sacrifice in yield now, but we think that ultimately investors will wind up with better income.

Table 1 gives an idea of alternatives. In the taxable market, two-year CDs presently yield about 90 basis points less than where CMA funds are now, but much better than we expect CMA rates to be a few months from now. The comparison is similar for tax-exempt CMA rates and two-year municipals.

For cash holdings: auction market securities

Naturally, most investors need to keep some portion of their portfolios in liquid, cash-like instruments. We find auction market securities (AMS) to be a better alternative than money funds for these purposes for investors with larger amounts to invest. The typical minimum investment in auction securities is \$25,000. The minimum for Variable Rate Demand Obligations (VRDOs) in the muni market is \$100,000.

As the Table shows, the rate on 30-day taxable AMS is 25 basis points higher than the taxable CMA rate. That spread is a narrower than normal, because, as we mentioned in the previous section, money market rates have not yet fully responded to the Fed rate cuts. The rate on 30-day tax-exempt AMS is 172 basis points higher than the tax-exempt CMS, which is a much wider spread than normal.

Auction market securities do not provide daily access to funds as money markets do, but they come close enough for many people. Investors can withdraw from AMS at the regular auctions, which can be at different intervals depending upon the security.

With the market volatility, some investors have raised questions about auction market securities. We address those questions in the next article.

Table 1: High-quality short term alternatives

Taxable	
CMA	4.21%
7 day auction market	4.23%
30 day auction market	4.46%
2-Yr Treasury	2.06%
2-Yr GSE	2.57%
2-Yr CD	3.10%
Tax-Exempt	
CMA	2.39%
7 day auction market	3.31%
30 day auction market	4.11%
2-Yr Municipal	2.20%

Source: [REDACTED]

[REDACTED]

[REDACTED] / Branch / Rep / Account No
0201 / F67K / [REDACTED]

February 1 - February 29, 2008

Activity Detail continued

Date	Account Type	Transaction	Quantity	Description	Price	Amount	Cash/Money Market/Swap Fund Balance
02/04	Cash	AUTO ACTIVITY		ACH DIRECT DEPOSIT TRACE # [REDACTED]		[REDACTED]	[REDACTED]
02/06	Cash	DIVIDEND		ALLIANCE NATL MUNI INC AUCTION RATE PFD SER T TUESDAY 020608 4		[REDACTED]	[REDACTED]
02/07	Cash	AUTO ACTIVITY		ACH DIRECT DEPOSIT TRACE # [REDACTED]		[REDACTED]	[REDACTED]
02/08	Cash	DIVIDEND		ALLIANCEBERNSTEIN PFD NATIONAL MUNI INC FUND SERIES TH 020808 52		[REDACTED]	[REDACTED]
02/11	Cash	AUTO ACTIVITY		ACH DIRECT DEPOSIT TRACE # [REDACTED]		[REDACTED]	[REDACTED]
02/13	Cash	DIVIDEND		ALLIANCE NATL MUNI INC AUCTION RATE PFD SER T TUESDAY 021308 4		[REDACTED]	[REDACTED]
02/13	Cash	PURCHASE	20.00000	BLACKROCK INVESTMENT QUALITY MUNI PREF 1SHR = 25,000 PRIN VALU	[REDACTED]	[REDACTED]	[REDACTED]
02/14	Cash	AUTO ACTIVITY		ACH DIRECT WITHDRAWAL TRACE # [REDACTED]		[REDACTED]	[REDACTED]
02/15	Cash	DIVIDEND		ALLIANCEBERNSTEIN PFD NATIONAL MUNI INC FUND SERIES TH 021508 52		[REDACTED]	[REDACTED]
02/19	Cash	AUTO ACTIVITY		ACH DIRECT DEPOSIT TRACE # [REDACTED]		[REDACTED]	[REDACTED]
02/20	Cash	DIVIDEND		ALLIANCE NATL MUNI INC AUCTION RATE PFD SER T TUESDAY 022008 4		[REDACTED]	[REDACTED]

Account name: [REDACTED]
 Friendly account name: [REDACTED]
 Account number: [REDACTED]

Your assets

Some prices, income and current values shown may be approximate. As a result, gains and losses may not be accurately reflected. Gains and losses for zero-coupon investments are not shown. See *Important information about your statement* on the last two pages of this statement for more information.

Cash alternatives

Other

Holding	Trade date	Quantity	Purchase price (\$)	Cost basis (\$)	Price on Apr 30 (\$)	Value on Apr 30 (\$)	Unrealized gain or loss (\$)	Holding period
BLACKROCK PFD INCOME STRATEGIES FUND SER W-7 AUCT PFD 3.932% EAI: \$41,515 Current yield: 4.25%	Feb 06, 08	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	ST
COHEN & STEERS SELECT UTIL FUND INC(THUR) SER TH7 AUCT PFD 4.066% EAI: \$41,348 Current yield: 4.24%	Feb 07, 08	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	ST
EATON VANCE LTD DURATION INCOME FD TUE TXBL AUCT PFD 3.849% EAI: \$39,131 Current yield: 4.01%	Feb 05, 08	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	ST
FRANKLIN TEMPLETON LTD DURATION INCOME TRUST SER F AUCT PFD 4.039% EAI: \$41,055 Current yield: 4.21%	Feb 08, 08	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	ST
KAYNE ANDERSON MLP INVST W7 SER B AUCT PFD 5.364% EAI: \$55,648 Current yield: 5.85%	Feb 06, 08	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	ST

continued next page



A lack of information available to investors

- No prospectus delivery because these were “secondary market sales”
- Financial Advisors received no information regarding risks of investment in ARS
- Regulators have acknowledged lack of transparency in pricing and sale

What investors were not told about auction rate securities

- These were not true auctions
 - According to Massachusetts AG, from January 2006 through February 28, 2008, UBS submitted bids that prevented auction failures in:
 - » 85.7 percent of auctions for municipal and student-loan backed auction rate certificates
 - » 50.9 percent of auction preferred shares auctions
- Liquidity was dependent on interventions
- Intervention strategy dictated by brokerage firms' internal considerations

What investors were not told about auction rate securities

ARS are not “cash equivalents”:

- SEC noted in March 2005 that ARS “*do not meet the definition of cash equivalents*” in paragraphs 8 and 9 of FASB Statement No. 95, *Statement of Cash Flows*.
- Many large corporations begin to unload ARS back to the broker-dealers, because they are unable to treat ARS as cash on their balance sheets.

ARS suffered from pervasive conflicts of interest

- Internal conflict between investment banking and retail (“wealth management”) functions resulted in brokers attempting to balance competing obligations:
 - issuer clients seeking to pay lowest possible rate of interest
 - Investor clients wanting high rate of interest
 - Brokerage firms simultaneously buying and selling ARS while serving as auction agent
- Retail clients ultimately served as outlet for unwanted investment bank assets

[REDACTED]

From: Schwyter, Anneliese
Sent: Wednesday, August 29, 2007 10:37 AM
To: Long, Chris; Jackman, Ross
Subject: RE: Short Term Inventory Update

Thanks Chris, did you receive any pricing indications from the desk, if yes send them to me. If not pls ask and forward.
Best regards,
Anneliese

From: Long, Chris
Sent: Wednesday, August 29, 2007 10:11 AM
To: Schwyter, Anneliese; Jackman, Ross
Subject: RE: Short Term Inventory Update

Anneliese,

Each morning we send a list of REPO eligible securities looking to gauge interest in terms of quotes and tenors, as of this morning we have had the Repo market has still to a great extent avoided entering into Non-Traditional Repo trades. An example given to us was that Fidelity, a mere three weeks ago had roughly US \$80 billion on Non Traditional Repo on with Lehman, they have since reduced that to below \$40 billion.

We have \$3.0 billion out on term funding, and continue to monitor our Settle (Cash) Date position to ensure that we are as close to 100% term funded as possible. We are making pricing decisions based on our ability to attract investors while managing issuer client relationships and will continue to do so in efforts to move securities.

Regards,
Chris

[REDACTED]

From: Shulman, David [REDACTED]
Sent: Wednesday, October 31, 2007 3:55 PM
To: Wolf, Robert
Subject: Fw: holding the bag
Attachments: ATT00586.txt

This is what we dealing with- fyi--retail wm that now is demanding liquidity -putting more pressure on balance sheet etc...this is the gift that keeps on giving...am speaking to weisberg tonight from zurich on this and **all failed auction stuff..this is a huge albatross..**really something..wm enjoyed all the fees and rev when times are a good..now the ib steps in to provide balace sheet and risk with a limited exit strategy- very hostage to wm for distribution--that was and is the model..totally lopsided..unreal

David H. Shulman
Global Head Municipal Securities Group

ARS suffered from structural problems

Design of rate reset process flawed

- In the event of a failed auction, reset rate must be high enough to attract liquidity
- Those ARS that remain unsaleable:
 - Lack meaningful penalty rates or
 - The maximum rate is subject to an undisclosed cap
- ARS were described internally as a “flawed product”
- Broker-dealers asked issuers to waive maximum rate caps to prevent collapse of auction rate market

----- Original Message -----

From: Long, Chris
To: Shulman, David+; Jackman, Ross; Paviolitis, Charles
Sent: Wed Dec 19 20:24:53 2007
Subject: Responses to Question 9 & 14...

Focusing on Student Loans, prevailing market conditions have continued to cut into excess spread of these structured products. Continued stress will trigger max rates ("available funds caps") potentially resulting in auctions resetting at below market yields. These max rates are integral in the securities meeting rating agency stress scenarios and ultimately maintaining current ratings. The unwillingness of rating agencies to grant waivers on current max rates, under current market conditions, will accelerate the onset of below market yields due to max rate caps. This forces the hand of every broker dealer in the auction market to decide between supporting deals, taking inventories on at levels far below market rates or failing auctions (not supporting) which triggers a chain reaction of selling across all auction products, regardless of them being Student Loans, Municipals or Auction Preferred Stock. Mark to market losses would be significant, to all parties involved.

Thanks
Chris

Christopher R. Long
Executive Director
UBS Securities LLC
1285 Avenue of the Americas
New York, NY 10019
Tel: [REDACTED]
Fax: [REDACTED]

----- Original Message -----

From: Jackman, Ross

To: Shulman, David+; Mohanty, Seema; Gallichio, Joe+

Sent: **Wed Feb 06** 21:48:57 2008

Subject: Re: Lloyds/NTHEA

Also as Sarah states in her original email her and kathryn discussed this option on Friday and what happened? We need to continue to press the issuers and liq banks for a solution it is unacceptable to continue under the current format. **Also D Day will come soon on the max rate issue on the ARCs we need solutions or we are going to be left buried with below market securities and no options.**

Loss Causation

- Loss causation: the loss must be foreseeable and caused by materialization of a concealed risk.
(Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005))
- Plaintiffs' losses are attributable to materialization of undisclosed risks:
 - Liquidity
 - Conflicts
 - Structural flaws

Damages

“We note that rescission is also available as a remedy for violations of § 10(b) and the regulations promulgated thereunder.”

(Boguslavsky v. Kaplan, 159 F.3d 714, 721 n.5 (2d Cir. 1998))

Class Certification

Predominance of common issues

- Were relevant facts withheld from all ARS purchasers?
- Did the omissions occur in connection with the purchase or sale of securities?
- Did broker-dealers act with intent to deceive or manipulate?
- Were the omitted facts material?
- Should reliance on the omitted facts be presumed?
- Did broker-dealers' misrepresentations and omissions cause plaintiffs' losses?
- Did plaintiffs suffer damages as a result of broker-dealers' misrepresentations and omissions?

Class Certification

Superiority of the class action

- Joinder of all Class members is impracticable
- Expense and burden of individual litigation makes a class action the most appropriate vehicle to litigate these claims
- Manageable as a class action

When all else fails: Blame the Market

“Due to the complexity and sensitivity of the ARS issues, when making U4 filings, the Firm, where appropriate, will add language that the complaint was due to the market dislocation.”

Regulatory Reporting of ARS Client Complaints

The significant disruption in the Auction Rate Securities (ARS) market has led to numerous client inquiries and in some cases, client complaints.

[REDACTED] as a registered broker-dealer and member firm of FINRA[®], is required by law to file amendments to a Financial Advisor's U4 form when the Firm receives a written complaint from a client that alleges sales practice violations and claims damages over a certain threshold. Under the law, [REDACTED] is required to report customer complaints even when the Firm disputes or challenges the allegations made by the clients.

ARS complaints alleging sales practice violations such as misrepresentation or unsuitability by a Financial Advisor fall within the U4 reporting requirement. The regulation requires [REDACTED] to file these amendments based solely on the *allegations* of the client's complaint – not on whether the allegations are true, fair, or were caused by events unrelated to any actions by the [REDACTED] like the ARS market disruption.

In light of the unprecedented nature of the events around the ARS markets, we have had numerous discussions within the industry, including conversations with our major competitors, industry representative groups, outside counsel and, most importantly, with FINRA itself, on this issue. In these discussions, we and our competitors have argued that complaints related to ARS should not be required to be reported on the U4 because they were caused by the market break and not by actions of the Financial Advisor. The response by FINRA was clear: the complaints must be reported. At this point, no firm has been given permission not to report ARS-related complaints.

Due to the complexity and sensitivity of the ARS issues, when making U4 filings the Firm, where appropriate, will add language that the complaint was due to the market dislocation.

For more information regarding the specific U4 requirements and the Firm's approach for handling U4 amendments relating to the ARS complaints, [click here](#).

We continue to work closely with FINRA, SIFMA and other industry representative groups on these issues and will provide updates as they become available.