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AUCTION RATE SECURITIES MARKET: A REVIEW OF PROBLEMS AND POTENTIAL RESOLUTIONS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

SEPTEMBER 18, 2008

Printed for the use of the Committee on Financial Services

Serial No. 110–140

U.S. GOVERNMENT PRINTING OFFICE

45–624 PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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AUCTION RATE SECURITIES MARKET: A REVIEW OF PROBLEMS AND POTENTIAL RESOLUTIONS

Thursday, September 18, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Maloney, Watt, Sherman, Hinojosa, Lynch, Scott, Green, Cleaver, Davis of Tennessee, Hodes, Klein, Perlmutter, Carson, Speier; Bachus, Royce, Jones, Shays, Capito, Neugebauer, and Campbell.

Also present: Representative Shea-Porter.

The CHAIRMAN. The hearing will come to order. I apologize for being a little late. Can we get the door closed back there?

This is a very important hearing and I want to say I am very appreciative for the hard work of a number of people, including my two Massachusetts colleagues who are here, and the people from the regulatory field, but also people from the industry. We sometimes have a hearing to lament the bad state of affairs. Obviously, this is a situation where there have been problems.

We rarely have hearings of self-congratulation, but I am pleased to note that the situation today regarding this looks a lot better than it did when we called the hearing; and, I am very appreciative of the efforts of a lot of people, as I said, including those who are here, who in leadership and industry responded. But it is still important for us to go ahead, because we have been focused, understandably as a Congress, in the Executive Branch and in the private sector on the important questions of systemic stability.

No one thinks this country is falling apart, but we are undergoing a degree of stress now that is having negative consequences far beyond what we would like to see, and trying to cope with them and trying to put in place rules going forward that diminish the likelihood of a recurrence have been very important. There is a danger here, and I don't impute it to any one individual, but it is a danger for all of us. As you focus on systemic stability, investor protection can slip, partly because it is just not at the top of everybody's agenda, partly because there are in some cases conflicts. To the extent that you have institutions that have been weakened, it is a question of what compensation they give is going to be raised in some people's minds.

Going forward, it is easier to make sure we do not allow these conflicts to arise, but I do believe that with regard to auction rate securities, there was a danger several months ago that investor protection was falling between the cracks, not outrunning the line decision to do it, but because other things were crowding it out, and because of some potential conflict in people's minds.

I think through the efforts of a lot of people, and I think this committee was a part of it by frankly announcing the hearings and our staff working together to talk to people that we have helped elevate investor protection to where it should be.

There are a couple of issues about it, but with regard to investor protection, one thing in particular stands out in my mind that has changed some of what opinion had been; and, that is, we had previously taken a view, for instance with regard to hedge funds, that we had to protect the unsophisticated investor, but that for sophisticated investors, the principle of caveat emptor could prevail. We had a million-dollar cut-off of hedge funds, but the people who have been victimized in this include some very sophisticated investors, individual and institutional.

I think what it shows is we are in a world today where the complexity and opacity of financial instruments is such that you cannot say, oh well, if you have more than a million dollars you are on your own. I think this makes it clear that it's not enough to simply say, okay we'll just let everybody do what they want, and we just won't let you into it. We need to have the kind of regulatory system that among other things provide some safeguards, because as I said, some of the most sophisticated entities and investors have been involved in this and that means we have to broaden it. So I appreciate the participation of the witnesses.

Our hearing is in part to figure out what has gone wrong. It is in part to encourage compensation, and I think we have made a lot of progress there and we will hear about that. I mean, what went wrong? How can we sort of compensate or see urged that people be compensated? Finally, and most importantly from this committee, what do we want to do going forward, because we will be adopting a set of regulatory rules going forward. What do we do to diminish the likelihood of this happening again?

Now, that being the statement, I do want to make one other announcement not related to this hearing, and it has to do with what the role of the committee will be going forward. There is clearly a lot of interest in what has been going on with regard to the interventions that have come from the Executive Branch and the case of Fannie Mae and Freddie Mac authorized by us, and the cases of Bear Stearns and AIG done by the Executive Branch or the Federal Reserve. And I have had some requests about what are we going to do to look into it. This committee has a busy agenda.

There is an overlap. I have had a meeting with Chairman Waxman of the Government Reform Committee; and, essentially, we have a kind of division of labor. That committee will be holding hearings under its jurisdiction, which is equal to us, as our friend from Connecticut, a very senior member of that committee knows. And it's always important to work out, I think, without friction, the authorizing committee and the oversight section; and, what we have agreed to is that this committee will continue to function on

the policy issues, in particular on what going forward we ought to put in place to make these things less likely.

The oversight committee, under its oversight function, will be looking into what happened, what didn't happen, and what should have happened. They will be looking at the actions of the private sector and the actions of the regulators. Obviously, those are not exclusively watertight compartments but that's where we are. So the thrust of the hearings into what happened and whether we are right or wrong are going to be going on the oversight committee.

We will be talking about what is going to happen, moving forward. There is continuous contact, we hope will go on between the staffs from both parties and both sets of committees; and I knew there was some interest in that and that's where we are.

With that, I will now call on the ranking member to make his opening statement.

Mr. BACHUS. Thank you, Mr. Chairman, for holding this hearing; and before I address auction rate securities, let me just say to Director Thomsen that I appreciate the action of the SEC yesterday. I think legitimate short-selling plays an important role in our capital markets, but what we have seen in the last year is abusive, naked selling.

I think it has weakened a lot of our financial institutions that probably would have survived had it not been for those abusive practices, because as short-sellers often acting in concert with each other, systematically singled out one institution and drove down their stock, it undermined the confidence of the public and the customers of those institutions in the institutions.

It impaired their ability to raise capital or to finance their debt and I think in many cases institutions fail; and, although it was not the root cause, the root cause of what we were facing today is years of over leveraging, risk-taking, over-extension of credit, failure of our rating agencies to properly regulate; and, in many cases, because of our outdated financial systems and inability in certain cases to regulate, or a patchwork or regulation where really no one was overseeing, for instance, the investment bank. But I will say that I believe with the action yesterday and the first action was taken it was limited to 19, I think, financial companies.

I expressed at that time my concern that the short-sellers when that happened, went to some of the smaller, more mid-size banks and began concentrating on some of your smaller institutions; and, I think that what was needed then and what you have done yesterday was a blanket order. I have compared these packs of short-sellers to jackals, which have actually attacked financial institutions and brought them to their knees, and I think it has definitely worsened what we are going through today.

In a conversation a year ago, Secretary Paulson told me that it was going to be almost impossible to avoid a painful deleveraging, because the chickens were coming home to roost—many, many, because of failure to regulate—many, because the Congress didn't address problems which we had known existed, and that is across all Administrations and failure to modernize our system.

But for whatever reason the industry, in many cases, resisted attempts to regulate. And they resisted very harshly. I was attacked across-the-board by the financial services industry when I proposed

a subprime bill 3 years ago; and they went out and told the public. They told my colleagues that there was absolutely no problem in subprime lending and trying to regulate and impose some standards was going to make things worse.

And a year-and-a-half ago, Chairman Frank and I referred to what we considered some dire straights that we were in and we were both criticized by our colleagues as exaggerating the situation they were in.

The CHAIRMAN. More of your colleagues than mine.

Mr. BACHUS. What?

The CHAIRMAN. I think it came more from your colleagues than mine.

Mr. BACHUS. There are quite a few.

And another thing that the Congress didn't do at that time, there were things for instance that the chairman and I agreed on, but some of our colleagues wanted more. Some wanted less. And they would not agree to compromise; so we could not get anything done. And often, that is the situation. You always have folks who say they want to go further, people who say they don't want to do anything at all; and, what fails to happen is anything and that certainly happened. I think had it been left to he and I, we would have had a subprime lending bill 3 years ago. It wouldn't have been all that people have.

I'm going to submit my remarks on auction rate securities as a matter for the record. Let me simply say with the auction rate securities, many of them were sold as being very liquid to investors. Cities, counties, they could get in, they could get out. It was a wonderful way to finance debt and it would always be liquid. Suddenly in February and March, they found that these assets were totally illiquid. It was almost like a roach motel, a financial roach motel. They could get in but they couldn't get out.

It was a nightmare for our cities and counties and our States, and I am glad, because of some of the efforts of people in our first panel and others, and our announcement with Mr. Kanjorski that we were holding a hearing and an investigation, that a lot of that appears to be resolving itself, but as we deal with the stability of our financial markets, a large component of that is going to be the auction rate securities market, and I do believe that is one area where we are making real progress, and it is beginning to resolve itself. I think that will have positive implications for the economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Before we get to the Orkin men and women on the panel, are there any other opening statements? I think the gentlewoman from New York has one?

Mrs. MALONEY. First of all, I want to thank the chairman for his leadership, not only on this issue today, but this has really been the most troubling time that I have ever seen on this committee. And I would say the markets have not seen such a turmoil in our country and I would say worldwide since the Great Depression. I strongly believe we should be looking like an RTC-like mechanism to take care of this crisis now.

We cannot continue to approach it in a piecemeal way. We need a comprehensive approach. I would like to be associated with my colleague, the ranking member, and the chairman of the committee

particularly on the naked shorts. Many people have called me and they believed that their company would be there, their jobs would be there, if this abusive practice had been stopped earlier, so I applaud the SEC's action and I feel that we should have a hearing and look in more to these naked shorts.

With regards to the auction rate securities market, we all have been following the situation since the market for these securities froze back in February. At its height, $160 billion worth of auction rate securities were issued by State and local governments, charities, and colleges and universities of all credit qualities and sizes. But, in February, everything just stopped. Since this time, everyone has been asking how these securities which were being marketed as something safe and as liquid and cash could have frozen all at once leaving $64 billion worth of securities locked up.

I have had constituents who have come to me, and they said they took out these securities. They said they could get their hands on it. It was as good as cash. They still cannot get their money back. Over the summer, we have seen settlements with the New York State and Massachusetts State attorneys general which would require banks to pay fines and buy back much of the $64 billion in frozen securities.

While I applaud this effort, I still have concerns about the cost that the States, municipalities, and other public entities who were the issuers of these auction rate securities have been forced to incur; and, their liability, of course, then becomes a taxpayer liability. In a recent speech by former SEC Chairman Arthur Levitt, he made the following point about these issues, and I request unanimous consent to put his entire—and he really points to the need of more transparency—and I quote from him as we try to unravel what happened.

What becomes clear is that too many issuers were left in the dark. Many had no independent advisors; and those that did not hire advisors often found themselves receiving advice from parties that were conflicted since these advisors also worked as a banker in the auction securities market. He also reminds us that problems in this market have been known about for at least 4 years as a result of an SEC investigation into the broader market in 2004 and 2008, and that a lawsuit by the Massachusetts Secretary of State revealed that going back to 2006, nearly 85 percent of the auction would have failed or produced different results without the single brokers' intervention.

At this hearing, I am particularly interested in learning exactly what happened and why it happened, and learning why exactly this market froze simultaneously in February, despite this market having problems and not functioning properly for many years. And why were these large penalty rates required for most issuers, but not required of the closed-end fund issuers or most structured bond issuers, though the securities were sold by the same underwriters to the same investors? So these are some of the questions to which I hope to hear answers today.

Again, I thank the chairman for having the hearing.

The CHAIRMAN. The gentleman from Texas is recognized for 3 minutes.

Mr. NEUGEBAUER. I thank the chairman and I would ask that I could just revise and extend my remarks.

The CHAIRMAN. All members will have general leave to put anything in the record they want.

Mr. NEUGEBAUER. I thank the chairman for having this hearing today because auction rate securities have played an important part of our market; and, particularly, I want to address my remarks primarily to the student loan program, because what has happened over the last year is one we passed legislation here where we reduced the amount of Federal subsidy to help some of the student loan securities be securitized in finance.

And, at the same time, one of the major financing vehicles for student loans was affected by the fact that auction rate securities, and so I think what we are saying, and I applaud the chairman, I think this committee does need to focus on those things that we can do to get the markets back acting in a normal way again, because the sooner we can do that the better for all of the players. Unfortunately, some of the actions by some of the players that were not good actions, poor decisions were made as affected the entire market place; and our auction rate securities have played an important part for cities and particularly for entities that are financing student loans.

We have been hearing from our bank friends all during the spring and summer their concerns about, because some of their traditional sources to be able to go with their student loans had basically dried up, because many of these entities, one of those in my district, has quit making student loans or quit purchasing student loans from banks until they can work through this, because quite honestly, right now, with the cost of financing or providing other financing vehicles for some of these loans just doesn't make economic sense for them.

So I think as we hear from the panel today, one of the things that we need to hear is the way you think. I'm not a big market interventionist from the Federal Government. Maybe the best thing for us is to get out of the way and let the markets start functioning again. But, certainly, the sooner that they function, we start functioning more appropriately, obviously, the better for students and cities and other entities that have used these securities. You know, because one of the issues was that there are a lot of these entities.

There wasn't the creditworthiness necessarily of those issues. It's just that once that pendulum started swinging there was a competence factor that spread throughout the market, and basically froze all of those auctions. And so raising the cost of financing for many of those entities, obviously providing some liquidity issues for people who thought that you could just get your money out of those at any time, and I think one of the underlying questions is you look into your crystal ball here.

Do you see auction rate securities back in the market place again?

With that, I yield back my time.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia for 3 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

I'll be very brief. I hear a lot of discussion on the other side about getting out of the way and letting the markets take care of themselves. We have learned that is absolutely the wrong thing for us to do. If anything, we need to get in the way, and, we need to get in the way very quickly, because this is not just a problem in the United States anymore.

This is a world-wide problem, and our prestige as a financial leader of the free world is at stake, the two underlining issues that we need to address very quickly is a decline in value of the dollar at home and abroad especially. But the other fact of the matter is where do you think we are getting this money? Where do you think we are going to get the money to bail out AIG, Bear Stearns, Fannie Mae, and Freddie Mac? It is not just being pulled off a tree.

We are borrowing this money. Our debt is going out of the ceiling; and, where are we borrowing it from? Foreign nations and foreign governments at a rate that is really crippling the future of our financial stability in the world. So, Mr. Chairman, I just wanted to add my 2 cents to that, because this is a very urgent issue, and we need to get in the way very quickly and we need to find the appropriate vehicle to intervene, much like the ROTC that the chairman has talked about. As we responded to the savings and loan crisis of 1984, I believe, so this is a very serious issue. The one before us with the auction rate securities is especially, and I want us to deal with more detail as we get into this discussion today about the risk, the risk that is involved with the ARS market.

We need to understand that. We need to know not only what is being done, but what can be done in the near future to address this collapse. Could more have been done to assess, to anticipate and further have prevented the auction rate mess?

Were investment firms and broker-dealers well aware that the ARS market bubble was about to burst? There's a lot of culpability here—the nature of the recent settlements—the role of the auction manager. There's a lot we have to get in with this, but this is part of this bigger picture, and I think the climate in Washington needs to get very serious and get in the way and save our economy and the prestige of the United States as being the financial leader of the free world.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Connecticut is recognized for 3 minutes.

Mr. SHAYS. Thank you, Mr. Chairman.

I first want to say that I think you are recognized by almost all the members here as being one of the smartest and the most effective. But I think the one are that you are not recognized, and I want to pay particular salute to it is that you have taken this issue, as you do so many others. Instead of trying to make it a political issue, have tried to say we have a huge issue; how do we come together. You have done a remarkable job, I think, of trying to get this committee to understand these problems and work together for the good of the country. And I just want to first thank you for that.

The CHAIRMAN. Thank you.

Mr. SHAYS. Secondly, I want to say that the smaller Federal family education loan providers, the FFELP providers, have utilized

the auction rate securities market to raise capital to originate new loans. And so when this market froze, certain FFELP providers were unable to obviously access capital.

On July 9th, I wrote to you and our ranking member, Mr. Bachus—I also appreciate the team that you have become—and said, let's have a hearing on this. So first, I want to thank you for doing this, for having this hearing. There's a lot about this process that I need to understand better. But what I do understand is that we have seen 19 of the top 100 lenders leave the Federal family education loan program entirely. And these totals include 14 nonprofit State loan agencies.

I am told that three State loan agencies—Pennsylvania Higher Education Systems, the Massachusetts Education Finance Authority, and the Michigan Higher Education Student Loan Authority—suspended all FFELP originations. So every type of lender has been affected, 14 State loan agencies, 56 banks, 14 credit unions, four nonprofit lenders, three school lenders, schools with 45 coming soon, and 34 non-loan banks.

This is a very serious problem. One of our strengths as a country is that we have the best educated, best trained workforce. Our strength has still been particularly in higher education; and I remember when the government was almost shut down, the Clinton Administration and the Republican Majority in Congress. And I think I heard more from parents concerned their kids were not going to get their student loans and the programs would start to shut down.

And it was interesting the number who were focused just on that issue. If we don't resolve this issue, we are going to hear from a lot of people and rightfully so.

I yield back.

The CHAIRMAN. I thank the gentleman. I thank him for his very gracious words, and the subject with the cooperation of most of the members of the committee that we have been able to do this, I would now put into the record under the general leaf a very thoughtful essay from Professor Frank Parker, who is a professor of real estate development at the Carroll School of Management, which is in the congressional district I represent, Boston College, and the State legislative district, the Secretary of the Commonwealth used to represent and lives near, but it's a very thoughtful article.

And then, also, a written statement from the North American Securities Administrators Association; and, let me just say as we begin the testimony, we have had debates here from time to time over whether or not there should be a pre-emption at the Federal level of the role that the States play in securities law. And anyone who wanted some evidence that it would be a mistake to wipe out the State role or substantially diminish it can look at the history of this issue, because it has been at the State level that we have seen from my own State of Massachusetts, from New York and elsewhere, a degree of intervention, I believe, the State of Missouri, our colleague's sister from the State of Missouri, Ms. Conahan, that in a number of States it has been the State securities officials and law enforcement officials who have taken the lead.

So I am pleased to put that statement in the record and they are entitled to say this is a strong affirmation of the need for that role.

We will now begin with our panel, and will first hear from Linda Thomsen, the Director of the Division of Enforcement at the U.S. Securities and Exchange Commission.

Ms. Thomsen.

STATEMENT OF LINDA THOMSEN, DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. THOMSEN. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee.

I am Linda Thompson, the Director of the Division of Enforcement at the Securities and Exchange Commission. Thank you for the opportunity to testify today about the Commission's efforts in response to the freezing of the auction rate securities market in mid-February 2008.

I have submitted my written testimony and asked that it be made a part of the record. I would like to start with the very big picture, and that is this: Thanks to the collective efforts of Federal, State, and SRO law enforcement and securities regulators, thousands and thousands of investors have billions and billions of dollars of liquidity restored to them in very short order. This relief is virtually unprecedented in type, magnitude, and timing. And due to these collective efforts, investors in auction rate securities at a number of firms, including retail customers, small businesses and charitable organizations will have the opportunity to receive quickly 100 percent of the dollar investments.

Customers who accept these offers will receive all of the interest payments or dividends they are due and will be given the opportunity to sell their auction rate securities without a loss. Since the auction rate securities market seized up in mid-February 2008, the need to restore liquidity for investors has been of paramount importance to the SEC and to our fellow regulators.

Through the Division of Enforcement, settlements in principle, with UBS, Citigroup, Wachovia, and Merrill Lynch, over $40 billion in liquidity will be made available to tens of thousands of customers. Auction rate securities were first developed in 1984, and as of 2008, it was estimated that the market had grown to $330 billion. Until mid-February 2008, auction failures were extremely rare and the market was highly liquid. For a variety of reasons, including the subprime mortgage and credit crisis that was unfolding throughout the second half of 2007, the auction rate securities market seized up in mid-February 2008 and the securities became illiquid.

The SEC staff reacted immediately. The Division of Enforcement began investigating, and deployed tremendous resources to the effort. In March of 2008, enforcement staff began collecting detailed information from 26 broker-dealer firms. We interviewed investors and other market participants including employees of broker-dealers and issuers. We established a dedicated e-mail box to receive investor complaints.

Since mid-February, the Commission has received over 1,000 complaints concerning approximately 50 broker-dealer firms. Investors reported that their brokers had led them to believe that they

were investing in safe and liquid investments, cash equivalents. And when the market froze, they could not access their funds for important, short-term needs, such as a downpayment on a house, medical expenses, college tuition, taxes, and for some small businesses, payroll.

To conduct investigations quickly and avoid unnecessary duplication, we also coordinated our efforts with other regulators including FINRA, the Office of the New York Attorney General, and the North American Securities Administrators Association and its membership, including, of course, the office of Secretary Galvin.

The two largest auction rate securities market participants were Citigroup and UBS. These firms became the primary focus of the investigations being conducted by the SEC's enforcement staff and our fellow regulators. We were acutely aware that time was of the essence, and we expedited our efforts accordingly. In early summer, enforcement staff, along with our colleagues for the New York Attorney General's office, embarked on an aggressive schedule of taking testimony from employees of Citigroup and UBS.

Our investigative record indicates that both firms made misrepresentations and omissions to their customers when marketing and selling auction rate securities. The SEC's investigation further shows that until the auction rate securities market seized Citigroup and UBS marketed auction rate securities as safe and highly liquid investments with characteristics similar to money market accounts, these firms misleadingly characterized auction rate securities as cash alternatives or money market and auction instruments. The firms failed to disclose, and in late 2007 and early 2008, auction rate securities liquidity risks had materially increased as the firms knew that there was an increased likelihood that they and other broker-dealers would no longer support the auctions.

Early on, the SEC staff, in coordination with the New York Attorney General's office, took the lead in structuring, proposing, and negotiating the framework for a settlement that included liquidity solutions. This framework was developed in consultation with the SEC's Division of Trading and Markets and other Federal regulators in light of the potential impact on the broader capital markets.

Of paramount importance was providing quick liquidity solutions for retail customers, charities, and small businesses that were from our perspective most in need of access to their funds. The agreements in principle with UBS and Citigroup established a general framework for other firm settlements. Other State regulators, especially through NASAA under the leadership of its President, Karen Tyler, and its auction rate securities taskforce, which included Secretary Galvin who provided tremendous leadership in this effort, quickly joined the efforts. And I should note that I believe it was Secretary Galvin who filed the first suit with respect to auction rate securities.

Although negotiating global settlements was not easy, the State and Federal regulators proceeded in good faith, working virtually round-the-clock for weeks. All of us felt that working together enabled us to maximize the relief provided to investors. In early August, the SEC, the New York Attorney General's office, NASAA,

and the Massachusetts and Texas securities authorities announced settlements in principle with Citigroup and UBS.

In pertinent part, both firms agreed to offer to purchase frozen auction rate securities from retail customers, small businesses, and charitable organizations at 100 cents on the dollar. Both firms also made whole any losses sustained by customers who sold their auction rate securities at less than par after the market had frozen and both will offer no-cost-loan programs to eligible customers with immediately liquidity needs.

The settlements also provide a mechanism through FINRA for customers to participate in a special arbitration process to pursue consequential damages. As for larger institutional investors, UBS has agreed to offer to purchase auction rate securities at par over a longer timeframe, while Citigroup has agreed to use its best efforts to provide liquidity solutions for its institutional customers.

The proposed settlements contemplate that the Commission will defer imposing financial penalties on the settling firms in order to evaluate, among other things, their performance under the settlements. The SEC staff is now finalizing the settlement terms with the firms which it will then recommend to the Commission for approval. In addition to the first settlements with UBS and Citigroup, the SEC staff and others have reached settlements in principle with Wachovia and Merrill Lynch. And our efforts are continuing.

I would like to thank you for this opportunity to discuss the Commission's efforts with respect to the auction rate securities markets, and I would be happy to answer any questions.

Thank you very much.

[The prepared statement of Director Thomsen can be found on page 137 of the appendix.]

The CHAIRMAN. Thank you for your testimony.

We will now hear from Susan Merrill, the Executive Vice President and Chief of Enforcement at the Financial Industry Regulatory Authority, FINRA.

STATEMENT OF SUSAN MERRILL, EXECUTIVE VICE PRESIDENT AND CHIEF OF ENFORCEMENT, FINANCIAL INDUSTRY REGULATORY AUTHORITY

Ms. MERRILL. Chairman Frank, Ranking Member Bachus, and members of the committee, I am Susan Merrill, Chief of Enforcement at the Financial Industry Regulatory Authority, FINRA.

On behalf of FINRA, I thank you for the opportunity to come and testify here today on these important issues. FINRA is the largest non-governmental regulator of the securities business in the United States. All told, FINRA oversees 5,000 brokerage firms and over 600,000 registered securities representatives.

We at FINRA have been actively involved in working to resolve the issues relating to auction rate securities. From our exam staff to our enforcement team, from our arbitration forum to our investor education group, we have devoted staff from all parts of our organization to provide a comprehensive and integrated response to the recent challenges in the auction rate securities markets.

Along with our regulatory counterparts, FINRA is committed to continue working on these important issues. We share this committee's interest in holding industry participants accountable and pro-

viding investors with real and tangible relief. Today, FINRA is announcing agreements in principle with five firms for violations regarding the manner in which these firms sold auction rate securities. The violations include using advertising and marketing materials that were not fair and reasonable and did not provide a sound basis for evaluating the facts regarding the purchase of auction rate securities.

They also include supervisory violations relating to the firms' failures to achieve compliance with FINRA rules surrounding the sale of these products. Most importantly, in settling these cases, FINRA focused on restoring funds to customers. All of the firms involved in the settlements today have agreed to offer buy-backs of auction rate securities sold to their individual and small institutional investors. This will mean that over a billion dollars of auction rate securities will become liquid again.

We at FINRA think that this is the right result. By expanding our scope beyond those firms that the SEC has rightly focused on, we have protected additional investors and restored funds to a broader span of customers. As for those firms who have not chosen to resolve their regulatory investigations and offer buy-backs of their customers' securities, we will continue to investigate these firms aggressively with a view to bringing enforcement actions where appropriate.

The cases we announce today are the result of the work that FINRA has been doing since the market for these securities froze up and we began to receive complaints in February. FINRA immediately questioned more than 200 firms regarding their holdings in auction rate securities, both proprietary and customer accounts. We then used that information that we gathered in that survey to inform our next steps.

After consulting with the SEC in order to avoid duplication of efforts, we sent out sweep letters in April to 2,000 firms. This summer, we sent out a second sweep letter to more than a dozen additional firms. Fifty-three FINRA staff members conducted on-site examinations of over 32 firms in more than a dozen States. On-site examinations are continuing as we sit here today. All told, FINRA enforcement is investigating over 40 firms in connection with their marketing of auction rate securities.

FINRA has also been active in issuing regulatory notices regarding auction rate securities. These notices provide guidance to firms on critical customer protection issues, including requiring firms to put customers' interests ahead of their own when allocating partial redemptions, and clarifying rules that allowed investors to sell auction rate securities at a discount if they wished to do so.

In addition to our regulatory, examination, and enforcement initiatives, we at FINRA feel strongly that effective investor protection begins with education. That's why in March we published a comprehensive investor alert explaining in plain English what happens when auctions fail and what options are available to investors.

In August, FINRA announced the establishment of special arbitration procedures for auction rate securities cases administered in our arbitration forum. Under these procedures, individuals who have worked for a firm that sold auction rate securities since Janu-

ary 2005 will not be eligible to serve as arbitrators. There are also special procedures for arbitrations filed pursuant to the regulatory settlements with the SEC and with FINRA. But it's important to note that the procedures I just outlined will be available to all auction rate securities investors, whether or not their firm has settled with the regulatory agency.

In conclusion, FINRA has employed a comprehensive and integrated response to the recent challenges in the auction rate securities markets. FINRA will continue to aggressively pursue possible violations by firms and will continue to work with this committee and our regulatory counterparts to advance our essential investor protection mission.

I thank you again for the opportunity to testify here today, and I would be happy to answer any of your questions.

[The prepared statement of Ms. Merrill can be found on page 97 of the appendix.]

The CHAIRMAN. Thank you.

And next, a securities administrator of the Secretary of the Commonwealth of Massachusetts, where we have the securities in his jurisdiction, who has been a real leader in efforts to provide protection here and is incidentally a former legislative colleague of myself, Mr. Markey, Mr. Delahunt, and Mr. Oliver.

So we welcome him here, Mr. Galvin.

STATEMENT OF THE HONORABLE WILLIAM FRANCIS GALVIN, SECRETARY OF STATE AND CHIEF SECURITIES REGULATOR, COMMONWEALTH OF MASSACHUSETTS

Mr. GALVIN. You left out Mr. Lynch.

The CHAIRMAN. Were you gone by the time he got there?

Mr. GALVIN. No.

The CHAIRMAN. Oh, you were hanging on longer than I thought. [Laughter]

Mr. GALVIN. Good morning.

I am William Galvin, Secretary of State and chief securities regulator of the Commonwealth of Massachusetts. I want to commend Representatives Frank and Bachus for calling today's hearing to examine the causes of the failure of the market for auction rate securities and potential ways of making our regulation of the financial securities industry more effective.

I am here today to discuss our findings and investigations into UBS and Merrill Lynch sales of auction rate securities. I feel compelled to say at the outset that there is a much larger issue here, and that is this: The auction rate securities scandal is just one more variation on a reoccurring theme that we have seen before. And that theme is the documented belief of large segments of the financial services industry that they are above the law, entitled to special privileges, entitled to engage in conflicts of interest, and have no duty or obligation to average investors.

I am here to speak of the lessons learned from our investigations and to present proposals for preventing such problems. But I must say that without stricter regulation and sustained and diligent enforcement, this theme will again emerge. Specifically, five basic facts, I believe, arise from the auction rate debacle. They are: Conflicts of interest need to be more aggressively monitored and dis-

closed to investors; financial advisor incentives need to be disclosed; financial advisor training needs to be enhanced; supposedly objective research reports need to be more tightly regulated; and self-regulation is not effective to prevent a scandal such as this one and that the State regulators, in conjunction with their Federal counterparts, need to continue to be actively involved in enforcement actions.

I believe that the need to ask ourselves difficult questions about how we can make our regulatory scheme more effective is especially important given this week's market events. Government intervention is more effective when it monitors aggregate risk-taking and prevents bubbles from building instead of having to bail out the parties after the bubble has burst.

In June of this year, my office filed an administrative complaint against UBS in conjunction with its marketing and sales of auction rate securities. The details of the allegations have been provided in my written testimony. Briefly, our investigation exposed a profound conflict of interest between UBS and its customers, and the devastating effect that this conflict had on those customers. It exposed how UBS was, unbeknownst to its customers, propping up its auction rate market and manipulating the interest rate at which the auctions cleared. It also exposed that as the auction rate markets became more risky, UBS increased its efforts to unload auction rate risk from its own balance sheets onto the accounts of its customers.

In July of this year, my office filed an administrative complaint against Merrill Lynch. The complaint charged that the firm was implementing a sales and marketing scheme which significantly misstated the nature of auction rate securities and the overall stability of the auction market. The complaint also focused on the extent to which Merrill Lynch co-opted its supposedly independent research department to assist in sales efforts be it towards reducing its inventory of auction rate securities.

Our goal has been that all investors stuck in auction rate securities will be made whole. My office as well as other regulators have entered into settlements with UBS, Merrill Lynch, Bank of America, and other underwriters and sellers of auction rate securities. In those settlements, the firms have agreed to repurchase tens of billions of dollars worth of these securities. Much work remains to be done.

However, it is not too early to step back and attempt to draw lessons from this experience that might help us prevent such breakdowns from occurring in the future. The UBS and Merrill Lynch cases highlight the conflicts of interest that can arise between a broker-dealer and its customers. It became apparent that the broker was controlling the interest rates at which most of the auctions cleared. In doing so, the broker was beholden to its investment banking clients to whom it had promised low-cost financing, yet needed to raise interest rates just enough to be able to unload its own inventory onto unsuspecting clients.

Prior to the market collapsing, when each firm made a big push to reduce its own holdings of auction rate securities, it did so by foisting those securities off on unsuspecting clients. These conflicts need to be aggressively monitored to determine whether they fundamentally impair a firm's ability to responsibly attend to its cli-

ents' needs. At a bare minimum, these conflicts need to be properly disclosed.

Two other points which arose starkly in our investigations were the significant incentives to financial advisors to move auction rate products and the profound lack of training those advisors received with respect to those products and their attendant risks.

Most investors assume that the financial advisor selecting financial products for them is indeed applying his or her professional expertise with the primary goal of choosing financial products that are most appropriate for that customer's particular circumstances. However, our investigations reveal that UBS and Merrill financial advisors receive substantial incentives unbeknownst to customers to sell auction rate securities.

I believe that regulators should require a more comprehensive disclosure of the financial incentives that financial advisors receive. This would allow the consumer to better assess whether the advisor is selecting the product based on customer suitability or maximizing commission revenue.

Another proposal that merits serious consideration is explicitly holding broker-dealer agents to a fiduciary standard of care with respect to their customers. Such a step is especially important given the increased complexity of financial products and increased dependence of customers on the advice of their financial advisors.

The next point I would like to discuss is research reports. Five years ago, a number of securities firms including Merrill Lynch reached a settlement with regulators that was supposed to eradicate the conflicts of interest that pervaded Wall Street research and analysis. However, that settlement technically applied to only stock research and not to fixed income research. Merrill was quick to make this distinction in its statement following my division's filing its complaint.

However, the principles underlying the settlement—that research reports presented to the public as being supposedly independent should not be tainted by undisclosed conflict of interest—have not been adhered to in this instance. As a result, more rigorous rules pertaining to research reports are necessary. I believe the overnight disappearance of the $330 billion market for auction rate securities should give pause to those who think that markets can effectively police themselves.

If the free market is to be truly free and survive, it must be saved from its own greed and its repeated willingness to deceive and dissemble in the name of higher profits. The conflicts of interest raised here stand in stark contrast to the idea that market participants guided by principles such as FINRA rule 2110 which imposes high standards of commercial honor will simply follow those principles and do not need more detail regulation.

It is difficult to imagine that off-loading a known and worrisome risk of auction rate failure off a firm's own balance sheet and onto its customers holdings is consistent with high standards of commercial honor. I believe that a move in the direction of principle-based regulation at the expense of detailed and enforceable rules would simply open the door for more misconduct. This point is especially important given this week's market events.

The CHAIRMAN. We are going to have to wrap this up.

Mr. GALVIN. I would conclude, Mr. Chairman, by saying that I think we are clearly at the point in time where the entire market regulatory scheme is going to have to be reviewed and I would urge this Congress and the next Administration to do so with a view towards rewriting the entire system.

I think this episode that we are here today discussing demonstrates the failure of that system, and I would hope that when it is rewritten, it is written in such a way as to protect investors first. That should be the first goal of any financial regulatory system.

I will be happy to answer any additional questions.

[The prepared statement of Mr. Galvin can be found on page 85 of the appendix.]

The CHAIRMAN. Thank you.

Next, another State official who has been very active in the consumer protection field, the Attorney General of Massachusetts, Martha Coakley.

STATEMENT OF THE HONORABLE MARTHA COAKLEY, ATTORNEY GENERAL, COMMONWEALTH OF MASSACHUSETTS

Ms. COAKLEY. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. I, like Secretary of State Galvin, am pleased to be here today. I appreciate the invitation. I am the Attorney General for Massachusetts and our office shares some responsibility with the Secretary of State for public enforcement for securities laws at the State level of Massachusetts.

Our office, as in most States, is authorized to bring criminal and civil actions in our State courts against investment banks, brokers, and issuers who deceive investors or fail to meet required legal standards.

Our office also has exclusive authority to bring actions under our State False Claims Act against entities that mislead towns, cities, and other State entities regarding investment decisions.

Auction rate securities sold in Massachusetts have been a great concern to us, and although these securities have long-term maturities for many years, they have historically been offered for sale at weekly or monthly auctions, which provided, and I stress, the appearance of periodic liquidity. My colleagues on this panel have discussed that.

That is one of the major issues for us in looking at these, was the appearance of liquidity. Because of the supposed liquidity, auction rate securities were touted as being cash alternatives and, when earlier this year the market for auction rate securities dried up, the auctions through which they were sold experienced widespread failures, eliminating liquidity and making it difficult to dispose of the securities at all, much of which has been evidenced by my colleagues here today.

When the securities were written down to reflect the reduced market value, many investors suffered serious losses in their investment principal.

In early 2008, Secretary of State William Galvin talked with our office and he requested that our offices divide responsibility and, frankly, our Attorney General's office concentrated just on the sales to towns, cities, and State entities and focused on whether State

entities as customers were misled regarding the appropriateness of auction rate securities as investments.

We served investigative subpoenas. We met with affected municipalities. We reviewed documents and we took testimony from investment banks and their agents. We carefully scrutinized broker behavior, disclosures, as well as the lack of disclosure, as we had done in the predatory lending market and the behavior of investment banks as they sought to transfer auction rate securities from their own accounts to those of their customers.

Six weeks after starting our review of the investments of Springfield, Massachusetts, and days before the broader market for auction rate securities began to melt down, we recovered from Merrill Lynch at par, the $14 million that Springfield had invested in auction rate securities.

We initiated our review of UBS on the same day. The UBS began letting its auctions fail and we completed that investigation in 10 weeks. There we recovered over $37 million for 18 Massachusetts municipalities and State entities. We began our review of Morgan Stanley in the same timeframe, which resulted in the recovery of an additional $2 million for cities and towns. And finally, last Friday, our ongoing review of Citibank resulted in Citi's agreement to return $20 million to the Massachusetts Water Pollution Abatement Trust.

Our recovery against Merrill was the first recovery by a State in the auction rate arena and our consent judgment against UBS was the first court-ordered resolution by a public enforcer.

We believe that our early investigations and litigation efforts helped jump start the broader resolution process and we commend the terrific work of Secretary Galvin, the SEC, and FINRA, and other regulators in other States for the roles they played in moving the larger process forward.

Let me make three quick recommendations. First, any solutions reached should actually return full investment amounts to all investors. We talked today about agreements to repay. I think it is really important that payments, in fact, be made. Second, that those be made extremely promptly; and third that nonprofit and governmental issuers should not be forced to incur additional expenses and losses as a result of this.

In addition, the committee should not overlook the problems with the underlying assets backing some of these securities, and we have submitted testimony for yesterday's hearings relating to our work around the predatory lending in the subprime market and how that has affected Massachusetts and how we, frankly, have not seen any restructuring of transactions to be successful.

I think that as we have stressed the restitution and having it quickly is important, and our emphasis obviously in State government is for our government entities and our nonprofit entities mentioned by members of the committee earlier, particularly around the student loans.

Finally, even if the committee is able to resolve the immediate auction rate problem, as Secretary Galvin has noted, we still need to consider the stability of the underlying assets that back these notes.

We should be careful to ensure that intermittent liquidity crises in financial markets do not disproportionately harm consumers.

We appreciate the chance to talk to you today. We are happy to answer questions, and more importantly, are happy to work with you as you look at further solutions and other legislation.

[The prepared statement of Attorney General Coakley can be found on page 80 of the appendix.]

The CHAIRMAN. Thank you. When we began, Ms. Merrill, you mentioned that there were five settlements recently reached. I am struck by the coincidence of those individuals, those entities, being willing to sign those agreements on this. Can you tell us who they are? I assume it would be appropriate to know who they are.

Ms. MERRILL. Absolutely. The names of the five firms that have settled with us today—the agreements in principle were reached last night and we are announcing them this morning—are: SunTrust Robinson-Humphrey; SunTrust Investment Services; Comerica Securities, Inc.; First Southwest Company; and WaMu Investments, Inc.

The CHAIRMAN. Thank you. I have a couple of questions. This is one that gets us to another topic, but Secretary Galvin, in an earlier point, was one of those who called to my attention problems with the arbitration procedures, and I believe we had a hearing on this, that the individual one-time investor, or investor engaged in a one-time arbitration, is at something of an institutional disadvantage.

I was pleased that you mentioned some special rules, but my question would be, if those are good rules for this why keep them special? Why not make those rules for arbitration in general in these situations?

Ms. MERRILL. That is a good question. We had a rule that covers exactly how our panels are constructed for arbitration. It would require a rule filing, which would take a good bit of time to get through the approval process, and so we wanted to quickly do it for this.

The CHAIRMAN. Your intention would be to carry that out for other things as well?

Ms. MERRILL. What we are doing in terms of our broader arbitration forum is, right now we have announced a pilot program with 10 firms that have agreed to use a pilot program for a specified number of cases for 2 years where investors can choose a non-public arbitrator or an all-public panel.

Once we see the results of that pilot program we will certainly look at expanding our rule to make that across-the-board, but we are very pleased that the firms have stepped up and agreed to the pilot program.

The CHAIRMAN. All right, well, we will get back to that. I don't want to not raise it, but that is important.

Let me go back to a point that Secretary Galvin raised and that is the principles versus the rules, and I understand the desire of many in our country to say, well, we like more flexibility.

But here is the dilemma that we confront. In a number of cases when people raise objections to certain behaviors, the defense is, well, it wasn't prohibited. That is, people need to understand if they are going to use the absence of a specific in hoc prohibition

as a permission to do something, then the case for more flexibility is undercut.

And I say that because people say, well, we want principles and not rules. I don't know the exact rules that were involved here, and in some cases it would seem to be there were rules probably broken. But I can't imagine that in principle people do not understand this is the wrong thing to do given what has been described.

So I ask the Secretary of State this: Is this an example, frankly, of people taking advantage of an absence of specificity and a case where principles that we would have assumed were pretty generally subscribed to didn't serve as an adequate defense?

Mr. GALVIN. Well, clearly I think that is the case if that were all we had to rely on. In the cases that we brought in Massachusetts, we alleged that there was fraud on the part of the two cases that we actually brought and we were still investigating some of the others.

But I think the absence of detailed rules, the absence of a requirement for our financial advisors to be looking at the financial suitability of certain investments, those are clearly demonstrated by the situation.

Many of the people who called my office, as you have heard from some of the other witnesses this morning, were specifically told that these were "cash-like instruments." They were promised liquidity. They were led to believe, not only because of past practice, but because of what was specifically said to them, that they would have no difficulty getting their money out and that obviously was not accurate; and was particularly sinister when there were firms that knew these things were going down and specifically had made a decision at some point no longer to support them. And that is what we maintained in our complaints.

I think it clearly requires more specific rules, and as I attempted to point out, I think it is a broader issue than just this particular type of—

The CHAIRMAN. The next question is for Director Thomsen. We have had questions in the past. Am I correct in inferring that this seems to be a case where there was reasonably good cooperation between the Federal regulator on the one end and the State regulators, and this is an example of how we might be pulling resources to the common good?

Ms. THOMSEN. I think this is an example of terrific cooperation on all our parts and I should jump in right now to congratulate FINRA on the recent cases.

But when you step back and think about this, the problem really arose in dramatic fashion in February of this year and through the efforts of everyone here, State regulators, Federal regulators, FINRA, we have reached a solution for retail investors in very short order that gets them 100 percent liquidity back and we have worked together to get that. It is really an exceptional result and it does reflect all of us working together, I think, quite well.

The CHAIRMAN. Thank you. I have to step out for a little bit and Ms. Waters will preside. I will be returning.

Ms. WATERS. [presiding] Thank you very much.

Mr. Bachus, our ranking member, for 5 minutes.

Mr. BACHUS. Thank you. Director Thomsen, what is the status of the Commission's examinations that were announced July the 13th to examine the controls against manipulation against security prices through the intentional spreading of false information?

Ms. THOMSEN. Well, let me talk generally about where we stand with respect to that, the concern about spreading false rumors. As you pointed out in your opening statement, if people are engaged in spreading false rumors, driving stock prices down, that conduct is reprehensible. It is also illegal.

Mr. BACHUS. Pull the microphone a little closer to you. That is good.

Ms. THOMSEN. Over the past several days, as you have noted, we have increased our efforts and our tools. As you may know, earlier this year, a few months ago, we brought our first case against someone for spreading a false rumor. It was the Berliner case. It was brought shortly after Bear Sterns collapsed.

We have been investigating aggressively, and as of 12:01 this morning, new rules went into place to put further controls on abusive short selling, naked short selling.

Last night we announced that the commission is going to be requiring reporting of short positions by large investors, which will help in both transparency and in law enforcement and, as you know, as part of last night's announcement, I made clear that the Enforcement Division will be pursuing these issues with a vengeance.

Mr. BACHUS. How quickly will the SEC be able to detect whether illegal trading or manipulation through illegal short selling is going on?

Ms. THOMSEN. I am not going to lie to you. These are difficult, difficult investigations. It is going to require lots of hard work, but we are deploying lots of resources to get there.

We will follow the evidence as quickly as we can and if there is evidence we will bring those cases as quickly as we can. We want to make sure if we bring those cases we have the evidence to sustain the action because, as I say, I think the behavior, if it can be established, is reprehensible and as I said, it is illegal.

Mr. BACHUS. Let me ask this question to FINRA and Ms. Merrill. The current broker licensing examination doesn't have a single question on auction rate securities. Is that an omission and should questions be asked of financial professionals, people who want to be in this regard?

Ms. MERRILL. Well, I think your question highlights an issue with auction rate securities that we are looking at internally at FINRA, and that is something that we look at on a risk-based basis.

We saw the securities as relatively low risk. Certainly on an examination for a registered representative, you can't ask about every product that a rep can sell, and so this one may not have risen to the level.

But now as we look back at this, we can see that there may not have been such default risk, but certainly there was liquidity risk, and since that is the way this product has really been marketed, as liquid, that is what we really need to go back and examine.

Mr. BACHUS. Are you all going back and looking when you train those who are going to market financial products and license them, whether there are other areas other than maybe auction rate securities where they simply don't have the expertise to market certain things; they don't disclose things because they may not know?

Ms. MERRILL. Training is so important. Firms are responsible for training their registered representatives, of course well beyond the licensing, the initial Series 7 test. And what we found when we went out and interviewed the brokers who are actually on the phones and talking with investors is that many of them did not appreciate the liquidity risk. They didn't understand the auction, and that is a failure of the firms to train their reps.

Mr. BACHUS. Okay, thank you. And that is with today's announcement that 16 firms that have made agreements. You still have about 35 now with the smaller firms, but some of the main street firms or regional firms, are you making a lot of progress with the other 35 firms?

Ms. MERRILL. Yes, most of the firms, in fact, that we are looking at are the smaller, downstream firms. The issues there are different from the cases that have been brought by Secretary Galvin and by the SEC and other members of NASAA insofar as these are really not fraud cases, but we do believe that every broker-dealer has the responsibility to be marketing the product fairly; and they may say that they didn't know that there were cracks in the auction rate system, but the way they market, the types of disclosures that they make have to be fair and balanced.

So we have made progress with the firms that we are looking at. We will continue to look to see if there have been rule violations, particularly the advertising and supervision rules. Where we find those violations we are going to apply pressure on these firms to do the buy-backs.

Mr. BACHUS. Thank you. I want to commend the Attorney General and Secretary of State of Massachusetts. I think your efforts have led to some recoveries in other States. I think you benefitted people not only in your home State, but across the United States, with some of your investigations.

Ms. WATERS. Thank you very much. I will recognize myself for 5 minutes, and I would first like to begin by congratulating and commending all of you for the work that you have done in helping to make sure that the investors are made whole, that they are taken care of.

That is good work and I have a real appreciation for that, but I would like to continue a little bit, my questioning, to ask about what I would consider preemptive work, or the kind of work that regulatory agencies do that avoid the problems in the first place.

And, of course, as we have entered this very difficult economic period, our own regulatory agencies that we are dealing with, not just with SEC, but as we are taking a look at what we are confronted with now, we are wondering what can be done.

What can be done to identify, to be able to determine through auditing, when these problems are beginning to surface? Do we have to wait until we hear from investors who are now screaming and calling and accusing and very, very worried and very scared that they are going to lose everything? What can we do? What can you

do to prevent—and let me start with the SEC—I know you are Enforcement, but what can be done before?

Ms. THOMSEN. Well, thank you very much, and it is a very important question. To a certain extent there is a part of me that thinks when Enforcement gets involved, we have already missed some opportunities and we would like not to miss those opportunities.

But as Secretary Galvin noted, we are not so naive as to believe that we are not going to be necessary in some instances. I think as we have talked about, the problem here is largely one of sales practice; and that is an important issue to address.

It is important for all of us to focus on the training of sales reps and registered representatives who interact with customers, especially retail customers, to make sure they understand the products that they are selling. So that is one thing that we can focus on and that the firms can focus on. It can surely be something that we focus on during our examinations.

It is also the case, as Secretary Galvin noted, that many of the issues that arise in the securities field arise due to conflicts of interest. It has been noted oftentimes in the past that we cannot eliminate those conflicts, but we can disclose them, we can manage them, and we can train around them.

I think one of the things that has been most dramatic here as we have dug into the facts is to see how little various registered representatives understood about the products that they were selling to their customers.

We also do need to be alert to changes in markets and think about what we do when those changes occur. Secretary Galvin noted that in some instances compensation was increased to encourage the sales of products.

I think that is one thing we can look for in examinations because that may change the incentives. We need to look at compensation structures, but it is also something firms can be alert to as they change their compensation practices to think about why they are doing it and what does that mean from a conflicts perspective.

Ms. WATERS. Let me just ask Ms. Merrill, in keeping with this conversation, discuss criminal penalties with me. What are the penalties?

We discovered in the subprime meltdown that, for example, in California there were two ways that real estate loan initiators could sell the products on the street. One was they could go through a licensing operation that we have; or the company, such as Countrywide, who is licensed, could then hire a salesperson who did not have to go through the licensing examinations, and they put them on the street; and we are finding that not only did a lot of our citizens and consumers get seduced into products that they did not understand, but perhaps the salesperson didn't understand them or misrepresented knowing that these ARMs and these other very exotic products were going to place these people at risk.

So let's talk about penalties. What should the penalties be? What are they?

Ms. MERRILL. In FINRA, our penalties in auction rate cases and our whole settlement structure has been focused on getting money back to investors. As I mentioned, the firms that we have been fo-

cusing on are primarily the smaller, downstream firms where we have not seen evidence of fraud. So without evidence of fraud, where we are enforcing our advertising rules and our supervision rules, we focus primarily on the remedy to customers.

We do have fines associated with our cases today as high as $1.65 million down to about $250,000. Those fines are meant to give those firms credit for the fact that they stepped up and bought back these securities from their investors, and that has really been our motivation.

The question that you asked before about what we can do to make sure this doesn't happen again, I assure you is a question that we have been asking ourselves internally at FINRA.

We have a group called the Emerging Issues group. We try to stay ahead of the curve on emerging issues. We talk to member firms. We talk to customers to find out how things are being marketed to them. We read the academic journals to see what is on the horizon and we are very concerned not only about the cases that we have brought today, but what other kinds of products are being marketed as cash alternatives or cash equivalents. Are they really cash equivalents and is the way these other types of products being marketed fair and balanced?

Ms. WATERS. Thank you very much. Mr. Shays for 5 minutes.

Mr. SHAYS. I am pretty convinced that those who were marketing these in a way that didn't represent an accurate picture are going to pay a penalty, and I am pretty content that fact has been established.

What I am interested to know is, and I guess I would ask the SEC, are auction rate securities going to disappear? Are they the same for the corporate, the student, and the muni? I mean, what is going to survive here?

And then I would like to ask the State folks if they had any sense, is the State out of the picture in terms of student loans right now? I am really concerned about student loans and I hope I get something from this hearing that has me feeling somewhat hopeful; and if not hopeful, at least a realistic picture of what is happening.

Ms. THOMSEN. Thank you. It is an excellent and difficult question. First, to start where you started and to reiterate some of the things that have already been talked about, yes, the individuals who have been involved in bad behavior will be pursued. We have not yet brought individual cases, but we continue to pursue them. We will bring remedies against them to the extent we can establish cases. And that will also serve a deterrent purpose and help us avoid things in the future.

As to the future of the auction rate securities markets, I think right now it is a difficult time for anyone to try to raise capital through an auction rate securities process in part because of the failures that have been demonstrated in this market.

You would have a very difficult time suggesting to an investor that these securities are liquid against the current—the freezing up in February. So I think it is fair to say that raising capital through an auction rate securities process is difficult right now.

Mr. SHAYS. In all three areas: Municipal; corporate; and student?

Ms. THOMSEN. I believe in all three, and I have to say that I believe that student loans are the most difficult because of the inter-

est caps that are associated with student loan auction rate securities.

Now on the good news front, to the extent there is some good news in all this, there is liquidity that is being restored to these markets, in certain instances, even in, to a limited extent, the student loan market. And people are engaged in some refinancing and whatnot, but I think the product itself is going to have to change—if it is going to be marketed as a liquid investment, that development's to assure that liquidity are going to—

Mr. SHAYS. And we are really talking, this is impacting the State loans student loans, not the Federal. Can either of you—

Mr. GALVIN. I think it has primarily affected student loan authorities, which many States have established.

I can tell you that in Massachusetts, the Massachusetts Educational Loan Association had suspended loans back in July causing great difficulty. Fortunately just yesterday or the day before, they were able to announce that they have secured some funding.

I think the general point regarding auction rates is probably true, that I think not just because of the bad press, if you will, associated with auction rate, but the whole concept of this auction has been discredited because the auction was, in many respects, a fantasy; it never really happened.

Mr. SHAYS. Right.

Mr. GALVIN. I think the bigger issue as far as financing educational funds is going to have to be approached from a number of different ways.

One way possibly is to have States, which was not the case specifically in Massachusetts but was suggested, have the States behind it with their State credit to verify for the authority to be able to go out and solicit some sort of financing.

Others have suggested, and I found this an appealing thought, I suppose it wouldn't apply for everybody, but that some of the large endowments of educational institutions ought to be sought out to be invested to support these funds. Many educational institutions enjoy very large endowments. I know in my State, and I believe in yours, they may well also be a source. I mean, these endowments—

Mr. SHAYS. Right. The bottom line is, though, you agree. This is an issue that we have to pay—

Mr. GALVIN. Yes, I would certainly agree. I think that for many students right now this is a critical time—

Mr. SHAYS. I just want to ask one last question and it is a real curiosity to me. If this has been an instrument for 24 years, has false advertising occurred all throughout 24 years?

Mr. GALVIN. I rather doubt it. I can't answer you decisively, but I believe that it became a practice, and because these instruments were successful for so many years and they worked for different consumers, they worked for the institutions who were trying to get some advantage to their debt, they worked for individuals who were looking for a slightly better rate. They did work, and as a result of the credit freeze-up as a result of the market starting to fall apart, they, indeed, became inoperative.

What we became involved in, and I think it has already been referred to here by myself and others, is that at some point the mar-

ket makers became aware of that and instead of dealing with it in an upfront way, they went ahead and deceived people.

Mr. SHAYS. Yes, that point was made, I'm sorry. I appreciate you emphasizing it. Thank you all. Thank you, Madam Chairwoman.

Ms. WATERS. Thank you. Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. Thank you very much and I thank all of the panelists. I would like to ask Ms. Thomsen and the SEC, when you censured in 2006, why did you not impose transparency in the auctions then? As I understand it, there was an investigation in 2004. Why did you not require disclosure just like the U.S. Treasury does on all of its auctions?

Ms. THOMSEN. Thank you for that question, and indeed there was a requirement of disclosure at that time. The investigation into auction rates that resulted in the actions in 2006 focused on—

Mrs. MALONEY. Excuse me, there was a disclosure requirement, a transparency requirement in 2004?

Ms. THOMSEN. In 2006 as a result of—

Mrs. MALONEY. Can the committee get a copy of that?

Ms. THOMSEN. Oh, sure.

Mrs. MALONEY. Did it talk about the fees and the fact that it is not cash and that it is really a hazard for people to get into?

Ms. THOMSEN. Excuse me, I misunderstood. The disclosure that was required in 2006 and the investigation that led up to the cases in 2006 had to do with how the auctions were conducted and the way the firms conducted the auctions, which included the fact that the firms went into those auctions and in some cases sort of gamed the system to get the price sort of in the "sweet spot," if you will.

Mrs. MALONEY. So you were looking at how the firms were gaming the system. Was there any disclosure or transparency that was given to issuers and investors to tell them about the risks? My constituents told me that they were told, "This is as good as cash," then they found out they couldn't get their cash. So they feel they were manipulated or treated criminally. And I just want to know, do we have any transparency now letting buyers know about the risks that are involved, and if not, why don't we start SEC rulemaking immediately so that this type of scam doesn't continue?

Ms. THOMSEN. There are certain kinds of disclosures that are associated with this, and there are certain disclosures that did not go to investors, as we have talked about. The investors, as a result of our action in 2006, for the firms who were part of that process, are given disclosure or have the opportunity to see disclosure about how the auctions operate.

Mrs. MALONEY. Are they told that it is not cash? I am told they were told it was as good as cash. It is not. Is your transparency telling them how risky it is, how many billions of dollars have been lost, how taxpayers have been hurt, how localities have been hurt? Are you disclosing that, and if not, why are you not disclosing that now in the billions of auctions that are currently being conducted each day?

Ms. THOMSEN. I think it is fair to say that as a result of this investigation and focusing on the sales practices, it is clear that investors were not told about the potential liquidity risk and—

Mrs. MALONEY. Are you telling them now?

Ms. THOMSEN. Well, right now there is no requirement for paper disclosure or written disclosure with respect to this. Indeed, most of the—

Mrs. MALONEY. Why not? We know that millions and millions of dollars have been lost, there have been two suits settled, and we know that—

And I want to bring into this and congratulate the State of Massachusetts for your 2008 lawsuit where the Secretary of State—I find this astonishing, really astonishing—the Secretary of State revealed that going back to 2006, nearly 85 percent of the auctions would have failed or produced different results without the single brokers intervention. So what are we doing to stop this conflict of interest?

And the SEC, I have to tell you, I have constituents who have lost their jobs, they tell me, because the SEC didn't act quickly enough to stop the naked shorts. I am glad that you have finally stopped it, maybe it can save some other firms. But we know about this scandal now, and why are we not telling clients and individuals and investors and issuers about this horror that it is not cash, they can lose all their money, they will not get their hands on the money, not to mention the taxpayers who are supporting these institutions that go into them, they are not being made whole.

So a lot of people are losing in this, and I think they should be told. Why aren't we telling them?

Ms. THOMSEN. The disclosure obligation is on those who are selling the product and it is a secondary sale, by and large—

Mrs. MALONEY. Well, why aren't you requiring them to tell the innocent people who are being lied to? You are telling me they were lied to. Why don't we get an SEC rule in tomorrow that says don't lie to investors and to consumers, let them know that it is not cash, that they can lose their money, and that there have been two lawsuits. Why are we going to continue?

We are in a financial crisis. We cannot continue financial practices that lose money, hurt communities, hurt consumers, and hurt investors.

Ms. WATERS. Mrs. Maloney, let us hear her—

Mrs. MALONEY. My time has expired.

Ms. WATERS. No, we want to hear a response in your time. You asked questions that have not been answered yet.

Ms. THOMSEN. We do have rules, and in fact the fact that we are able to bring the cases that we are bringing right now demonstrates that registered reps cannot lie to their clients, they cannot tell them false information, they cannot represent something to be liquid that isn't, and that is what we are doing with our law enforcement efforts here.

Mrs. MALONEY. I would like a point of clarification in writing. Constituents are telling me that they are being told that they can get their cash back, but the State of Massachusetts went to court over this, that they can't get their cash back. Some of them, to this day, can't get their cash back. So are we clearly telling people in the disclosure that this is not cash, that you can lose your money? If you could just get back to us in writing exactly what you are doing.

Ms. THOMSEN. Oh, sure. But the actions here, what happened was people were told information that was false, and that is why we are bringing the actions that we are bringing, and that is why we were able to get the resolutions we were getting. But you are absolutely right, investors should not be lied to, and brokers and registered reps who lie to them should be accountable for those lies.

Ms. WATERS. Thank you very much. Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you. I am going to deviate a little bit from what we have been talking about.

Director Thomsen, I think last year the SEC repealed the Uptick Rule, and I have had a lot of conversations with a lot of folks here recently who tell me, really, with the change of that, it almost becomes a self-fulfilling prophecy that now are people are shorting on a downtick, and that you keep shorting and the ticks. One of the reasons that the Uptick Rule was actually put in place back in the 1930's was to bring some stability to the markets. Is it time to reconsider the repeal of that Uptick Rule in this environment that we are in right now?

Ms. THOMSEN. Well, as you know, I do enforcement, but I have to say that the Commission has obviously been extraordinarily busy considering the substantive area that surrounds the Uptick Rule. So for example, the rules that went into place this morning at 12:01 that relate to short sales, a hard delivery requirement, the exclusion of certain exceptions under reg show, an additional antifraud rule, all of which into effect at 12:01 today, the requirements that are going into effect to report short positions on an extremely timely basis as well as the enforcement initiatives that are underway and will continue to be underway, I think they all demonstrate the Commission's acute focus on the subject matter of how to address abusive trading.

Mr. NEUGEBAUER. So back to my original question: Do you think it is appropriate at this time to review that rule?

Ms. THOMSEN. I think the Commission is reviewing all rules and reviewing all options to address market conditions.

Mr. NEUGEBAUER. As we are requiring a number of these firms to re-purchase a number of these auction rate securities, are we in any way possibly jeopardizing the liquidity of some of those firms by putting this enforcement action on them and maybe creating some other problems?

Ms. THOMSEN. As I mentioned, it was something that we took into account as we thought about the remedy and how to get to the remedy. I mean first and foremost, I think we were all focused on restoring liquidity to investors who had done nothing wrong and found themselves without liquidity. But the cost of restoring liquidity is, as you suggest, quite high.

So we worked among ourselves, we talked to—certainly at the SEC we talked to our experts in the division of trading and markets to understand what were the firms' positions and what they could undertake and on the timetable they could undertake it. We talked to the firms themselves who reached these agreements. Everything we are talking about is something that firms agreed to and they are very sophisticated firms so we expected them to be worrying about their capacity as well. We also, through our division of trading and markets, reached out to other Federal regu-

lators, the Fed and Treasury, to understand the positions of the firms.

Baked into these resolutions you will see things like timetables, and I think at a certain level, all things being equal, you want liquidity restored yesterday and the day before and the day before that. But I think the fact that there are timetables built into the settlements reflects the fact that people were taking into account the capacity, if you will, of the firms.

So I think we have worked very hard to get to a resolution that is good for investors but also takes into account the cost.

Mr. NEUGEBAUER. Are there auction rate securities that have begun to trade again in auctions that have been successful?

Ms. THOMSEN. Yes.

Mr. NEUGEBAUER. Is there a particular sector where that has been more prevalent, or is it a—

Ms. THOMSEN. Well, I know the one that is hardest hit is student loans, and the others are coming back. And others, some of the issues are being restructured so that, essentially, they are being redeemed and restructured in different kind of financing.

Mr. NEUGEBAUER. I yield back. Thank you.

Ms. WATERS. Thank you very much. Mr. Watt.

Mr. WATT. I thank the chairman and the chair pro tem for the recognition. I am going to get to a point which I think Mr. Galvin was about to get to when he almost ran out of time, at least I hope that is where he was about to get to.

The thing that surprised me as the chair of the Oversight Subcommittee of this committee more than anything else is two reactions following this whole big market thing, including this part of the meltdown. One is everybody is looking for somebody to blame, and there is a strong desire for retribution. I want to punish somebody, why haven't we put somebody in jail? And that reflects itself with me as chair of the Subcommittee on Oversight because people keep asking me to have hearings about what created this problem and who is at fault.

I have quite honestly and publicly been very vocal that I have no intention of having that kind of hearing unless the chair, of course, asks me to have that kind of hearing, because I think we need to be focused more on getting the heck out of this crisis right now than who was to blame for it or punishment. We don't punish in the Legislative Branch anyway. Some prosecutor needs to go out there and investigate and indict somebody, and there are a bunch of people out there who I think are qualified for that, but that is not my job.

And even the suggestions about reform, really, that I have seen, haven't been suggestions about reform. They have been about restructuring the regulatory system, who is in charge rather than what the person—I mean we had regulators regulating all of this stuff, and if they had been competing to do their job rather than competing to protect their particular constituencies in their industries, we probably would have avoided a lot of this stuff. So this whole restructuring thing about, "Let's name a new regulator," seems to me to beg the question, "What is the regulator going to do?" And even all of this discussion this morning, except when Mr. Galvin was about to get to it and ran out of time, hadn't gotten to

that question. We have talked about who was at fault, who did what bad, we need to restructure, we need to realign the regulation.

And the single question that I keep asking, and I would like each one of you four just to tell me one thing that you would do in terms of a specific regulation that would stop this from happening in the future, because we have to do something. We are already here. Sure we have to dig ourselves out of the ditch, but I am looking for something that will stop future crises of this kind from happening.

I have given my speech. Now just one thing. Don't tell me realign the regulation because that doesn't tell me what that new regulator is going to do. Tell me, whomever the regulator is, what they ought to be doing to prevent this from happening again. In your little area of the world, here, please, just give me one suggestions.

Ms. THOMSEN. I think we ought to do more of what we did in this particular cases, which is to work together and bring swift law enforcement action to those who have engaged in wrongdoing.

Mr. WATT. Unresponsive, I'm sorry. Go ahead, Ms. Merrill.

Ms. MERRILL. I wouldn't write a new rule. I think we have a lot of regulations that cover what we saw here, and that is why we have been able to bring the investigations and the cases that we have brought. What you are asking is how can we keep from having to bring an action, how can we keep there from being this kind of thing again. And there I think we have been looking internally, in that when we go out into firms and do—

Mr. WATT. Ma'am, don't tell me what you have been doing, tell me one thing that you would do to stop this from happening in the future, please.

Ms. MERRILL. I would question firms at our on-site examinations about how they are actually marketing cash equivalents, over the phone to their customers, and not just look at the script, but question people about what they are saying, are they disclosing the risk?

Mr. WATT. Mr. Galvin. I am sorry.

Mr. GALVIN. Thank you. If I were to summarize in one idea, it would be to revisit the idea of whether the significant or substantial repeal of Glass-Steagel in the late 1990's was a good idea. I think by taking down the wall that existed between investing and banking, you open the door for many conflicts, and I think if we are going to be serious about regulation you have to have rules that make some sense, and I think this one didn't, and it is time to change it again.

Mr. WATT. Ms. Coakley.

Ms. COAKLEY. Two things, and they are included in Secretary Galvin's testimony. I think you have to prohibit some conflicts of interest now, and I think you have to require disclosure on others. And the second piece is I think you have to look at the financial incentive piece. You have to prohibit some of them and you have to disclose others. That has been at the root of the subprime mortgage problem, and it is at the root of this.

They all come from the same lack of appropriate disclosure by those who are involved in this. And I say this as an enforcer, I'm not a regulatory body, Secretary Galvin is. But we can do the au-

topsy in what happened in the subprime mortgage, we can do the autopsy in what happened here, and I think Secretary Galvin very succinctly says we need to change those rules, how people play this game, because otherwise we are going to be back here in 5 years or 10 years with all of these enforcement actions.

Mr. WATT. I yield back. Thank you.

Ms. WATERS. Thank you very much. Mrs. Capito for 5 minutes.

Mrs. CAPITO. Thank you, Madam Chairwoman.

First of all, before I begin, I would like to ask unanimous consent to enter into the record prepared statements submitted by the Municipal Securities Rulemaking Board and the Regional Bond Dealers Association.

Ms. WATERS. Without objection, it is so ordered.

Mrs. CAPITO. Thank you. I would like to bring the questions down more on a street level, I guess. Could you quantify, just approximately, how many holders of these kind of securities would have been entities and how many would have been individuals?

Mr. GALVIN. If I may, I think it varied by firm. Some firms tended to sell a higher percentage of theirs to institutions, nonprofits, for instance. Other firms had a higher percentage that were amongst individuals.

That is why, when we worked out these settlements, we focused on different categories such as so-called "retail investors." Those were individuals, and small businesses, which, again, it varied from case to case, but we set a dollar amount, usually about $10 million I think was the number we were working with, and then the larger so-called institutional investors which were in most of the settlements the last category. The theory was that the smaller people, the individuals, were probably less sophisticated and also, presumably, more in need of the money, whereas the theory was, fair or unfair, that the institutions were in a better position long term. There is a best efforts requirement on most of these agreements.

Ms. MERRILL. I have some statistics that we were able to gather through our survey of over 200 firms; 43 percent of auction rate securities were held in retail customer accounts, another 21 percent were held by customers who were considered high net worth individuals, and 37 percent were held by institutional accounts.

Mrs. CAPITO. Okay, great.

Ms. THOMSEN. And to add something else, we believe that while there were more retail customers in terms of numbers of customers, that the holdings were about 50–50 between retail customers and institutional customers.

Mrs. CAPITO. Okay, another question I have is, for the individual who is holding a bond, can you make a distinction—if somebody is watching this today and they are holding something in their account that they thought was a very solid State instrument or something that was—how can you make a distinction for them between what they are hearing today and what they are holding now?

Ms. THOMSEN. Well, I think you raise a very good point and something that we ought to mention is that by and large, the underlying securities on all of these auction rate securities remain solid. That is, the expectation is that the bond will pay off accord-

ing to its terms. What has really been lost is the liquidity, which was what it was marketed to be.

Mrs. CAPITO. So you couldn't turn around and—

Ms. THOMSEN. Exactly. People thought that they could immediately turn this investment—

Mrs. CAPITO. Even if it had a 30 year—

Ms. THOMSEN. Even if it was a 30-year maturity.

Mrs. CAPITO. Okay. Let me switch gears a little bit here then. So the institutions or the folks who have been issuing these universities—I mean I represent a small area—government entities. How is there liquidity now and they are going out in the market and trying to build a new wing to the hospital, create a new ambulance authority, or whatever transportation or infrastructure. Where is that now? That really troubles me because we want to move forward, obviously, for a lot of different reasons, but there are a lot of jobs involved in a lot of this issuance as well.

Ms. THOMSEN. Well I think this, as a fundraising vehicle, capital raising vehicle, is not as attractive as it once was. Even at the time people were using auction rate securities to raise capital, there were alternatives in underwriting, for example, that were more expensive. But I think across the board, not just municipalities, but for just about anybody trying to raise capital, it is a difficult and more expensive environment than it was.

Mrs. CAPITO. So it is tight.

Ms. THOMSEN. It is tight.

Mrs. CAPITO. I noticed, too, in our briefing papers that the issuers of these auction rate securities were allowed, permitted in February, to begin buying their own paper, essentially. Is that still going on, and what is the situation in terms of—it seems to me that could be almost a double hit in some ways.

Ms. THOMSEN. Well it was allowed and—okay, I have the numbers here. The public sector borrowers have now refinanced or made plans to refinance at least $103.7 billion of the original outstanding $166 billion in municipal auction rate debt, of 62 percent, according to data that was compiled by Bloomberg. So that answers your prior question.

The rule that was put in place in March is still in effect, as I understand it, and I think I am going to have to get back to you on the impact of that.

Mrs. CAPITO. Okay. Thank you.

Ms. WATERS. Thank you very much. Mr. Scott, we are going to take you, one from Mr. Royce, and then we are going to go vote, and then we will return.

Mr. SCOTT. Okay, thank you very much.

Let me start off by asking, put a quantity around this. There is $300 billion worth of investor funds that are still locked up, is that right?

Ms. MERRILL. No, they are not still locked up today. That number has shrunk dramatically over the last few months thanks to the efforts of the regulators and also thanks to some restructuring on the part of the issuers. I think we are down into the 100 billions now, which is still quite a lot.

Mr. SCOTT. And many of these are small investors?

Ms. MERRILL. That is right.

Mr. SCOTT. As we got into this, basically the auction rate security market, as it was set up, basically catered to your smaller individual investor, and as the crisis kind of got worse and kind of drifted in and the big banks came to be more relied upon as participants. As many of these smaller investors are now unable to sell these liquid securities, they haven't even looked elsewhere for satisfaction, but there really aren't many places that they can go for help, is that correct?

Ms. MERRILL. I think the market actually started out as a more institutional market, and over time the issuers allowed a smaller amount to be the minimum that you could invest in an auction rate security, and once that amount got down to about $25,000, that is when you started to see more retail investors buying the product and the broker/dealer firms marketing to more retail investors. Those investors do, of course, have other options of where to put their money. This was marketed by many firms as a cash equivalent, which we think was not a fair and balanced way to market it, particularly firms that didn't highlight the liquidity risk if the auctions failed.

Mr. SCOTT. So many of them, their course of action would be, as some of the broker firms, some of the larger investors, were to file lawsuits, and these lawsuits have been settled with them. I am interested to know, given the smaller investor, how many lawsuits have been filed by small investors in this debacle?

Ms. MERRILL. We have about 300 claims that have been filed in the FINRA arbitration forum by investors. Some of those, undoubtedly, will be dropped because some of those investors will be part of the buybacks that have been announced today and previous buybacks have been announced by other regulators. But certainly there are small institutional investors whose firms have not yet offered the buyback. We have the FINRA arbitration forum available for them and we have set up special procedures to make sure that those claims are being looked at fairly and effectively.

Mr. SCOTT. And it is fair to assume that many of the financial institutions, brokerage firms who represent these smaller investors, one could say played a role in this. Are they playing a role in helping these small investors, and what are the regulators doing to help the small investors? My information tells me that the lawsuit option has not been that good for small investors because to file a lawsuit costs a lot of money in many cases, so that is not an alternative. And my picture of this is some of them are just left swinging in the wind here, so what are we doing? Are the brokerage houses, many of them who might have inadvertently helped get the small investor in the mess as it is, are they working, are they doing some things? And then what the regulators doing to help these small investors?

Ms. MERRILL. What we have been doing at FINRA, really from the beginning, is focusing on getting money back to retail investors. Our enforcement investigations, I believe, have provided the incentive for firms to step up to the plate and offer buybacks to their customers. We have five of those cases today; $1.8 billion worth of auction rate securities will be bought back. Other regulators, the people on the panel with me today, have other settlements that

have freed up over $40 billion, I believe, in auction rate securities. So we are focusing on getting those funds back.

I agree with you that the best solution is to have the firms do the buybacks as quickly as possible, but we do have the arbitration forum there for customers whose firms have not yet entered into those settlements.

Mr. SCOTT. Thank you very much.

Ms. THOMSEN. I think it is fair to say that the settlements to date, and including the ones that FINRA just announced, if you focus on retail investors, the smaller investor, a large majority of those investors will have the opportunity to get cash back, 100 cents on the dollar, all of their interest paid to date as well as an opportunity to recover any consequential damages through a FINRA process that is quite streamlined without ever having to file a lawsuit.

Mr. SCOTT. That is good to hear. Thank you.

Ms. WATERS. Thank you very much. We have 5 minutes to get to the Floor. Mr. Royce has a burning question that he wants to ask.

Mr. ROYCE. Just one. Director Thomsen, the settlements have not specified how individuals' funds held in fiduciary accounts and invested short term in student loan auction rate securities and now due back to the individual investor, or for closing an individual transaction, how that is to be handled. And the investment banks who sold the student loan auction rate securities for short term investment are unsure if they are to redeem these smaller individual investments held in fiduciary accounts on the front end of their settlements. For example, should they be treated the same as any individual holding the security directly? That is my short question.

Ms. THOMSEN. And our objective is to get the small retail investor redeemed early and first, and we are working out those details as we finalize these settlements.

Mr. ROYCE. In terms of this fiduciary account situation, that would be an affirmative or—

Ms. THOMSEN. It will be something that we are going to address as we finalize it.

Mr. ROYCE. Thank you. Thank you, Madam Chairwoman.

Ms. WATERS. Thank you very much. Panel, you have been very patient and very good. However, we do have other members who have questions that they would like to ask.

We have to go to the Floor; we have two votes. One is a 15-minute vote, and the other is a 5-minute vote. If we go and take these votes, and take about 5 minutes to get back, we should be back in 25 minutes, so I would like to ask you to please remain so that our other members will have an opportunity to ask their questions. Thank you very much.

[Recess]

Ms. WATERS. The committee will come to order. I would like to ask our panel, Ms. Thomsen, Ms. Merrill, Mr. Galvin, the Honorable Secretary of the Commonwealth of Massachusetts, and the Honorable Martha Coakley, Attorney General, to please return, and we will start with Mr. Green of Texas for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman. I thank the witnesses, the members of the panel. I thank the chair of the full com-

mittee. Let's start with acquiring a better understanding of what the auction rate security is. We are talking about a long-term bond that has short-term interest rates that are reset about every 28 days, and they are reset as a result of an auction process.

Now when we say that it fails, that we had a failure of an auction rate security, what does that mean, in essence? What happened in the technical sense, in the procedural sense, what happened? Some folks showed up to bid, or what happened?

Ms. THOMSEN. There aren't enough buyers.

Mr. GREEN. And when you have a dearth of buyers, how does that impact the sale itself, the actual—

Ms. THOMSEN. The holders continue to hold the security. There's no sale. So you continue to hold the security, and if—in a failed auction, the interest rate typically goes up, the interest rate paid to the holders is—gets higher and it goes high enough in theory that the expectation is that there will be an incentive at the next auction for there to be buyers, or for the issuer to restructure because it's an expense—

Mr. GREEN. Would you define "holder" for me, please?

Ms. THOMSEN. The people who bought the securities in the past auction and who hold them.

Mr. GREEN. So the person who purchased initially in this process in a past auction when they had a failure, and you didn't have enough buyers, that person had a smile, and said, wow, my interest rate just went up?

Ms. THOMSEN. If what they are looking for is interest rate, that's right.

Mr. GREEN. Okay.

Ms. THOMSEN. The interest rate went up.

Mr. GREEN. Okay.

Ms. THOMSEN. If they are looking for liquidity, they will have a frown.

Mr. GREEN. But if the interest rate is important, then that was a good thing for this person?

Ms. THOMSEN. Absolutely.

Mr. GREEN. The interest rate just went up. Does it go up exponentially?

Ms. THOMSEN. It goes up—depending on the type of security, whether it's corporate or whether it's a student loan.

Mr. GREEN. That's a good point. Let's talk about the type. Individuals can purchase auction rate securities, correct?

Ms. THOMSEN. Yes.

Mr. GREEN. And you have classes of individuals. You have the average Joe, a person like me who might have $25,000 that he scraped up and he buys, and then you have a wealthier class of individuals as well, two classes?

Ms. THOMSEN. Yes.

Mr. GREEN. And these individuals who are holding long-term bond, short-term interest rate, interest rate goes up, initially, the impact is not adverse to their best interest if they are not interested in immediate liquidity?

Ms. THOMSEN. If they are not interested in liquidity, they have earned a higher interest rate. That's correct.

Mr. GREEN. So it's the liquidity that creates the problem in terms of persons coming in and saying, hey, I need my money now—

Ms. THOMSEN. Exactly.

Mr. GREEN. —and I would like to have the interest rate that you promised me as well. That works pretty fine, it works well as long as everybody doesn't show up at the same time usually. Is this one of those cases where if some show up and say I need my money it's okay, but if you have a great number that show up, you have a problem?

Ms. THOMSEN. No. It is an auction, so the people who want to sell arrive through their broker-dealer at a certain date, and there have to be enough purchasers so that they can all be liquidated at the same time.

Mr. GREEN. Okay. Now moving forward to the process, continuing with this, we have in this process a group of people who are known as broker-dealers?

Ms. THOMSEN. Yes.

Mr. GREEN. Okay. And the broker-dealers, they work with the investors?

Ms. THOMSEN. Some of the broker-dealers just sell the investments. They are the sort of secondary ones that Ms. Merrill was talking about. Some are also underwriters and participated in structuring the products in the first place.

Mr. GREEN. Do the broker-dealers come into contact with the average Joe who had the $25,000?

Ms. THOMSEN. Yes.

Mr. GREEN. Okay. These are the people who, in a sense, engage in some sort of marketing process, whether it's secondary. There may be a primary marketer that gets me in. They are secondary tertiary, or maybe even quadirary in the process, but they are in the process?

Ms. THOMSEN. Yes.

Mr. GREEN. And these broker-dealers are allowed to see the investors bid before the bid is submitted?

Ms. THOMSEN. Yes. I think that's right. Yes.

Mr. GREEN. They see the bid?

Ms. THOMSEN. Yes.

Ms. MERRILL. Yes.

Mr. GREEN. Now if they see the bid before it is submitted, can that—not saying that it does in every case—but can that have an adverse impact on the process?

Ms. THOMSEN. That was the subject matter of the action we brought in 2006, that this auction practice itself, and as a result of that action, those who run auctions and who settled in 2006 were required to disclose their auction practices.

Mr. GREEN. Do this because my time is up. Do this for me. Tell me what is the adverse impact of the broker-dealer actually knowing what the bid is before it is submitted. Tell me that, please.

Ms. THOMSEN. There's a possibility that there could be favorable treatment and negotiating towards a price to the middle, if you will.

Mr. GREEN. Okay. Explain that, please. This is an important aspect of it. What actually happens here? Because we are getting to

the heart of this. It's about deception, if not fraud. Explain it to us, please.

Ms. THOMSEN. In the auction rate process, the broker-dealer who sort of, if you will, underwrote the security, had two interests that were of interest to that broker-dealer. One of the issuer. The issuer's interest is to raise capital at the lowest price possible. The other is the purchaser of the security, who of course wants the highest interest rate possible, and not to overgeneralize, but in the case involved in 2006, we found conduct by broker-dealers that was undisclosed to the issuers or the purchasers that was trying to get the price, if you will, into the middle, trying to prevent failed auctions as well as holder auctions where no one was willing to sell, and to get an interest rate that was, if you will, in the middle.

Mr. GREEN. Thank you.

The CHAIRMAN. Thank you. The gentleman from Colorado is now recognized.

Mr. PERLMUTTER. Thank you, Mr. Chairman, and my friend Mr. Green. He and I are always on the same wavelength, and he's asking a lot of the questions that I would like to ask, because there's a microeconomic kind of a transaction piece to this. There's a macroeconomic piece to this, which is what is the whole world doing with these things, and then there is either the marketing piece, which can be either fraudulent or accurate or whatever.

So I just have to say—there are sort of four truisms that I have to mention before I ask my questions. If it's too good to be true, it generally is. If something has to come to an end, it will. Res ipsa loquitur, the thing speaks for itself. And the last one right up there, e pluribus unum. And I want to start with that piece, because—and I want to focus this on my chairman and also the ranking member.

The problems that we have in the financial market today are gigantic. This is one sliver of it. And when we have good times, we can be many and do all sorts of things on our own, and we'll be fine. When we have tough times—and we are in tough times—we are in the vortex of some kind of financial hurricane that none of us understands. We come together, and it's going to take a lot of challenges and a lot of work and a lot of sacrifice on the part of everybody here is going to have to pick up the pieces, and millions of people across this country.

And this committee, because of the—I think the bipartisan nature and the way that our ranking member and our chairman work together, we are going to be able to help America get back on track.

So the res ipsa loquitur, for the lawyers on the panel and for everybody out there, the thing speaks for itself. This apparently turned out to just be a mess. Because on one day we have people investing in these kinds of instruments, and the next day $330 billion or whatever Mr. Galvin said, is gone. And—you know, these auctions go from 2 percent to 22 percent to try to make these things move. So let's go to the microeconomic piece. My mom comes in, you know, his average Joe. My mother comes in. She wants to buy $10,000 of these things. She sees—she's told, okay, you're going to buy a long-term bond and you're going to get interest rate X and you ought to be able to get out of this in 30 days, or did they

say you will get out of this in 30 days? What was the promise that was made by the middle man?

Ms. THOMSEN. It depends person to person, obviously, but by and large, I think our evidence suggests that these were marketed as you can get out of it any time you want. It's as good as cash. And it provides a slightly better interest rate.

Mr. PERLMUTTER. But there—I would say there is some responsibility on my mother's part to say, wait a second. I'm buying a long-term bond. I'm getting this little higher interest rate, and I'm promised this liquidity. At the end of the day, I'm still buying a long-term bond, right?

Ms. MERRILL. Don't be so sure that is what they were told. I am not sure that—

Ms. THOMSEN. Some didn't even know they were in an auction.

Ms. MERRILL. Yes. I'm not sure that investors were told this is a long-term bond with a reset at a short-term interest rate. I'm not sure they were told anything like that. I think they were in many cases told, here's a cash equivalent, like—maybe like a money market. You'll be able to get your cash out every 7 days or every 28 days, whatever the auction period was. So, I'm not sure they actually were told this is a long-term bond with a short-term interest rate.

Mr. PERLMUTTER. So then it was a fraud from the outset?

Ms. THOMSEN. It depends person to person and sales practice to sales practice. We have seen instances where people did understand that it was a bond, that it was set at auction, but they understood that they were getting a higher interest rate, a slightly higher interest rate than say a money market fund, because they were giving up liquidity for 7 days.

Mr. PERLMUTTER. All right. So now let's go to the macroeconomic piece of this. Who was buying this stuff? Was my mother buying this or was China buying this, or who was buying this? And why did they stop buying it? Because they saw the potential for deception or something else? And I know you're all on the enforcement side of this thing, but who was buying it and why did they stop?

Ms. THOMSEN. The investors were both retail and institutions. There were more retail investors in terms of numbers than institutional investors, but the amount was split about 50–50 between them. While it's always difficult to tell the reasons things seize up, beginning in 2007, as the credit—the subprime credit crisis hit, there was softness in this market. That was not necessarily transparent to the investors.

But one of the things that happened—the other thing that happened is that this market grew relatively dramatically. In 2006, the amount outstanding was over $200 billion. By 2008, when it froze, it was over $300 billion. That is a lot to absorb. And then in January of 2008, the monoline insurers that sort of back these securities were downgraded, and that affected to a certain extent we believe, people's perception of the creditworthiness of the security. And so it was not very long after—

Mr. PERLMUTTER. So would that be the AIG or some other organization thing? We are going to—

Ms. MERRILL. Ambac, BIA, yes.

Mr. PERLMUTTER. Not only is this a good investment, but we are going to insure it's a great investment.

Ms. MERRILL. Yes.

Mr. PERLMUTTER. So then the insurer goes down, people start getting nervous. Now were there any big blocks of purchasers? I mean, I want to know if there was a lot of foreign investment that stopped and really started this house of cards tumbling. So we have a fragile economy, a fragile market, but it was just generally everybody stopped?

Ms. THOMSEN. I don't believe so. What happened was that increasingly beginning in the summer of 2007, the underwriters were coming into the auctions to keep them from failing. So they would put in bids so there were no failures, which meant that they were taking on more of these securities onto their books as they were becoming less liquid in a time when they were having a hard time carrying illiquid securities. And I think they hoped at some level that the market would recover and they wouldn't have to keep doing this, and by February, in combination with the monolines, the pressure became so great that they simply stopped supporting the auctions.

Mr. PERLMUTTER. Okay. Thank you.

The CHAIRMAN. The gentleman from California and then the gentleman from Missouri.

Mr. SHERMAN. Thank you. I would like to digress for a bit here, Ms. Thomsen, to talk about not securities that are pretty close to complying with SEC laws, or laws administered by the SEC, to a different issue. Is the SEC authorized and does it have people who are pretending to be investors in dealing with all these investments out on the Internet, etc., that are just obviously, blatantly in violation of securities law?

Ms. THOMSEN. We do not. We cannot operate undercover. We can't pretend to be anything other than—

Mr. SHERMAN. And is that a failure of Congress to give you that authority, or is that also a failure of the SEC to ask for it?

Ms. THOMSEN. I believe it reflects the fact that we are a civil law enforcement agency, and that we work with—

Mr. SHERMAN. So if we want to focus on legalisms and we have always done it that way and we are just civil, then we can have a circumstance where no one is protecting the investor who is so unsophisticated that they are willing to invest in something that is an obvious violation of securities law. The reason I bring this up is, it's by no means clear that anybody in this room is going to protect really smart people from themselves. The one thing we know the government could do is protect the ignorant. But you don't want to, or you're not in that business, and Justice doesn't want to either and Congress doesn't want to do anything about it.

Ms. THOMSEN. Actually—

Mr. SHERMAN. And so as much as we can talk here about exactly who was an inch over the line, the people who are 10 miles over the line are pretty safe. I'll let you respond.

Ms. THOMSEN. Well, I hope not. And it's our effort to not keep them safe. I was going to say that we have been working—we work with criminal authorities when they can go undercover. And one of the things that I put in my submitted testimony is while we have

been focusing on auction rate securities and what we have been talking about, we have brought three hundred and eighty-some other cases during that same time period, and included among them are some really frankly outrageous ponzi schemes.

Mr. SHERMAN. If you're not pretending to be an investor, if you don't want to be in criminal law enforcement, if you don't—because I'll tell you right now, my local DA has crime on the streets. He doesn't exactly want to focus on crime in the suites. And you're here to talk about how we are going to protect the smart people, and I wish you were here saying we have to have your people pretending to be unsophisticated investors in cleaning up the part of this that we can clean up.

Now shifting to the purpose of—I will introduce legislation, but without SEC support, I'm going to have to be even more persuasive than my usual level of persuasiveness. I probably won't be successful. Now what has happened here is that the market is under price risk. They achieve this by ignoring risk and telling others to ignore risk. And in particular, today's hearings focus on 30-year bonds issued by private corporations and they are priced in the market as if they are Treasuries or insured deposits.

Now the issue—one view of this is widows and orphans were sold a bill of goods by smart people who knew better. But as far as I can tell, all the smart people on Wall Street thought these were accurately priced. Was anybody selling these short in a big way? Was there anybody smart enough to say the market has massively underpriced the risk here?

Ms. THOMSEN. I don't believe you can sell these short.

Mr. SHERMAN. What?

Ms. THOMSEN. I don't think you can sell these short.

Mr. SHERMAN. Okay. Was anybody investing, say selling short the stock of the monoline insurance companies who insured these? Was anybody smart enough to realize that these things were not priced correctly and there was money to be made because the market was dumb?

Ms. THOMSEN. I don't believe we have evidence of that.

Mr. SHERMAN. So we are in a situation where, yes, it's true individual investors may have been told, hey, it's as good as cash, or almost as good as cash, or really what you're saying is, it's only 100 basis—it's only 20 basis points worse than a Treasury and you're getting 25 basis points in return for that. The fact is, the smartest people on Wall Street seemed to have believed this utterly false tale.

Ms. THOMSEN. I'm not sure I would go that far because I believe those who underwrote beginning in the summer of 2007 knew what was happening in the markets, knew they had to go in, knew that liquidity was failing.

Mr. SHERMAN. But they were buying these.

The CHAIRMAN. The time has expired. She can finish the answer, but we are over—

Mr. SHERMAN. Okay.

Ms. THOMSEN. I think that those who underwrote understood that the liquidity feature was being undermined and degrading as they continued to sell them.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. I like Dan Quayle—let me just make an announcement. Dan Quayle's grandfather was a very prominent and profound Methodist bishop. There are Quayle United Methodist churches all over the States of Kansas and Oklahoma, Quayle buildings on college campuses, Methodist college campuses. Dan Quayle was not quite so profound, however, as his grandfather. In a speech trying to make reference to the motto of the United Negro College Fund, which is "a mind is a terrible thing to waste," Vice President Quayle got a little mixed up and said, "It's a terrible thing for a man to lose his mind." And I happen to agree with him.

I would like to misquote him some more. A crisis is a terrible thing to waste. I think that we are in a major crisis. I don't think anybody who can read or hear would contradict that statement, and I think that if we are going to go through all of this pain, we need to come out on the other side, having made some adjustments and changes, because a crisis is a terrible thing to waste. And by that I mean I'm wondering whether or not we need maybe a new kind of an enforcement structure that will deal with these knotty issues that keep cropping up, in addition to some stringent regulations.

I'm interested in your comments. But, for example, many of the ARS contracts actually allowed broker-dealers to see investor bids before they were submitted to the auction agent, which of course gave the broker-dealers an unfair advantage. And if that is legal, wouldn't it suggest that there is a need for some serious regulations? And then of course as has been discussed widely this morning, some investment banks actually sold products as cash equivalents. And if that is legal, we need some strong regulations.

So I actually have one question with a couple of components. And the thing is, do you agree that now is the time for us to deal with this crisis and come out on the other side with regulations? And then secondly, is there a need for a new enforcement arm? Not all at once, but—

Ms. THOMSEN. Well, let me start by saying I agree with you that a crisis is a terrible thing to waste. You can learn lessons from it and decide what if anything you should do differently. With respect to a new enforcement model, we are here because the enforcement tools we have allowed us to bring enforcement actions in this arena. We were able to get this liquidity back to investors on really very, very short order because the behavior was illegal and because we worked together. So I think in terms of enforcement tools, we had some pretty good ones and we used them well in this instance.

That being said, I always want more, but I think it's fair to say that in terms of the enforcement tools that were available to address this problem, they were adequate to the problem, and I think the combined efforts of everyone you see here and the hundreds of people who aren't there using them was used to good advantage.

Mr. CLEAVER. I appreciate the fact that the attorneys general forced a buyback of some of the ARS. I think that was good. But then the second part comes, and that is, is there a need for some stronger regulatory components for enforcement? I mean, I know—before you answer, you know, if you answer the phones in our offices whether you're a Republican or a Democrat, people are angry all over this country, and I'm not sure how many people want to

go home and stand up in front of a crowd and say, well, you know, we had a couple of little problems and they'll work themselves out, you know. The market always is self-correcting. I mean, people want to know, number one, are the people who violated the law going to have to pay for it? And then secondly, is this going to happen again? Have you guys done anything to make certain that this doesn't happen again?

Ms. MERRILL. If I may respond to that?

Mr. CLEAVER. Ms. Merrill.

Ms. MERRILL. First of all, I completely agree with you that the financial crisis that we see all around us today is something that we have to review and assess in terms of reforming our regulatory system.

Our CEO, Mary Shapiro, has talked about the fact that the regulation of this country, the way we regulate financial products, has to be fixed. It is a patchwork. Often it is split on product lines, and yet when you talk to a consumer, the consumer isn't split on product lines. In other words, they need an insurance product. They need securities, they need bonds. And they don't want to hear that a different regulator is in charge of each one of those different aspects of their entire financial health. So we do have to do something to fix that sort of alphabet soup of regulation that we have.

In terms of the enforcement piece, I'll just take another adage. I don't know if Dan Quayle has used this one, but an ounce of prevention is worth a pound of cure. And I wouldn't look for a new enforcement arm. I would go back and look at how could we have been smarter about seeing these issues before they came to the enforcement front. And that's where we have spent time internally looking at what can we do on our examination program when we are in firms, when we go in to examine our member firms, what should we be looking at to see how they are marketing products. Should we be looking at products that people have been thinking about as safe for 20 years, and really digging down into some of those products?

We spend a lot of time looking at the way firms market very risky and very complex products, derivative products, but I think what we are seeing in this crisis of the auction rate securities is that even something that's marketed as as good as cash, something that was perceived to be by the firms to be relatively simple, isn't always as simple as it seems.

Mr. CLEAVER. Ms. Coakley, I'm interested—I mean, you have taken people to court.

Ms. COAKLEY. We actually didn't, because when we went to Merrill Lynch and UBS and said you have broken the law under Massachusetts, you cannot sell these kind of auction rate securities to municipalities, it's illegal, they said, okay, we better pay you back, which is what they did. So we didn't have to sue.

My answers to your questions are yes and yes. I have forgotten what the questions were but I knew I had the answers at the time you asked them.

Mr. CLEAVER. Well, you know, in my time on this committee, you are the first person since I have been here who has answered the question directly and quickly. I have been waiting for you for years.

[Laughter]

Mr. CLEAVER. Thank you. Mr. Galvin?

Mr. GALVIN. Thank you. I think you touched upon one issue in your question, that's clearly I think the conflict of interest issue, when you spoke of the bidders being—the bids being revealed, and I think that's something that has to be addressed. It has to be, in my opinion, this would be a regulatory change, there has to be much stronger and direct regulation relating to conflicts of interest, not just in auction rate securities but in a broader way.

Secondly, I think the concept of a fiduciary duty, especially in the case of those that would actually be selling these, and this gets to the sales practices issue, there has to be some duty imposed upon the seller to be aware at least of the circumstance of the buyer, and whether that's cast in terms of disclosure, which many of us have spoken to, or an affirmative obligation to say that if you know that that person left your office believing—or is in your office believing this is liquid and you know it's not, you have an obligation to disclose that to them and you should not sell it to them if you know it's not in their best interest. Those are some specifics.

I think on the enforcement side, you can rearrange the structure. I think this instance here demonstrates I think the structure has worked collaboratively rather well. I think the bigger problem, as has been mentioned by Ms. Merrill, is the anticipatory side of enforcement. In other words, when you have an enforcement action, you have already had a failure. You have had something go wrong. There has to be something done on the other side to anticipate problems with products that are out there. There has to be a review of products that are out there.

As I said, I think what has clearly been discredited—you spoke of a crisis, and there's no question that there is one. What has clearly been discredited in my opinion is this idea that the free market is going to figure this all out. Products will fail. No one will ever buy them again and it has corrected itself. Not without great loss. Not just the individual loss to the people who have been away for their money for a long time, but to the collective economy of our country.

This money that has been tied up, whether it's individual money, small business money or institutional money, is money that could have been working in our economy during this very critical time, and it wasn't available. So I think it has to be an anticipatory enforcement as well as an enforcement after the fact.

Mr. CLEAVER. Your answer is yes, too.

Mr. GALVIN. Yes. Yes.

Mr. CLEAVER. Thank you.

The CHAIRMAN. I thank the panel. We will move on to the next panel now. I apologize, but—oh, I'm sorry. Ms. Speier. I didn't see Ms. Speier. The gentlewoman from California is recognized for 5 minutes.

Ms. SPEIER. Thank you, Mr. Chairman. I'm going to try and focus my questions on three areas: Professional misconduct; cost recovery; and the enforcement activities going on in States other than Massachusetts. My hat is off to you in Massachusetts. You are doing an outstanding job. I worry that we are not doing what you're doing in Massachusetts around the country.

But first let me move to professional misconduct. As I look at the description of your organization, FINRA, Ms. Merrill, it's a little unnerving to me. It's a self-regulatory regime based on something we took off your Web site, that your focus is on registering and educating and you're dedicated to investor protection.

Now based on what we have heard today, the use of auction rate securities was only used by sophisticated institutional individuals since 1984. And then 3 years ago, that was changed, in which it was opened up to less sophisticated investors who had $25,000 or more. Now who made the decision to reduce the requirements as to who could get into these auction rate securities? And maybe this goes to Ms. Thomsen and to Ms. Merrill.

Ms. MERRILL. I'm not sure that the level of $25,000 was only lowered 3 years ago.

Ms. SPEIER. It said a few years ago in our packet.

Ms. MERRILL. Okay. But it is true that the auction rate securities market originated as being sold primarily to institutional investors. The $25,000 level is something that is set by the issuer, I believe, in terms of what they will allow as the minimum amount that can be purchased at the auction.

Ms. SPEIER. Okay. If that is the case, the issuer can do that on their own. Doesn't it seem appropriate for you to then—interested in protecting investor interests, to require greater disclosure to those investors that are less sophisticated? And why didn't you?

Ms. MERRILL. For every security that is sold by a broker-dealer to a customer, for every one that is recommended, our suitability rules require that broker-dealers make an affirmative determination that the product is suitable for that individual investor. And they have to take into consideration things like the risk tolerance of the individual, their investment horizon, and their need for liquidity. And if they don't do that, then we bring cases against brokers. We have brought over 500 cases against individual brokers who have just this year alone, against individual brokers who have recommended unsuitable investments to their individual clients.

Ms. SPEIER. All right. I have only 5 minutes, so I am going to cut you off just ever so briefly.

Ms. MERRILL. I appreciate that.

Ms. SPEIER. Have you filed—do you have authority to file any action against individual brokers—

Ms. MERRILL. Absolutely.

Ms. SPEIER. —to take their licenses away from them?

Ms. MERRILL. Absolutely.

Ms. SPEIER. Have you done that in this particular scenario with the auction rate securities?

Ms. MERRILL. In the auction rate security area, we started with the companies, with the broker-dealers themselves because they are the ones who can supply the solution that we really wanted, which is to buy back investors' money. But we have not stopped, and we are continuing our investigation as to individual brokers, and where we find that there have been misrepresentations and suitability violations, we do have the tools and we have used them again and again to bar people from the securities industry—

Ms. SPEIER. For how long?

Ms. MERRILL. Permanently.

Ms. SPEIER. Permanently?

Ms. MERRILL. Permanent bars.

Ms. SPEIER. And how often have you used that?

Ms. MERRILL. We have over 300 permanent bars this year alone, and another two hundred and some suspensions on top of that.

Ms. SPEIER. But none in the auction rate securities area?

Ms. MERRILL. But our investigations are not complete.

Ms. SPEIER. All right. Let me move on to cost recovery. How much did it cost you to do your investigation, Ms. Thomsen?

Ms. THOMSEN. I don't know the answer to that, but other than the cost to our budget, if you will, deploying our resources, this did not cost the government anything.

Ms. SPEIER. Well, but it did.

Ms. THOMSEN. Obviously. Wherever we investigate, we are not investigating somewhere else.

Ms. SPEIER. Do you have the authority to seek cost recovery from the entity that you find has done wrongdoing?

Ms. THOMSEN. No. We do have the authority, and we use it, to get penalties which go back either to the government or in fair funds to investors. We did not—we have not yet sought penalties in these matters because we wanted to make sure that all available resources were being used to recompense investors, and because we deferred the issue of penalty until the end of the process to make sure that the firms had actually stayed true to their word and had made investors whole.

Ms. SPEIER. I think for the American public, they are less concerned about making sure that the money just gets back to the institutions. I mean, they certainly want the money to come back to them as individuals. But they also want people disciplined. And they certainly don't want the taxpayers of this country to pick up the tab to have to do the investigation of folks who weren't complying with the law to begin with, and that's why I believe you should have the authority for cost recovery and why I would seek to have our committee look at that issue.

The CHAIRMAN. If the gentlewoman wants an additional 2 minutes, go ahead.

Ms. SPEIER. All right. Thank you. And to you, Attorney General Coakley, I'm impressed by what you did in Massachusetts, and to you, Secretary of State Galvin. I worry that unless States have taken on this that there are many institutions and individuals who are not going to be made whole. I'm curious as to whether or not the U.S. attorneys around the country have engaged, and if not, why not, and would like your thought on whether or not there should be some nationwide class action brought.

Ms. COAKLEY. Well, in a nutshell, you know, the SEC as a Federal agency has regulatory authority over institutions, and in many instances, States are preempted from banks and regulatory authority there for a long time. We have approached it from the point of view of what our own State's statutory authority lets us do. We have a False Claims Act. We have Chapter 93(a) that does consumer protection, and we have a statute in Massachusetts that says you can't sell to cities and towns products like this that aren't liquid. So that's the basis on which we were able to go forward in this instance.

But I think your question actually redounds to what the chairman's comments were at the beginning, that when we look at the overall picture here in terms of the auction rate securities and predatory lending and all of these pieces, I think Secretary Galvin and I would be strong voices, along with the chairman, to say we need a strong Federal regulatory scheme.

We need strong enforcement, including whatever else you think in terms of cost recovery, but you need to allow States, depending upon how much of this activity takes place in the State, what is in the interest of that legislature, that enforcement, to be able to work in a very complementary way to look at from the ground up what is happening. And I think in this instance the States—it's not only Massachusetts; New York has done a lot, and California has done a lot. That's where a lot of this activity takes place and where these financial houses live. But that whole piece of how we are going to do this has to I think be approached with the State piece of it, not preemption for us and let the States do what they feel they need to do.

Mr. GALVIN. Just to put your mind at ease, the North American Securities Administrators Association has taken this on and has worked with the Securities and Exchange Commission. And while State entities have brought individual actions, they have been representing the national interests. So in other words, it's open to every State. And indeed, even in the fining structure, that is the penalty structure, some States that were not lead States will still get some fine as a result of this.

So, for instance, when Massachusetts negotiated with regard to Bank of America, we negotiated for all Bank of America customers throughout the United States, and the agreement we secured from Bank of America was applicable to all customers. Similarly with Fidelity, which was a downstream broker, in which we just entered an agreement with last week. That's for all of Fidelity's customers. It's not limited to Massachusetts customers.

So there has been a comprehensive effort here on the part of the States, but I think the concern is that, you know, what about the next time? This was a remarkable case of collaboration and a very effective case of collaboration, but I think the anticipatory issues are the really—the bigger issues that you folks are going to have to deal with.

The CHAIRMAN. I thank the panel, and this has been very useful. We will take the next panel now.

I thank the panel. I apologize for the delay in getting to you. There is a lot of interest in this subject. We will begin with Ms. Leslie Norwood, the managing director and associate general counsel of the Securities Industry and Financial Markets Association, SIFMA. Ms. Norwood.

STATEMENT OF LESLIE NORWOOD, MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Ms. NORWOOD. Good morning, Chairman Frank, and members of the committee. My name is Leslie Norwood, and I am managing director and associate general counsel of the Securities Industry and Financial Markets Association. I serve as the staff advisor to the

Association's Municipal Securities Division. Thank you very much for the opportunity to testify on the auction rate securities market today.

The credit crisis over the last 18 months is like none we have ever experienced before. As problems in the mortgage market spread into mortgage securitization in 2007, faith in the monoline insurers, insurers of mortgage bonds and collateralized debt obligations, began to waiver. Investors became wary of being exposed to anything with a potential for downgrades, including any securities connected with the insurers themselves. Because of the critical role the insurers play in the ARS market, demand for ARS and other variable rate securities began to show signs of decline, and the number of failed auctions increased.

While this is not the first time ARS auctions have failed, this is the first time a significant number of auctions have failed. Between 1984 and 2006, only 13 out of thousands of municipal securities auctions failed. By contrast, 31 failed municipal securities auctions are estimated to have occurred during the second half of 2007 alone. As the demand for ARS began to evaporate in 2007, many broker-dealers purchased ARS in order to support the market and to prevent failed auctions. Pursuant to the terms of the legal offering documents, broker-dealers were not and are not obligated to support an auction. As the credit crisis began to impact the liquidity and capital of the broker-dealer firms, many firms lacked the capacity to continue supporting the ARS market.

The issues in the ARS market are unprecedented and flow from overall issues in the financial markets. While SIFMA cannot speak to the specifics of the sales and marketing practices of various firms, it is fair to say there were deficiencies in the market. I'm sure you will hear many anecdotes about sales and marketing practices. It is important to remember that the liquidity problems in the ARS market are a result of the ongoing credit crunch. While there were disclosures made to customers about the risks associated with ARS, in hindsight, the disclosures could have and should have been better. As the committee is aware, several firms have settled or are in the process of negotiating settlements to buy back ARS to provide liquidity to investors.

While it is of little comfort to investors expecting liquidity, for the most part, ARS issuers are still to this day paying interest and principal payments on securities to investors as they come due and the underlying credit ratings of ARS issuers remains high. The ARS failures have left issuers to face steep increases in the cost of capital. Some State and local government issuers of securities have found their securities resetting to maximum rates as high as 20 percent. The high maximum rates compensated the investors for their loss of liquidity and encouraged issuers to restructure these securities into a more cost-effective form of debt.

As stated earlier, in 2006, the SEC settled with 15 broker-dealer firms for auction practices that were not adequately disclosed to investors. In light of the settlement, SIFMA developed best practices for broker-dealers of auction rate securities, which describes the role of the broker-dealer in an auction. SIFMA also created the SIFMA auction rate securities indices to serve as a benchmark for issuers and investors.

SIFMA and its member firms have sought action to ease the regulatory burdens which hampered efforts of the municipal issuers to redeem or restructure their outstanding ARS. SIFMA and its member firms are helping issuers to restructure their ARS. In addition, over the last few months, a number of firms have agreed to buy back securities at par value from customers. However, many firms are facing capital limitations as a result of the continuing credit crunch, limiting the funding available to buy back outstanding ARS. I would like also to note that not all firms have the same level of activity in the ARS market. Some firms underwrote securities, some firms acted as selling agents, and other firms merely had these securities transferred to them from other firms due to customer account transfers.

Many firms also faced regulatory constraints. For instance, if a broker-dealer holds inventory of a particular ARS issuer, its affiliate bank is limited in how much credit assistance it can offer a distressed issuer because of Regulation W, which limits the size of covered transactions. A safe harbor for Regulation W for these firms would allow banks to buy back more of their outstanding ARS.

SIFMA and the broker-dealer community are also actively working with the MSRB, the Municipal Securities Rulemaking Board, on its new disclosure system for ARS and VRDOs, which will expand their new disclosure system called EMMA, the municipal securities version of the SEC's EDGAR System.

In conclusion, auction rate securities were an attractive source of funding for State and local governments and student loan financing authorities for over 2 decades. A tightening of the credit markets led to a sharp decline in the demand for ARS and ultimately resulted in failures across the ARS market. The broker-dealer community is working to return liquidity to the ARS market and to assist issuers in refinancing and restructuring their ARS as quickly as possible.

Thank you for the opportunity to testify before you today, and I look forward to answering your questions.

[The prepared statement of Ms. Norwood can be found on page 107 of the appendix.]

The CHAIRMAN. I am now going to go a little bit out of order, and I would ask unanimous consent that we allow our colleague from New Hampshire, Ms. Shea-Porter, to sit with us. I hear no serious objection, therefore, she is allowed to participate. I should note that because of the situation involving New Hampshire and education, Ms. Shea-Porter has been one of the Members most active and energetic in calling on us to do what we can to facilitate this, and I would now call on her to make a statement and introduce the next witness.

Ms. SHEA-PORTER. Thank you very much, Mr. Chairman, and thank you for the privilege of joining you for this important hearing. I am pleased to have the opportunity to industry a fellow New Hampshirite, Ms. Tara Payne. Ms. Payne is here to share with the committee the New Hampshire Higher Education Assistance Foundation, or as we call them, NHHEAF, experience with the auction rate securities.

The NHHEAF network is made up of four nonprofit organizations that collectively serve as New Hampshire's leading provider of college planning and funding. She has worked for the NHHEAF network since 1996 and currently serves as the vice president of corporate communications and marketing. Thank you so much for being here today, Ms. Payne. I look forward to hearing your testimony.

And thank you again, Mr. Chairman, for the opportunity to participate. I yield back.

The CHAIRMAN. I thank the gentlewoman. I should point out that we have had a great deal of cooperation here between this committee and the Committee on Education and Labor, which has a specific interest in education. And one of the things I'm proud of in this Congress is that we really avoided, I think, the kind of jurisdictional hair pulls that just annoy everybody and shouldn't happen. And with regard to the impact of auction rate securities on education funding, we have been able to be cooperative. I appreciate the Education and Labor Committee, having worked with them. They have had some constructive results, the chairman tells me, in dealing with the Federal Department of Education. So we are glad you're with us. Ms. Payne, why don't you go ahead, and then we'll get back to the others.

STATEMENT OF TARA PAYNE, VICE PRESIDENT FOR CORPORATE COMMUNICATIONS, NEW HAMPSHIRE HIGHER EDUCATION LOAN CORPORATION

Ms. PAYNE. Thank you. Chairman Frank, Ranking Member Bachus, and members of the committee, I am Tara Payne, representing the New Hampshire Higher Education Loan Corporation. It is an honor to participate in these discussions. I would like to thank the representative from New Hampshire who continues to be a strong advocate for student access to higher education. Thank you.

Thousands of schools and millions of students have relied upon FELP providers to finance postsecondary costs. In our capacity as a nonprofit student loan provider, NELCO takes great pride in educating students about responsible borrowing. Consequently, we consistently have among the lowest cohort default rates in the Nation. When students successfully repay their Federal loans, everyone benefits. Taxpayers don't have to shoulder the burden of increased Federal debt to cover loan losses. Schools maintain their eligibility to award Federal financial aid, and best of all, students realize the full benefit of the investment they have made in higher education.

The FELP community is dedicated to promoting college access, particularly for underserved students, and it does so by offering an extensive array of college outreach programs. The impact of these programs is enormous and widespread. Consider that in New Hampshire alone, 95 percent of public high schools and 34,000 students and parents relied on the services we provided last year, and I must stress the importance of having agencies such as ours across the Nation.

One of the unintended consequences of the legislative cuts to subsidies for nonprofit lenders and the current liquidity crisis is the risk of losing programs like the Center for College Planning in

New Hampshire. Access to college begins with increasing aspirations, but it ultimately ends with the availability of financial aid programs and funding options.

We are proud of the integrity and commitment we have made to these programs, but in this year, fulfilling our most essential mission has been extremely challenging. NELCO is New Hampshire's leading provider of student loan financing and funded $184 million in Federal loans and $67 million in alternative loans in Fiscal Year 2007. In all, NELCO has $1.5 billion in outstanding bonds which have funded our program since 1997.

The auction rate market has been an important key source for liquidity for student loan lenders. For the last decade, NELCO borrowed money to fund loans by selling auction rate certificates. However, investors are no longer investing in the auction rate market, thus issuers like NELCO can't raise capital that funds loans.

Our organization has always held itself to a high standard of financial accountability. We recognize that we bear responsibility to ensure that whatever taxpayer money is spent, our program is minimal and that access to higher education is made possible through our sustaining a strong financial base. This strong base has been significantly compromised by NELCO's long-standing trusted financial advisor, the UBS Securities LLC.

On August 14th, the New Hampshire Bureau of Securities Regulation announced that it was taking action against UBS for fraud. The action relates to UBS's representation of NELCO in the sale of bonds. Essentially, the order issued by the Bureau states that UBS knew that the market for these bonds was on the verge of collapse. At the same time that UBS was actively encouraging NELCO to extend its commitment on these bonds, UBS advised NELCO to reset the maximum rate on NELCO's taxable bond to 17 to 18 percent to ensure liquidity and prevent auctions from failing.

We now know this was a scheme. It was a scheme to make the securities more attractive to investors and to keep NELCO in the market. UBS never disclosed to NELCO that the market was at risk of freezing and that the maximum interest rate payable on the bonds could lead to NELCO's financial harm, or that UBS was preparing to end its support of the market as it had always done.

On February 13, 2008, UBS stopped supporting the market and it collapsed, leaving NELCO and investors with billions of dollars frozen. We support the New Hampshire Bureau in its assertion that UBS failed in its fiduciary and moral duty to NELCO.

Alternative loans have become a key factor in affordability and access. NELCO's non-Federal alternative loan program provided funding to close the gap between what students receive in financial aid and what the college actually costs. In Fiscal Year 2007, over 6,000 students borrowed $67 million through our alternative loan program. Still, recognizing the severity of the liquidity crisis, the reduction to lenders from recent legislation, and the lack of viable solutions from our financial advisor, NELCO was forced to suspend its alternative loan program in March, leaving thousands of students to search for other alternatives.

Any interruption in the loan program hurts college-bound students. It causes a disruption in financial aid delivery and creates

another layer of complexity to a tedious financial aid process. Naturally, this has the greatest impact on our most vulnerable students. Following our suspension of the alternative loan program and becoming gravely concerned about our ability to fund even Federal loans, NELCO asked the member institutions of the New Hampshire Bankers Association and New Hampshire credit unions to provide liquidity that would enable NELCO to fund the Federal program. Currently, $94 million has been raised, and I can assure you that NELCO would have suspended its Federal program if it were not for the overwhelming support of community lenders to provide a temporary solution prior to the Ensuring Continued Access to Students Loan Act.

Thank you sincerely for your time.

[The prepared statement of Ms. Payne can be found on page 123 of the appendix.]

The CHAIRMAN. Thank you.

Next, Mr. Roger Sherr, the vice president of Sherr Development Corporation.

STATEMENT OF ROGER SHERR, VICE PRESIDENT, SHERR DEVELOPMENT CORPORATION

Mr. SHERR. Thank you, Mr. Chairman. My name is Roger Sherr, and I am vice president of Sherr Development Corporation, a Michigan-based real estate company that has been creating retail and construction-related jobs since the mid-1980's. I appreciate the opportunity to address this committee.

My purpose is to describe how Comerica Bank's misrepresentation regarding auction rate preferred securities purchased on our behalf has harmed our company, individuals who would have worked for our company if not for the misrepresentation, our community, and the overall integrity in the financial system.

In 2005, our company sold a number of retail shopping centers. At that point, we had an unusually large cash position. Our intent was to park those proceeds for a relatively short period of time, intending to pay capital gains taxes, and then redeploy those monies in other projects as opportunities presented. Our goals for the funds were safety and liquidity. We made those goals clear to Comerica Bank, which has served as our family's and company's bank for over 60 years.

Comerica directed the purchase of specific auction rate securities as a place to park those funds. Comerica sold these securities as cash equivalents. There was no disclosure of any risk to liquidity or value. The particular securities we now loan are listed for you in my written testimony.

In February of this year, we were stunned to learn that as a result of the freezing of the market for ARPS, our funds placed by Comerica were no longer available to support our ongoing business operations. In multiple letters to Comerica officials, we requested the bank to follow through and give us our promised cash on demand. Even though Comerica selected the specific securities we purchased and earned healthy commissions, they refused to shoulder any of the responsibility for their misrepresentation.

Until recently, Comerica has repeatedly refused to repurchase these securities or participate in any settlements with regulators.

We now understand that as of this morning, Comerica has agreed to cooperate with regulators and repurchase the securities that it sold to retail investors. We only hope that this would have come more voluntarily from Comerica without regulators and enforcement officers breathing down their back at a significant cost to taxpayers.

Having cash on hand provides important competitive advantages for a firm our size. It allows us to move quickly and pursue projects we may not otherwise have been able to do. To the extent retail opportunities we pursue create jobs in America, the liquidity of our balance sheet is important. It may be of interest that in the past, Sherr Development has completed retail and residential-related projects with aggregate values exceeding $250 million. As a result, thousands of jobs have been created, and millions in taxes have been paid.

The Michigan economy is facing some difficult times today. Comerica's failure to fully correct the illiquid condition at our company has directly contributed to tough times in Michigan. One investment, for example, we would have pursued is the development of a large shopping center in the City of Detroit. It would have provided needed retail services for people living in the area, as well as hundreds of highly paid construction jobs and hundreds of retail positions. Because our funds are still locked up with these auction securities, we were not able to make a rapid decision and pursue this project. As of now, the site remains undeveloped, and residents in the area need to travel further distances for the groceries and other goods they need. Others in the area may remain unemployed or underemployed.

Comerica Bank has $60 billion in assets, and ranks as one of the top 20 banks in the country. It advertises that it puts its customers first, and has hundreds of branches to serve you. Unlike Goldman Sachs, Merrill Lynch, or UBS, Comerica is a hometown regional bank, trusted to sell safe products designed to protect their customers. Comerica's customers have a good reason to hold them to a higher fiduciary standard of care than is applicable to brokers in the fast-paced world of investment banking.

Comerica sold more than 2 billion of these securities to individuals, municipalities, and firms like ours that pay taxes and create jobs. Clearly, given the resources and sophistication of the bank, they should have understood and accurately communicated the types of securities they were selling in large volumes. If they had advised us and other customers of the true nature of these securities, they would have not have been purchased as money market instruments. Like any retailer, they should be held responsible for their misrepresentation.

It is important to note that judicial remedies alone are not sufficient here. If we and thousands of other firms, municipalities and individuals are forced to go to court for justice and wait months, if not years, to be heard, the economy will suffer in the short and the long term. In the short term, without access to funds, firms like ours cannot create desperately needed jobs. In the long term, trust and confidence in the banking regulatory system, which is now facing a critical challenge, will be further eroded.

In conclusion, many firms such as ours relied on their local bank for sound, conservative money management advice. In this case, Comerica sold auction rate securities as cash equivalents and misrepresented the products they sold. As a result, our business has been damaged, we have been unable to create needed jobs, and the trust in the banking system has been undermined.

Thank you.

[The prepared statement of Mr. Sherr can be found on page 134 of the appendix.]

The CHAIRMAN. Next, we will hear from Mr. William Adams IV, vice president of Nuveen Investments.

STATEMENT OF WILLIAM ADAMS IV, EXECUTIVE VICE PRESIDENT, NUVEEN INVESTMENTS

Mr. ADAMS. Chairman Frank, and members of the Financial Services Committee, thank you for inviting me to testify about the continuing turmoil in the auction rate securities market and about possible solutions.

We commend you for holding hearings on this important topic and appreciate the opportunity to express our views. My name is Bill Adams, and I am executive vice president of Nuveen Investments. Nuveen sponsored closed-end funds together represent the largest issuer of auction rate preferred securities and we share the committee's deep concern over this issue and its impact on investors.

One hundred of our closed-end funds had more than $15 billion of auction rate preferred shares or what I'll call ARPS at the time this market failed in February. Since the failures began, my team has worked very hard to resolve the problem for our funds shareholders. The failed auctions have prevented tens of thousands of Nuveen shareholders from selling their ARPS and have increased fund financing costs for the fund's more than one million common shareholders.

As you and your constituents well know, this problem has created significant, financial hardship for many preferred shareholders. Following the breakdown of the ARPS market, Nuveen and the funds' independent directors determined that it was the absence of market liquidity rather than credit concerns regarding our funds that caused the auction failures. We also concluded that the existing ARPS market was unlikely to return to normal.

In March, Nuveen and the funds announced that they would seek to refinance all the funds' outstanding ARPS. Our goal was to reduce the funds' cost of borrowing for the benefit of common shareholders, while providing liquidity at par for the funds' preferred shareholders. Since then, we have kept all our shareholders fully informed of our progress and the challenges we face. The unprecedented turmoil and the financial markets has made it even more challenging. Still, we have made significant progress.

To date, Nuveen's closed-end funds have redeemed or have announced their intention to redeem nearly $5 billion of their $15 billion of outstanding ARPS. So how have we refinanced the ARS? Our first approach has been to employ conventional financing methods to the greatest extent possible. This includes bank loans, lines of credit, and other forms of secured lending as well as tender

option bonds. Most importantly, we have created a new form of preferred stock called, "variable rate demand preferred," or VRDP. This new security offers two critical benefits.

One, like the ARPS, it allows our municipal closed-end funds to obtain financing at favorable tax-exempt rates, and two, because of the liquidity backstop from a bank, VRDP is eligible for purchase by tax exempt money market funds, the largest buyers of short-term, tax exempt securities. In fact, we recently sold $500 million of this new preferred stock to refinance all the ARPS for four of our funds and we believe there is a lot more demand for money market funds that could allow the Nuveen funds and potentially all closed-end funds to refinance all ARPS to cash out ARPS shareholders.

We appreciate the guidance we have received from the SEC and the Department of the Treasury, and the sense of urgency this committee has imparted on regulators and market participants to find creative solutions. We have made progress, but clearly there is more to be done. We have learned through our discussions with banks and institutional investors that a number of regulations continue to limit our funds' ability to issue larger amounts of VRDP and resolve this issue more quickly.

I would like to end by highlighting three suggestions. The first would be for the Federal Reserve to broaden the ability of banks to own VRDP in their role as liquidity providers and to permit banks to pledge VRDP as collateral at the Fed discount window. This would remove the obstacles that have limited the ability of banks to provide liquidity backstops for VRDP. Second, the SEC should expedite its consideration of relief under the Investment Company Act to temporarily permit closed-end funds to use debt financing to a greater extent than currently permitted. And, third, it would help if the Treasury Department would further clarify the equity treatment of preferred securities that include liquidity backstops and to permit not only fixed-income funds but also equity funds to issue such preferred securities.

Again, thank you for the opportunity to explore these issues and potential issues on behalf of the millions of investors caught up in this unprecedented situation. I look forward to answering your questions.

[The prepared statement of Mr. Adams can be found on page 60 of the appendix.]

The CHAIRMAN. Thank you, and finally, I am going to step in for my colleague, the second ranking member of the committee, and the chairman of the Capital Markets Subcommittee, Mr. Kanjorski, who wrenched his back today. He is unlike most of the people concerned with the financial services interview today in that he has a pain in his back.

[Laughter]

The CHAIRMAN. I am therefore glad to introduce a man with whom he has worked and who appeared with us at the press conference earlier on when we announced this hearing. And I have to say that as important as this hearing is, I think our having announced it a couple of months ago was probably the biggest contribution we made to getting things moving.

James Preston is president and chief executive officer of the Pennsylvania Higher Education Assistance Agency. I know Mr. Kanjorski welcomes the assistance and advice he has given us.

So, please, Mr. Preston.

STATEMENT OF JAMES PRESTON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY

Mr. PRESTON. Thank you very much. I am Jim Preston, president and CEO of Pennsylvania Higher Education Assistance Agency (PHEAA). I would like to thank Chairman Frank and Ranking Member Bachus for holding this hearing. I am especially grateful to Mr. Kanjorski for his leadership on the student loan aspect of this important issue and his support of a comprehensive solution to the student loan liquidity issue.

As someone with more than 25 years of investment banking and student loan funding experience, I can attest that today's situation is unprecedented and is in urgent need of attention. The fact is nobody knows how long it will be before today's problems become too deeply rooted to be resolved without extensive government intervention. The collapse of the auction rate securities market and the dysfunction of other markets which might have provided alternative sources of funding for not-for-profit student loan secondary markets have left nonprofit agencies with few, if any, ways to raise needed funds, funds that students and families depend upon to meet college costs.

In May, Congress took a first step by passing the Ensuring Continued Access to Student Loans Act, ECASLA, which has been crucial in assuring access to Federal student loans for this fall. And last night, an Act passed again to extend it for one more year. However, this Act is little more than a temporary solution and applies only to federally-guaranteed student loans.

Unless Congress and the Administration address the underlying cause of the current liquidity difficulties, there will be continued instability in the student loan marketplace. In March of this year, PHEAA reached the conclusion that we must suspend origination and purchasing of Federal student loans. The cost of raising capital to fund student loan originations and purchases had become financially impossible. There was no way to generate a positive return on our investment, and additionally traditional sources of liquidity were withdrawn and just not available.

We simply could not sustain limitless, unlimited losses, and continue to provide access to student loans and maintain essential services to the citizens of Pennsylvania. To finance the loans we have made and purchased over the years, PHEAA maintains nearly $12 billion in outstanding debt obligations. These obligations take many forms and involve a mix of both taxable and tax exempt; approximately $7.4 billion is in the form of auction rate securities.

PHEAA uses these funds to originate student loans and to serve as a secondary market for student loans. By purchasing loans from originators for par plus a reasonable premium, based on the value of the loans, PHEAA enables hundreds of lenders to participate in the Federal student loan program. These lenders, which rely on secondary markets to recycle their funds in order to make new

loans, now find themselves with no outlet for the loans they originate. Their balance sheets are filling up rapidly, which cannot be continued indefinitely.

Today we find ourselves unable to issue new debt obligations due to the lack of investors, and because even if investors are found, the price required is too high to allow issuers to make or purchase loans without losing money on each new loan. Additionally, rating agencies and credit providers are demanding that debt issuers add substantial capital of their own to any new security, which is a significant obstacle for those of us without access to funds.

We realize that any effort to provide vehicles to fund student loans must benefit three groups: The investors who find their assets trapped in these investments; the issuers who are unable to refinance these securities; and the Federal Government, which should not bear any financial burden as a result. Earlier this year, PHEAA in concert with two sister agencies put forward a proposal to Treasury that we believe would accomplish all three of these objectives.

Since then, Treasury has adopted the core principles of this proposal, but has done so not for student loans but for mortgaged back securities as part of its rescue of Fannie Mae and Freddie Mac. Treasury's plan is to create a new market for mortgage-backed securities; in essence, to stand in place of the global markets, which are unable to supply sufficient capital to support the homeowners of this Nation.

Our proposal is for Treasury to do the exact same thing for student loans. In Treasury's fact sheet that accompanied their announcement on September 7, 2008, Treasury stated clearly that taxpayers will benefit from this program, directly through potential returns on the Treasury's portfolio of mortgage-backed securities. We believe these same principles would apply to a program to purchase student loan backed securities. And since FFELP loans are already 97 percent guaranteed by the Federal Government, such a plan would be 97 percent less risky for the Federal Government than actions that involve non-guaranteed assets.

Overall, guaranteed student loans are reliable, performing assets, and they are not subprime loans. Earlier this year, Treasury advised Congress that it requires new statutory authority to purchase student loan-backed securities. Thus, we urge you Mr. Chairman and members of the Financial Services Committee to provide Treasury with such authority. You can do so by adopting H.R. 5914 sponsored by Representative Kanjorski.

Please give us the chance to solve this issue before too many players are forced to end their participation in the student loan program to the detriment of millions of Americans.

Thank you for allowing me to appear here today.

[The prepared statement of Mr. Preston can be found on page 129 of the appendix.]

The CHAIRMAN. Thank you, Mr. Preston.

I heard what you said, and I really appreciate your participation. This has been mutual.

We have some votes. They are going to take an hour, so we are not going to ask you to stay.

I am going to ask Ms. Shea-Porter if she has any questions. Again, I think the willingness of the people here to participate in this hearing has moved this ball forward. We will be looking at your testimony and will try and do it tomorrow. But Ms. Shea-Porter will have time for questions.

Ms. SHEA-PORTER. Thank you, Mr. Chairman.

Ms. Payne, I did want to ask you, the collapse of the market clearly had a significant impact on NHEF. It was around this time that the auctions failed that NHEF announced it was suspending its alternative loan programs. How many students were impacted by the suspension, and what has happened to them?

Ms. PAYNE. Well, at this point, there have been over 6,000 students who last year participated who this year could not and had to find other alternatives. Right now, we are actually doing a survey to find out where those borrowers have landed. However, we know from past surveys that 28 percent of students, even prior to the crisis, were putting tuition on credit cards. I can only imagine that number has increased, particularly now that parents aren't able to get, say, second mortgages.

It has become more difficult for those private loan providers out there. It has become more difficult still for students to access money, because of tightening credit restrictions. So we are not sure exactly, and I think that we may see a big shift second semester as well. Students were able to use summer earnings to manage through a first semester. We'll be interested to see what happens by second semester as well.

Ms. SHEA-PORTER. So do you suspect that not only are they taking the dead-on on credit cards but that maybe some of them aren't even trying to go anymore, that they have given up on the idea?

Ms. PAYNE. Again, only through stories that we have had through families who have come into our office overwhelmed by this. You know, we know the kids definitely were able to get some funds through other lenders, national lenders perhaps, but at what price? I mean, certainly, for a much higher price than they were through a nonprofit agency and that will flush itself out, I think, by mid-year.

Ms. SHEA-PORTER. Okay. Thank you.

I yield back. Thank you.

The CHAIRMAN. And finally, on behalf of our absent colleague, I believe the gentlewoman from New York, Mrs. Maloney, has some questions.

Mrs. MALONEY. Just very quickly, Mr. Preston. Earlier this year, Congress passed the Ensuring Access to Student Loan Act to ensure liquidity in the student loan market; and, while this has been beneficial to many lenders, other smaller, nonprofit lenders still have much of their now illiquid auction rate securities. What is being done to help these smaller nonprofit lenders, and what more can be done for them to ensure that they can continue to lend to our students?

Mr. PRESTON. The small nonprofit lenders play an important part in the overall delivery system in the United States, not only for origination directly to students but also buying from banks that participate. And it's very important to keep the banks in this business to support the higher education program.

What we are finding, just like many of the small, secondary markets in the United States and the not-for-profits is that there are no financing alternatives available. For example, when the auction rate started to deteriorate, many of us, all of us, probably, went and started lining up bond insurance and letters of credit to refinance.

I was in New York on January 18th, when MBIA and Ambac got downgraded. That day was a threshold event, because then all the options started going away and, by February, the auctions then started failing. So whether it's a big or small not-for-profit, we are all in the same boat and it's all affecting the whole chain of delivery of student loans through the banks.

Mrs. MALONEY. On that point, can anyone on the panel speak on the point that he raised on why the auction rate security market froze back in February?

And then going forward, what reforms do you believe the auction rate security market needs to be made viable again so that we can continue these student loans and other activities? Why did it freeze in February?

Mr. PRESTON. I will take a shot at it. I think it froze because it became apparent there weren't other alternatives available to refinance and that it just became a point of diminishing returns for those holders. And, you know I think the auction rate market is not a viable product now or in the future. If it does come back, it will have to come back as a specific, institutional product where the risks are clearly understood and they are willing to hold it. But I just don't see that product as being viable.

So solutions going forward will have to be the variable rate demand market coming back, which is insurance and liquidity from the banks, and the floating rate note market which is the overseas market. Those are our only options to finance variable rate products, both tax exempt or taxable. And until those stabilize, we don't have any options to refinance.

The CHAIRMAN. I thank the panel. If there are any further comments you want to submit later, we will take them. I think this has been useful.

Oh, I'm sorry. The gentleman from Colorado.

Mr. PERLMUTTER. I just want to thank the panel and I also want to say that our Congressional Research Service often gets overlooked. They have put a heck of a report together that we got as of today, the kind that goes through the chronology of this and is very instructional. So I think for everybody on the panel as well as the members of our committee, and you guys often go overlooked. You do a great job in helping us understand these things.

Thank you, Mr. Chairman.

The CHAIRMAN. I appreciate that, and I think we have gotten some resolution on the current situation, although not to everybody's satisfaction. They weren't entirely satisfied.

As for the future, while this specific instrument is probably not going to occur, everybody, I think, learned some lessons about what we should put in place if anything similar shows up.

I thank the panel, and the hearing is adjourned.

[Whereupon, at 1:45 p.m., the hearing was adjourned.]

A P P E N D I X

September 18, 2008

Testimony of William Adams IV
Executive Vice President
Nuveen Investments, Inc.
Before the Committee on Financial Services
U.S. House of Representatives
September 18, 2008

Chairman Frank and members of the Financial Services Committee, thank you for inviting me to testify today about the continuing turmoil in the auction-rate securities marketplace and about our efforts, as a closed-end fund sponsor and investment adviser, to find ways to relieve the significant financial burdens being borne by the preferred and common shareholders of leveraged closed-end funds.

Introduction

My name is William Adams IV, Executive Vice President of Nuveen Investments. I have been employed at Nuveen for 27 years and currently head our Closed-end Fund Group. For the past seven months, my team's principal charge has been to find a resolution to the auction-rate crisis on behalf of our funds' shareholders. Nuveen, through its subsidiaries, is the largest sponsor and investment adviser of closed-end funds in the United States, managing a total of 120 closed-end funds with approximately $50 billion in assets. One hundred of these funds (the "Funds") have issued auction-rate preferred stock ("ARPS") as a way to seek to capture the difference between generally lower short-term borrowing rates and generally higher long-term investment returns, thereby offering common shareholders the potential for enhanced distributions and total returns over time. Nuveen Funds together represent the largest issuer of ARPS with more than $15 billion of ARPS outstanding at the time the auction rate securities market experienced sudden and widespread failures in February of this year. My testimony will provide some background on how the ARPS market developed and functioned, and the causes of that market's breakdown, but given the Committee's focus on helping resolve the current situation, I plan to focus primarily on potential solutions.

Impact on Investors

The failed auctions for our Funds have continued uninterrupted to the present time. This has resulted in decreased earnings for the over 1 million common shareholders of our Funds, and has prevented tens of thousands of ARPS shareholders from liquidating their shares at par at weekly auctions. This has created significant financial hardship for many preferred shareholders who have been unable to

sell their ARPS to meet a host of pressing financial needs. The ARPS turmoil has also introduced increased uncertainty and volatility in the market for the Funds' common shares, which trade on stock exchanges. The industry-wide scope of this problem is more far-reaching than many believe, as it affects preferred shareholders with over $60 billion in closed-end fund ARPS holdings and common shareholders with over $100 billion in common share holdings.

Nuveen's Response to ARPS Crisis

Soon after the systemic breakdown of the auction-rate securities market, we concluded that it was the absence of market liquidity, rather than credit concerns related to our Funds, that caused the auction failures. It was also our view that the existing ARPS market was unlikely to return to normal in the foreseeable future and that continued failed auctions would be detrimental to our Funds and their shareholders. In March, Nuveen and the Funds announced they would seek to refinance all the Funds' outstanding ARPS. Nuveen and the Funds set a goal to refinance the outstanding ARPS using a range of alternative financing methods, and to do so in a way that would reduce the Funds' relative cost of leverage over time for the benefit of our Funds' common shareholders while providing liquidity at par for our Funds' preferred shareholders. We sought to do this as quickly as possible, cognizant that there would be significant challenges due to the extremely difficult financing environment and the need to obtain regulatory relief to enable certain potential refinancing solutions. We committed to keep common and preferred shareholders and other market participants fully informed of our progress towards our goal with ongoing press releases, conference calls, and website information.

Our primary approach for refinancing the ARPS issued by our non-municipal closed-end Funds was to use conventional debt financing in the form of bank loans, lines of credit, and other forms of secured lending. For our municipal Funds, we considered the use of tender option bonds, or TOBs[1], which due to collateral requirements could be used only to a limited extent. More importantly, we undertook to develop a new form of preferred stock – Variable Rate Demand Preferred or VRDP – that included a liquidity backstop, or put, furnished by a financial institution with a short-term debt rating in the highest tier that would make the new preferred stock eligible for purchase by tax-exempt money market funds pursuant to Rule 2a-7 of the Investment Company Act of 1940 (the "Investment Company

[1] TOBs involve a fund depositing portfolio securities into a trust and having the trust issue short-term floating rate interests (called "tender option bonds") secured by the deposited securities. The depositing fund gains the use of the proceeds of the sale of the TOBs, which the fund can use to invest in other portfolio securities or to redeem other leveraging instruments. TOBs are typically sold to tax-exempt money market funds, which are required to adhere to strict credit quality standards.

Act"). Our municipal Funds, which have issued a significant majority of our Funds' ARPS, need to employ a financing vehicle that is characterized as equity for tax purposes and that enables the Funds to pass through the Funds' tax-exempt income to preferred shareholders. VRDP would be the only means for the Funds to continue their financing at lower tax-exempt short-term rates of interest, as was the case with ARPS. VRDP also benefits from the lower 200% asset coverage threshold required by the Investment Company Act rather than the 300% asset coverage required by the Investment Company Act for debt financing. For this reason, we also identified VRDP as a potential financing alternative for our equity and corporate debt Funds.

Progress on Potential Solutions

Significant progress has been made in the seven months since our Funds began their ARPS refinancing efforts. Still, we are not where we and our preferred and common shareholders would have wanted us to be at this point in time. Unprecedented turmoil in the financial markets, including the failure of major financial institutions and resulting market disruptions, has severely limited the availability of financing and liquidity backstops, even for highly creditworthy entities like the Funds. To date, Nuveen's non-municipal Funds have redeemed or announced plans to redeem $2.7 billion of their outstanding ARPS using traditional lending arrangements with a variety of major financial institutions. In addition, 32 of our municipal Funds have completed or announced a partial redemption of their outstanding ARPS totaling $1 billion through the use of TOBs. Most significantly, we have recently achieved an important breakthrough in our efforts to develop VRDP. In August, four of our municipal Funds successfully refinanced all of their outstanding ARPS, totaling approximately $600 million, using the proceeds from both TOBs and the issuance of a total of $500 million of VRDP that was purchased by tax-exempt money market funds. The VRDP was developed in close consultation with major money market funds and a major commercial bank, and we believe there is significant additional demand for VRDP from money market funds that could enable the refinancing of all our Funds' outstanding ARPS, and potentially much or all of the outstanding ARPS of closed-end funds industry-wide.

We greatly appreciate the timely guidance that we (along with others in the industry) have received from the Securities and Exchange Commission ("SEC") and the Department of the Treasury ("Treasury") in the development of VRDP. We also appreciate the sense of urgency this Committee has imparted on regulatory agencies and market participants to find creative solutions to this serious problem. That said, we believe there remain a number of regulatory impediments that hamper our Funds' ability to significantly expand their issuance of VRDP as well as to pursue other approaches for refinancing

outstanding ARPS. With additional regulatory relief and/or guidance from the SEC, Treasury and the Federal Reserve, we believe that we and the entire closed-end fund industry will be able to significantly accelerate our ability to provide liquidity for preferred shareholders while facilitating new and viable forms of financing for closed-end funds moving forward.

Key Regulatory Actions That Could Accelerate Progress

I would like to briefly highlight a few of the areas where regulatory relief or guidance would be most instrumental and which I discuss in greater detail later in my testimony.

First and foremost is clarification of the ability of banks to own VRDP pursuant to their purchase obligations as a liquidity provider for VRDP, and approval from the Federal Reserve to allow banks to pledge VRDP as collateral at the Fed discount window. Existing constraints regarding the ability of banks to own preferred stock, and the fact that VRDP is not eligible collateral for Fed discount window purposes, have significantly limited the ability of banks to provide liquidity backstops for VRDP despite VRDP's inherently high credit quality and despite significant potential demand from money market funds and other institutional investors.

Second, it would be quite helpful if the SEC would expedite its consideration of exemptive relief requests under Section 18 of the Investment Company Act to temporarily permit closed-end funds to use debt financing to a greater extent than currently permitted and enable funds that utilize debt leverage to fully refinance their ARPS. The SEC is currently considering these requests on a case-by-case basis. Ideally, it would be very helpful if the SEC made the requested relief available to all closed-end funds seeking substantially the same relief.

Third, it would be helpful if the Treasury Department provided further clarity regarding the equity treatment of closed-end fund preferred that includes liquidity backstops. The Treasury's recent guidance in this area, while helpful, is limiting in that it is applicable to a type of preferred stock with very specific features that may not be the most desirable set of features for closed-end fund preferred stock, including variations on VRDP, still in development. Ideally, we would appreciate it if Treasury would provide greater flexibility for closed-end funds to structure new forms of preferred stock as an equity security for tax purposes, and that would allow equity as well as debt-oriented funds to issue such preferred. It would also be helpful if the guidance was permanent rather than applicable only to funds refinancing existing ARPS within the next two years.

Finally, it would be helpful if the Treasury Department would clarify that federally tax-exempt municipal bond interest subject to the Alternative Minimum Tax (AMT) should not be subject to the provisions of Revenue Ruling 89-81 which requires different types of income earned by a closed-end fund be allocated to common and preferred shareholders on a pro-rata basis. The need to allocate AMT income earned by our funds to VRDP shareholders, even in small amounts, has precluded a meaningful number of major money market funds with non-AMT policies from becoming potential purchasers. We do not believe such a clarification, narrowly written, would undermine the general policy intent of the Revenue Ruling.

Background on Use of ARPS by Nuveen Closed-End Funds

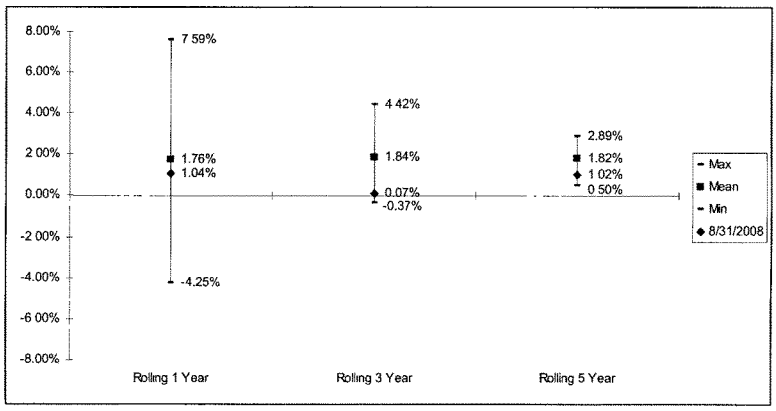
Before getting into more detail on needed regulatory actions, I would like to provide some background on the use of ARPS by our Funds. Many Nuveen Closed-End Funds employ financial leverage as a strategic element of their overall design in order to offer shareholders the potential for enhanced distributions and total returns over time. Nuveen believes that there are certain asset classes whose yields and long-term returns historically have consistently exceeded short-term financing rates. By judiciously using leverage that pays dividends or interest based on such short-term rates and investing the proceeds in these higher-yielding or higher returning asset classes, a fund can enhance its long-term performance potential. Keep in mind that the Investment Company Act limits the amount of leverage closed-end funds can employ to a relatively conservative maximum of 0.5 to 1 (e.g., $1 of leverage for every $2 of assets). Most Nuveen funds that employ leverage are leveraged at a ratio of between 0.33 and 0.4 to 1.

Leveraged municipal bond funds are one of the largest segments of the closed-end fund market and account for the substantial majority of Nuveen's leveraged closed-end fund assets under management. Leveraged municipal bond closed-end funds are designed to capture the persistent yield spread that has existed historically between long-term and short-term rates in the municipal bond market. This yield spread reflects the generally upward-sloping nature of the municipal yield curve created by the mismatch between municipalities' preference for issuing longer-term securities and municipal investors' preference for shorter-term securities.

Historically, this yield spread has offered closed-end fund investors an attractive opportunity to enhance both common share dividends and the total returns available from a portfolio of municipal bonds.

The accompanying chart shows that, for a hypothetical leveraged municipal closed-end fund investing its portfolio in a long-term municipal bond index and leveraging itself at the rates of a short-term municipal bond index, leverage generated positive incremental returns (often quite significant) to common shareholders over 100% of all 5-year rolling periods, over almost 100% of all 3-year rolling periods, and over the vast majority of all 1-year rolling periods, during the 19-year period covered by the chart. The actual experience of the common shares of Nuveen's leveraged closed-end municipal funds is very similar.

Historical Incremental Returns from Leverage*
Rolling Investment Horizons, July 1989 – August 2008



*For illustrative purposes only. Incremental returns based upon an assumed 35% leverage ratio.
Long-term rates are represented by the Lehman General Municipal Bond Index. Short-term rates are represented by the SIFMA Municipal Swap Index.

As mentioned earlier, closed-end funds investing in municipal bonds earning federally tax-exempt income cannot efficiently leverage themselves by borrowing or issuing debt securities, because such funds are not permitted by the Internal Revenue Code to pay interest that is federally tax-exempt. Absent something else, they would therefore need to pay financing rates at a federally taxable rate that would not be able to take advantage of the upward-sloping municipal yield curve previously mentioned. The Code, however, does authorize municipal bond funds to pay dividends that qualify as "exempt interest dividends," effectively passing through to fund shareholders the tax-exempt quality of the income earned on a fund's investment portfolio. Our municipal Funds thus elected to employ leverage by issuing ARPS, which pay dividends at rates determined at a weekly auction. Those auctions also served as the normal medium through which investors could buy ARPS and preferred shareholders could sell their ARPS. We describe this process in more detail later in my testimony. For almost 20 years, the ARPS

succeeded at both providing the closed-end funds with a low-cost financing vehicle for their leverage and preferred shareholders with an attractive and historically liquid investment paying short-term rates. The success and cost-efficiency of ARPS for municipal closed-end funds caused non-municipal closed-end funds to also use ARPS as their primary leverage financing vehicle.

While leverage offers a closed-end fund the opportunity for higher common share distributions and total returns over time, a leveraged fund also exposes common shareholders to increased risk from greater volatility in common share yield and net asset value (NAV) than an otherwise comparable non-leveraged fund. First, the spread between long-term fixed-income funds' earnings rates and short-term rates (i.e., the fund's borrowing rate) can vary widely over time, and this changing spread can increase the volatility of the leveraged fund's common share earnings and distributions. Moreover, because common shareholders of a leveraged fund bear the market risk on a fund's portfolio assets attributable to leverage, the NAV of a leveraged fund will fluctuate to a greater degree compared to an otherwise similar non-leveraged fund.

Background on the ARPS Market and the Auction Process

Nuveen's leveraged closed-end Funds typically issued ARPS several months after the initial public offering of their common shares, to coincide with the completion of the investment of the proceeds raised in the funds' initial common share offering. The Funds engaged a major broker/dealer firm to serve as lead underwriter (the "lead manager"), and often additional underwriters ("co-managers") that would initially place the ARPS with investors. The ARPS issued by the Nuveen Funds have a "liquidation preference" (akin to a bond's "par amount") of $25,000 per share. The aggregate liquidation preference of the ARPS issued by a Fund would correspond to the Fund's desired leverage ratio (e.g., a ratio of common share assets to ARPS of 2:1 would result in a leverage ratio of .33).

The lead manager, co-managers, and other broker/dealer firms that may not have participated in the initial ARPS offering (collectively "Auction Participants"), would enter into an auction participant agreement with the Funds that enabled them to participate in the weekly auctions for the Funds' ARPS. Auction Participants were permitted to participate in the Funds' ARPS auctions by submitting bids on behalf of their investor customers, or for their own account, to an independent third party (the "Auction Agent") pursuant to guidelines specifying the types of bids and the process for submitting such bids. Any investor wishing to buy or sell ARPS in the auctions needed to do so through the broker/dealer firms that were Auction Participants or broker/dealer firms that had clearing relationships with Auction Participants

who would bid on their behalf on an agency basis. On average, Nuveen Funds had approximately 25 Auction Participants bidding at weekly ARPS auctions, with 6 of them serving as lead managers. For their role in bidding at the auctions and all the attendant responsibilities involved, including recording and clearing ARPS trades, disseminating ARPS rates and relevant market information to investor customers, and submitting bids on their behalf, Auction Participants were paid a weekly fee at the annual rate of 0.25% based on the par amount of ARPS held by the broker/dealer and its customers.

The ARPS auctions were conducted in a manner commonly referred to as a "Dutch auction". Existing ARPS shareholders could, with respect to their existing shares, place one of three types of orders: "hold", "hold at (or above) a specified rate", and "sell". New investors (including existing shareholders wishing to buy additional shares in an auction) could place either a "buy" or a "buy at (or above) a specified rate" order. The dividend rate set in a particular auction would be the rate, as determined by an Auction Agent that conducted each auction, that would "clear" all the shares being sold – the lowest rate at which the number of shares being sold would exactly equal the number of shares being newly purchased (with a process for prorating any "ties"). The lead manager of the underwriting of a particular Fund's series of ARPS would typically assume the responsibility of closely overseeing the conduct of that series' weekly auctions, and would place "buy at a rate" bids in auctions with its own capital to help ensure that there would be a sufficient number of bids to "clear" the auction if there were a larger-than-expected number of "sell" orders (including "hold at/above a rate" orders with high specified rates).

Under the terms of the ARPS, a failed auction results in the dividend rate on the ARPS being determined based on an index-based formula designed to penalize the Fund and compensate the ARPS shareholder for their inability to liquidate their ARPS at the auction (the "Maximum Rate"), while at the same time offering some protection to the Fund's common shareholders from a potentially egregious cost of leverage should the rate be set at whatever level the market might bear (this was the case for many municipal issuers who saw interest rates on their failed auction-rate bonds rise well into double digits). This higher Maximum Rate was also intended to draw potential buyers back into the auctions so that the subsequent auction might succeed.

The federal securities laws and the terms of each Fund's ARPS preclude Nuveen's closed-end Funds from participating at the auctions for their own or their affiliated Funds' ARPS. Nuveen, as the Funds' investment adviser, is similarly precluded from participating in the Funds' ARPS auctions for its own account. Nuveen is allowed to, and did routinely, place "buy" or "sell" orders in the weekly auctions

solely on an agency basis on behalf of other broker/dealers and their investor customers. Nuveen did not have any direct relationships with ARPS investors and mainly provided the operational capabilities as a service to broker/dealer firms who did not have the necessary personnel and trading systems to bid at the ARPS auctions directly. Other Auction Participants served in a similar role for similarly situated broker/dealer firms. The principal goal behind Nuveen's role was to help expand the number of firms bidding at the Funds' ARPS auctions with the expectation of increasing competition among bidders, and potentially achieving a lower cost of leverage for the Funds that could enhance potential common shareholder net income and/or returns. Nuveen placed "buy" and "sell" orders on an agency basis only for Nuveen Fund-issued ARPS. Like other Auction Participants serving in a similar capacity, Nuveen receives the Auction Participant fee based on the holdings of Nuveen Fund ARPS beneficially owned by investor customers of the broker/dealers on whose behalf Nuveen placed orders. Nuveen shares approximately 50% of the amount it receives with the broker/dealers on whose behalf it placed bids. The balance retained by Nuveen is intended to cover the cost of its ARPS-related personnel and trading systems and is reviewed at least annually by the Funds' independent trustees. In addition to the above activities, Nuveen's and the Funds' principal role in the secondary market for the Funds' ARPS is primarily related to disseminating the clearing rates on Nuveen Fund ARPS through their website and responding to client service questions from financial advisors regarding the Funds' ARPS.

Risk Disclosures Regarding Potential Auction Failures

The Funds' ARPS offerings were made pursuant to a registration statement filed with the SEC including a prospectus that was provided to potential investors at the time of the initial offering. Beginning with the very first offering of ARPS by a Nuveen closed-end Fund in 1989, the prospectuses used in connection with offerings of ARPS by Nuveen Funds contained detailed disclosure regarding the auction process, including, among other things, disclosure of the risk of a "failed auction" – the risk that shareholders may be unable to sell their shares at times when they have placed sell orders. The first offering of ARPS by a Nuveen Fund was completed by the Nuveen Performance Plus Municipal Fund in October 1989, and the prospectus for that offering included the following statement:

> "*If Sufficient Clearing Bids do not exist, . . . Existing Holders that have submitted Sell Orders may not be able to sell in such Auction all shares of [ARPS] subject to such Sell Orders.*"

As the specific auction procedures evolved over time, so did the disclosure describing the auction process and the risks associated with that process. Even though auctions involving ARPS for a number of Nuveen Funds had been successfully completed for more than ten years and the perceived risk of failed auctions was considered remote, Nuveen Funds continued to disclose the inherent risks of the consequences of a failed auction. For example, in the May 16, 2001 prospectus for the ARPS offering by Nuveen Dividend Advantage Municipal Fund 2, the first risk disclosed was (Page 2 of the prospectus):

> *"• if an auction fails you may not be able to sell some or all of your shares;"*

In that same prospectus, the following was the first sentence of the Risk Factor entitled "Auction Risk":

> *"You may not be able to sell your [ARPS] shares at an auction if the auction fails; that is, if there are more [ARPS] shares offered for sale than there are buyers for those shares."*

Prospectus disclosure also made it clear that a Fund has no obligation to repurchase shares in the event a shareholder is unable to sell shares in the event of a failed auction or as a result of a failure to sell shares in the secondary market. The following sentence was included in the prospectus under the Risk Factor entitled "Secondary Market Risk":

> *"Broker-Dealers that maintain a secondary trading market for [ARPS] are not required to maintain this market, and the Fund is not required to redeem shares either if an auction or an attempted secondary market sale fails because of a lack of buyers."*

As mentioned above, as the auction process evolved over time, so did the relevant disclosure. However, the offering materials consistently disclosed that shareholders were subject to the risk of failed auctions and a potential inability to sell shares when they desired to do so. While the disclosure among Funds varied from time to time, the above disclosure cited from the prospectus for the Dividend Advantage Fund 2 remained a representative example of the type of disclosure made on behalf of the Nuveen Funds that issued ARPS from 2001 through 2007.

Background on the Auction Failures

As mentioned earlier, Nuveen closed-end funds first issued ARPS almost 20 years ago. The auction process described above worked smoothly with no Nuveen Fund ever experiencing a failed auction on their ARPS until late January of this year. Over those nearly 20 years, dividend rates on ARPS fluctuated in fairly close concert with relevant short-term money-market indexes, and over time, ARPS became an effective means of leveraging the Funds. The first failed ARPS auction experienced by one of our Funds in late January was unexpected and was viewed at the time as an isolated incident related to the inability of the lead manager of the original ARPS issuance to produce enough "buy" orders to clear the auction. Indeed, all auctions for Nuveen ARPS, including the ARPS whose auction initially failed and other auctions for which the same firm served as lead manager, succeeded in the ensuing days and weeks. Several weeks later, however, all auctions for all series of ARPS issued by Nuveen Funds and most other closed-end funds – irrespective of which firm was the lead manager – failed virtually in unison as credit and liquidity concerns began to spread through the financial markets, and Auction Participants, including the various lead managers, did not submit sufficient bids to cover ARPS sell orders. The failures caused all of the funds' ARPS dividend rates to be set at the Maximum Rate, a condition that continues to this day. This, in turn, has increased the cost of leverage for our closed-end Funds and their common shareholders and illiquidity for ARPS holders, a condition that is expected to persist as long as auctions continue to fail.

Although auctions have continued to fail since mid-February, auctions continue to be held for all of our Funds' ARPS. Auction Participants continue to place orders at the auctions on behalf of their investor customers, although the majority of orders are "sell" orders. From time to time, the Auction Agent receives small amounts of "buy" orders which are matched against "sell" orders and executed pursuant to an impartial lottery system administered by the Auction Agent. A number of entities have sought to create a secondary market for the ARPS. There have been reports, that we cannot confirm, of closed-end fund ARPS sales in these markets at prices below par. However, due in part to the successful efforts of a number of closed-end fund sponsors to refinance their funds' ARPS at par, the significant majority of ARPS shareholders have opted to wait, albeit anxiously, for their ARPS to be redeemed through refinancings by the funds. Most major pricing services and major broker/dealer firms have continued to price closed-end fund ARPS at par or very close to par. More recently, announcements by major broker/dealer firms of their intent to repurchase ARPS and other auction-rate securities at par from certain classes of investors has provided the prospect of some liquidity to ARPS shareholders. Still, the broker/dealer purchases do not provide liquidity to all ARPS shareholders and are unlikely to result in the

resumption of successful auctions. Nuveen and our Funds thus remain committed to our original goal of reducing the relative cost of leverage for the Funds and providing liquidity at par for all ARPS shareholders.

Expanded Discussion of Regulatory Actions That Could Help Resolve the ARPS Crisis

Since the substantial failure of the auction process, Nuveen and other sponsors of leveraged closed-end funds have sought to diligently and systematically develop marketable and economically feasible long-term or permanent refinancing solutions for ARPS. Our Funds' recently completed VRDP issuance is an important potential solution, as are similar preferred securities proposed by other closed-end funds that include liquidity support furnished by a financial institution with short-term debt ratings in the highest tier (collectively, "Demand Preferred").

Many of the possible solutions to replace ARPS have presented challenging issues for key regulators. As mentioned earlier, we would like to express our gratitude to the Committee for its continued interest in achieving the widest possible range of solutions to this difficult situation. Regulators such as the SEC and Treasury have worked with the industry to overcome regulatory hurdles, and we believe that the Committee's support has helped accelerate the speed with which the industry has been able to obtain necessary clarifications and relief. For example, the SEC staff has already issued a letter clarifying the eligibility of liquidity supported preferred stock, such as Demand Preferred, for purchase by money market funds, and Treasury has issued guidance that confirms that certain types of Demand Preferred are equity securities for tax purposes.[2] These interpretations are critical building blocks in the industry's efforts to create a viable market for Demand Preferred.

We believe additional regulatory actions are needed to ensure the economic feasibility of permanent or long-term refinancing solutions for ARPS issued by closed-end funds. While the potential supply of new municipal Demand Preferred is estimated to range from $15 billion to as much as $25 billion, to date only $500 million of Demand Preferred has been issued, a sharp contrast to developments

[2] With respect to the SEC action, see Eaton Vance Management, SEC No-Action Letter (June 13, 2008), which clarified the situations under which a liquidity provider purchases Demand Preferred, as well as whether or not Demand Preferred is a redeemable security under the Investment Company Act, and which allows Demand Preferred to be tendered for purchase by a liquidity provider without compliance with the tender offer requirements of the federal securities laws. With respect to the Treasury action, see Notice 2008-55, 2008-27 Internal Revenue Bulletin, 11, June 13, 2008 (revised June 25, 2008), which explains that where the issuer of ARPS adds a liquidity facility to support the stock (or replaces the stock with Demand Preferred), the IRS will not challenge the treatment of the ARPS or Demand Preferred as equity for income tax purposes provided certain conditions are satisfied. Among the conditions that must be met, the ARPS enhanced or replaced must have been outstanding in February 2008, and the issuer's portfolio must consist primarily of debt.

in the municipal bond market where $50 billion or more of municipal auction rate securities have been refinanced. Further, we estimate that, due at least in part to regulatory constraints, only about $2 billion of additional liquidity support for new issuance of Demand Preferred has been publicly announced to date. Liquidity support has been elusive despite the fact that almost all of the ARPS issued by closed-end funds have long-term preferred stock ratings in the highest tiers (AAA or AA), and are over-collateralized, as indicated by asset coverage levels substantially in excess of Investment Company Act asset maintenance requirements, and otherwise are potentially attractive business opportunities for liquidity providers.

The success of Demand Preferred as a replacement for outstanding ARPS issued by closed-end funds hinges on the Demand Preferred being eligible for purchase by money market funds in accordance with Rule 2a-7 under the Investment Company Act. The eligibility and desirability of Demand Preferred as an investment for money market funds in turn depends on the ability and willingness of financial institutions to provide, at a reasonable cost to its closed-end fund issuers, liquidity to shareholders of the Demand Preferred in the form of an unconditional purchase obligation or guarantee consistent with the requirements of Rule 2a-7. Other critical factors include preserving the equity character of Demand Preferred stock and, for the tax-exempt market, the tax-exempt character of Demand Preferred dividends.

Below, we suggest, with greater specificity than the similar discussion earlier in this written testimony, a number of banking, tax and securities law actions that we believe would benefit the development and success of both the Demand Preferred market. These initiatives would facilitate Rule 2a-7 eligibility and enhance the attractiveness of Demand Preferred as an investment for money market funds, and create other means to finance the replacement of outstanding closed-end fund ARPS, all while adhering to the policy objectives of the relevant regulatory regimes.

Matters Relating to Banks Acting as Liquidity Providers

1. Eligible Collateral for Extensions of Credit by a Federal Reserve Bank - We have found through our discussions with potential liquidity providers that the ability and willingness of banks to act as liquidity providers for Demand Preferred issued by closed-end funds, in sufficient volume to replace a meaningful amount of ARPS, is primarily subject to such banks obtaining regulatory approval to use Demand Preferred as eligible collateral for extensions of credit by the Federal Reserve. Absent such approval, these liquidity provider facilities may be too expensive to provide a meaningful solution for Demand Preferred.

We understand that the Federal Reserve has been reviewing requests to treat various structures of Demand Preferred as eligible collateral but that no action has yet been taken. In our view, there should not be any economic or policy objection to permitting the use of Demand Preferred as eligible collateral. This is because, as discussed below, Demand Preferred must constitute an eligible bank investment in order for a bank to acquire Demand Preferred in its role as liquidity provider (see next sub-section below); Demand Preferred will be investment-grade rated at the time of issuance; the issuer will be subject to both ratings maintenance covenants and regulation under the Investment Company Act with respect to the amount of permissible leverage; and Demand Preferred may have a final term through a scheduled mandatory redemption. We seek only to level the playing field between Demand Preferred and other income-oriented and creditworthy collateral already permitted and, accordingly, an expedited favorable resolution of this matter from the Federal Reserve would be highly beneficial to the development of the Demand Preferred market.

2. Eligible Investments for Banks - National banks, state banks and even foreign banks doing business in the U.S. through domestic branches may act as liquidity provider for Demand Preferred of closed-end funds only to the extent that such securities constitute eligible investments under applicable Federal and state banking regulations. These regulations require, among other things, that the assets of every closed-end fund issuing the Demand Preferred consist solely of assets that themselves constitute eligible investments for banks. This regulatory "look through" has caused significant obstacles for banks seeking to serve as liquidity providers for certain closed-end funds that invest, even to a miniscule extent, in "ineligible investments.[3]" Those closed-end funds must either alter their investment policies to invest only in bank eligible investments or must look to financial institutions other than banks to serve as liquidity providers for their Demand Preferred.

To permit closed-end funds issuing Demand Preferred broader and more meaningful access to banks as liquidity providers, while preserving their ability to invest in accordance with their stated investment objectives and policies described in their prospectuses and shareholder reports, the applicable banking regulations would need to be revised to treat Demand Preferred of a closed-end fund as an eligible bank investment, without "looking through" to the assets of the closed-end fund. Alternatively,

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[3] For example, we are told that these regulations prohibit a bank from investing in (and therefore from serving as liquidity provider for) preferred shares of a closed-end fund that itself invests in shares of another fund (a "2nd layer fund") if any of that 2nd layer fund's assets are "ineligible" under the banking laws (in industry parlance, the closed-end fund issuer of Demand Preferred would need to "look through" the 2nd layer fund to that fund's portfolio). Since the investing closed-end fund cannot typically assure itself that the 2nd layer fund owns no "ineligible" investments at all times, it cannot own shares of such a 2nd layer fund. This prohibition occurs regardless of whether the 2nd layer fund holding is 0.1% of the portfolio or 10%.

the regulations could be revised to permit the closed-end fund to satisfy the eligible investment requirements based on "looking through" to its assets, so long as the closed-end fund does not invest more than a limited percentage (for example, up to 10.0%) of its portfolio assets that may not meet the definition of eligible investments, but in any event subject to the investment restrictions imposed under the Investment Company Act. Either such change would be consistent with the policies underlying the regulation of eligible bank investments, because (1) the Demand Preferred will be an investment-grade income-producing security that is highly rated at the time of issuance, and subject to ratings maintenance covenants, and (2) the Investment Company Act contains ongoing ceilings with respect to the amount of permissible leverage. We believe that expedited favorable regulatory action on this issue alone would be highly beneficial to the development of the Demand Preferred market, without compromising the banks acting as liquidity providers or existing investors in the closed-end funds.

Federal Income Tax Matters

1. Equity Character of Demand Preferred Stock – Significant tax impediments have arisen in connection with closed-end funds issuing Demand Preferred to refinance outstanding ARPS. In particular, both the engagement of a liquidity provider for a closed-end fund's Demand Preferred, and the granting to such a liquidity provider the right to put back to the closed-end fund the Demand Preferred acquired pursuant to the liquidity provider's purchase obligation, may jeopardize the classification of the Demand Preferred as stock for Federal income tax purposes. For a municipal bond closed-end fund, Demand Preferred must be classified as stock for Federal income tax purposes to assure that the dividend paid on the Demand Preferred is itself tax-exempt. Such a result would render the Demand Preferred unusable for municipal bond funds. It would be very beneficial if Treasury could continue to clarify (as it did in Notice 2008-55) and, if appropriate, liberalize its standards for closed-end funds treating Demand Preferred stock as equity for tax purposes.

If the Demand Preferred, standing alone, would otherwise be classified as stock under ordinary tax principles, we believe that engaging a liquidity provider to assure a regular and ordinary market for the Demand Preferred should not cause the Demand Preferred to be reclassified as debt. We particularly believe this should be the result where the Demand Preferred adheres to specified parameters that help ensure that the liquidity provider was engaged primarily to assure a regular and ordinary market for the Demand Preferred. For example, the liquidity provider could be required to hold the Demand Preferred for a least six months before exercising its right to put it to the closed-end fund. In addition, preferred stock qualifying for such tax treatment could be limited to stock with a scheduled mandatory redemption

date not less than 20 years from the date of issue, and the closed-end fund could be required to engage the liquidity provider at a time when (i) the closed-end fund had no foreseeable basis for expecting that the liquidity provider would have to buy the stock and hold it for an extended period, and (ii) the closed-end fund had more than 200% asset coverage for the Demand Preferred.

Alternatively, and much more simply, it would be beneficial if Treasury were to adopt a policy permitting a closed-end fund to itself determine and declare the debt versus equity character of its Demand Preferred. This is similar to what Treasury did a decade ago with its "check-the-box" regulations for corporation versus partnership status, and would require all holders of Demand Preferred to treat their investment in the Demand Preferred as being of the character determined and declared by the closed-end fund.

At the very least, we believe that Treasury could modify its recent guidance on Demand Preferred (in Notice 2008-55) in two important respects. First, the relief should apply to all liquidity-supported preferred stock issued in the future, not just the stock issued to refinance ARPs that were outstanding on February 12, 2008. By so doing, there would be no competitive advantage to those funds that already have issued ARPS and no barrier to entry for new closed-end fund issuances. Second, Treasury's relief should apply to all closed-end funds, not just those that invest predominantly in debt. If the Treasury's reluctance to broaden the scope of that relief to equity funds – such as concerns about the tax abuse that might ensue if a fund were permitted to pay all of its Dividends Received Deduction-eligible income to one class of shareholder comprised of investors that benefit from such deductions, and to pay DRD-ineligible income to another class of shareholder comprised of investors that do not benefit from such deduction – the market may well be better served by regulations specifically tailored to the troubling abuse in question.

2. *Exempt Character of Demand Preferred Dividends* – Municipal bond funds need greater flexibility in distributing their earnings. A closed-end fund that invests in tax-exempt municipal bonds should be allowed to classify all of the dividends paid to its Demand Preferred shareholders as consisting entirely of tax-exempt income from the investments of the closed-end fund. To comply with a 1989 IRS ruling (Revenue Ruling 89-81), a closed-end fund having more than one class of stock and more than one type of income must allocate to each class of stock its proportionate share of each type of income. This means, for example, that even if 99.9% of a closed-end fund's income is tax-exempt and only .1% of its income is subject to the regular tax or the alternative minimum tax (or capital gains tax), the closed-end fund will still allocate a portion of the .1% of taxable income to its Demand Preferred.

Certain potential shareholders, such as certain tax-exempt money market funds, cannot or will not accept any allocation of taxable income. For that reason alone, they will not acquire Demand Preferred even if the Demand Preferred is otherwise economically attractive. It is important for the Treasury to modify Revenue Ruling 89-81 to permit a leveraged municipal closed-end fund greater flexibility in allocating all of its taxable income or at least all of certain types of its taxable income (for example, its income subject to alternative minimum tax) to its common shareholders.

Investment Company Act Matters

Significant policy issues as well as modest technical issues under the Investment Company Act have impeded the resolution of certain ARPS issues.

1. Section 18 of the Investment Company Act - Section 18 of the Investment Company Act requires that closed-end funds maintain asset coverage of at least 200% for preferred stock they issue and at least 300% for debt they issue. In connection with the failed auctions for ARPS issued by closed-end funds, a number of fund complexes are seeking exemptive relief from the SEC so that the 200% asset coverage requirement (rather than the 300% asset coverage requirement) would apply to debt issued to redeem ARPS outstanding prior to February 2008. These applications have been pending for a number of months. This exemptive relief is needed on an expedited basis. Furthermore, it would be helpful if the SEC adopted a temporary rule making the requested exemptive relief available to all closed-end funds similarly situated or otherwise provided expedited treatment for all applicants seeking substantially similar exemptive relief.

The requested exemptive orders seek only temporary relief (i.e., two years from the date that a fund borrows in reliance on the order) from the 300% asset coverage requirements for borrowings. We believe that Congress should consider amending the Investment Company Act to permanently change the asset coverage requirement to 200% (or at least some amount substantially less than 300%) in the case of privately arranged borrowings by closed-end funds from banks or other financial institutions, because such institutions do not require the protections of the Investment Company Act.

2. Section 12(d)(1)(A) and (B) of the Investment Company Act – To prevent fund pyramiding, Sections 12(d)(1)(A) and (B) of the Investment Company Act restrict investments by an investment company in another investment company. Specifically, these sections limit a registered investment company from (i)

acquiring more than 3% of the outstanding voting stock of another investment company, (ii) acquiring securities of another investment company in excess of 5% of the value of the acquiring company's total assets, and (iii) acquiring in the aggregate securities of other investment companies in excess of 10% of the value of the acquiring company's assets.

One reason for these limitations is to avoid the duplication and layering of fees that result from a fund investing in other funds without a corresponding benefit. In the case of closed-end fund preferred shares such as Demand Preferred, however, there is no such duplication or layering of fees. The fees and expenses of Demand Preferred and similar preferred shares are borne by the common shareholders, not the issuing fund's preferred shareholders. Consequently, an investment company purchasing Demand Preferred does not experience the duplication and layering of fees that Section 12 is intended to limit.

Another reason for the Section 12 limitations is to prevent complicated and opaque capital structures and to prevent one fund from gaining undue influence over another fund through a pyramid capital structure. The risk that a money market fund could exercise undue influence over an issuing closed-end fund through the ownership of Demand Preferred is low because Demand Preferred is typically created in institutional-sized preferred shares (e.g., a liquidation preference of $25,000 or $100,000) representing only a very small percentage of the closed-end fund's voting securities.

While we believe the Section 12(d)(1) limits should not apply to money market funds investing in Demand Preferred, in particular, it would be helpful if the 10% aggregate limit on investment in other investment companies be eliminated or raised, for example to 25%, by SEC rulemaking in the case of money market funds buying Demand Preferred of closed-end funds. This change would be especially helpful in facilitating the sale of Demand Preferred to money market funds. Furthermore, consideration should be given to removing by SEC rulemaking the 5% limit on investment by money market funds in the Demand Preferred of one closed-end fund, since the money market funds are already subject to the issuer and demand feature provider diversification requirements of Rule 2a-7.

3. Determination of Whether a Liquidity Provider is an Affiliated Person of the Closed-End Fund Issuer of Demand Preferred - A recurring question that arises in discussions between closed-end funds seeking to issue Demand Preferred and potential liquidity providers is whether a liquidity provider will be deemed to become an affiliated person of a closed-end fund issuer for purposes of the Investment Company Act and other Federal securities laws solely on the basis of the liquidity provider entering into the contractual

liquidity provider arrangements with the closed-end fund or acquiring Demand Preferred issued by the closed-end fund pursuant to its obligation as liquidity provider.

Because the Demand Preferred market is an institutional sized market as described above, such instruments are very unlikely to constitute more than a minimal amount (typically less than 0.1%) of a closed-end fund's total outstanding voting securities, among other reasons. Accordingly, we (and other members of the fund industry) take the view that no presumption of affiliated person (within the meaning of the Investment Company Act and other Federal securities laws) status is created solely on the basis of the liquidity provider entering into the contractual arrangements with the closed-end fund to provide liquidity support or by acquiring Demand Preferred issued by the closed-end fund pursuant to its obligation as liquidity provider. Given such limitation on ownership, the fact that the Investment Company Act gives preferred shareholders certain rights to elect directors does not negate this view, since the directors elected by the preferred shareholders have a fiduciary duty under state law to represent all shareholders (including the common shareholders that represent the vast majority of the total ownership), not just the interests of the liquidity provider or other preferred shareholders as a class.

A "no-action" letter request was submitted to the SEC staff in early July 2008 by an industry group seeking staff concurrence with the view expressed above. We believe that staff assurances along these lines would enhance the willingness of financial institutions to step forward to act as liquidity providers, and it would be beneficial if the SEC staff were to issue a positive response in the very near future.

4. Redemption Notification Pursuant to Rule 23c-2 under the Investment Company Act - Rule 23c-2 requires that registered closed-end funds provide the SEC with at least 30 days' prior notification of redemptions of outstanding securities, such as ARPS. Further, such notification must be made not less than 10 days' prior to publication of notice to shareholders, if such publication is required. These requirements have added inefficiency and cost to the process of refinancing outstanding ARPS with new Demand Preferred, since the closed-end fund issuer cannot determine the terms of the redemption of the ARPS until the Demand Preferred have been issued. The SEC staff has provided temporary relief to various funds and fund groups on a case-by-case basis during the ARPS crisis, which has been very helpful to address the associated inefficiency.

Under the rule, the requirements relate only to notification; no review or other action by the SEC is involved. Accordingly, the prior notification requirements serve no apparent purpose, at least in the

context of refinancing ARPS. In order to eliminate the associated inefficiency and cost, the prior notification requirements should either be eliminated or, for example, amended so that the issuer may notify the SEC concurrently with the giving of notice to shareholders as required by the terms of the ARPS.

Tender Offer Matters

The right of a holder of Demand Preferred to tender its securities for purchase by the liquidity provider has caused some persons to question whether the exercise of such rights may be subject to the Tender Offer Rules.[4] For the reasons set forth in Eaton Vance Management, SEC No-Action Letter (June 13, 2008) (the "Eaton Vance Letter"), among others, we and other industry participants believe the Tender Offer Rules do not apply and that the protections afforded by the Tender Offer Rules are superfluous in the context of Demand Preferred. While the SEC staff has granted certain relief in this regard, as set forth in the Eaton Vance Letter and in other contexts, a blanket exemption or similar relief recognizing the inapplicability of the Tender Offer Rules would be beneficial to the development and success of the Demand Preferred market, as it would provide greater certainty and enable closed-end fund issuers to continue to develop and modify the product to satisfy evolving needs of prospective investors without potentially having to repeatedly return to the SEC staff for relief.

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Thank you for the opportunity to testify today. I can assure you that our efforts to address the turmoil in the ARPS marketplace to relieve the significant financial burdens being experienced by common and preferred shareholders of leveraged closed-end funds will continue unabated. I welcome your questions.

[4] Sections 13(e) and 14(d) of the Securities Exchange Act of 1934, as amended, and Rule 13e-4 and Regulations 14D and 14E thereunder.

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TESTIMONY OF MASSACHUSETTS ATTORNEY GENERAL MARTHA COAKLEY REGARDING AUCTION RATE SECURITIES

Thursday, September 18, 2008

Thank you for inviting me to testify here today. I am Massachusetts Attorney General Martha Coakley. Our Office, along with the Secretary of State of the Commonwealth, provides public enforcement of securities laws at the state level in Massachusetts. The Attorney General's Office is authorized to bring criminal and civil actions in our State Courts against investment banks, brokers, and issuers who deceive investors or fail to meet required legal standards. Our Office also has exclusive authority to bring actions under our State False Claims Act against entities that mislead towns, cities, and other state entities regarding investment decisions.

Auction rate securities sold in Massachusetts have been a great concern to us. As you know, these securities are debt and debt-like instruments, such as a bond or preferred stock, for which the interest rate or dividend is periodically reset through an auction mechanism. Although these securities have long-term maturities of many years, they historically have been offered for sale at weekly or monthly auctions, which provided the appearance of periodic liquidity. Because of this supposed liquidity, auction rate securities were often touted as being so-called "cash alternatives." When earlier this year the market for auction rate securities dried up, the auctions through which they were sold experienced widespread failures. These failures largely eliminated liquidity, making it difficult to dispose of the securities at all. When the securities were then written down to reflect their reduced market value, many investors suffered serious losses in their investment principal.

Responding to allegations of misleading sales practices, we began to review auction rate securities last year after certain mortgage-linked auction rate securities experienced failed auctions in August of 2007. In early 2008, Secretary of State William Galvin requested that our two Offices divide responsibilities. Our Office concentrated on sales to towns, cities and state entities under our False Claims Act authority, while the Secretary performed an administrative regulatory review of retail sales as part of a national North American Securities Administrators Association (NASAA) task force. Our Office served investigative subpoenas, met with affected municipalities, reviewed documents, and took testimony from investment banks and their agents. Our review focused on whether state entities, as customers, were misled regarding the appropriateness of auction rate securities as investments. We carefully scrutinized broker behavior, disclosures, as well as the lack of disclosure, and the behavior of investment banks as they sought to transfer auction rate securities from their own accounts to those of their municipal customers. We performed our investigations thoroughly but quickly, and obtained prompt results.

Six weeks after starting our review of the investments of Springfield, Massachusetts, (and just days before the broader market for auction rate securities began to meltdown) we recovered from Merrill Lynch at par the $14 Million that the city had invested in auction rate CDO securities. In our review of UBS, which we initiated the same day UBS began letting its auctions fail, we completed our investigation in approximately 10 weeks and recovered $37 Million for 18 Massachusetts municipalities and state entities (we later recovered additional monies from UBS, including repayments to town trusts holding third party monies and a $1 Million payment to the state including fees and costs). We began our review of Morgan Stanley in the same time frame, which resulted in the recovery of an additional $2 Million for towns and cities. Most recently, our ongoing review of Citibank resulted in Citi's agreement to return $20 Million to the Massachusetts Water Pollution Abatement Trust. Our recovery against Merrill was the first recovery by a state in the auction rate arena, and our consent judgment against UBS was the first court ordered resolution by a public enforcer. We believe our early investigative and litigation efforts helped jump-start the broader resolution process, and we commend the good work of Secretary Galvin,

Attorney General Cuomo in his role as New York's administrative securities regulator, the SEC, NASAA, and FINRA, for the roles they are playing in moving the larger process forward.

I commend this Committee for looking closely at the auction rate securities market, and for trying to find ways to help investors and issuers. This is complicated, and it is important to ensure that all solutions reached will provide relief for investors and the entities that issued the auction rate securities. I would like to make three suggestions to the Committee:

1. Any solution should actually return full investment amounts to all investors.

2. The monies must be returned promptly.

3. Non-profit and governmental issuers should also not be forced to incur additional expenses and losses as a result.

Additionally, the Committee should focus on the larger picture and address the problems with the underlying assets backing some of these securities.

1. On the initial matter of restitution, it is important that we seek to provide full par value payments to all investors, and to cover any losses that those investors suffered. In our cases, we have achieved this goal, obtaining full recoveries for the affected Massachusetts entities. However, voluntary buy-back initiatives or liquidity solutions proffered unilaterally by the investment banks have not provided full restitution. And, although the regulatory settlements announced by the SEC and state administrative regulators have obtained promises to repay some investors at par, other investors have not been provided any repayments at all. Our Office recently experienced this first-hand, when we learned that our Massachusetts Water Pollution Abatement Trust, which held $20 Million in Citi's auction rate securities, was not actually covered by the widely announced regulatory settlement between NASAA and Citibank. In conjunction with our investigation under the state False Claims Act, we had to separately negotiate with Citi to return those monies. Municipal governments must keep substantial operating

reserves in cash accounts and were frequently persuaded to place such monies into auction rate securities with supposedly "guaranteed" liquidity by the very entities now settling with other regulators. So-called "global" settlements that do not return monies to towns, cities, and state trusts fail to protect the public fisc. These entities provide vital public services, and citizens are shortchanged when local and state governmental investments are left to suffer losses. Similarly, while the regulatory settlements may help many well- heeled individual investors, they fail to help investors of more modest means who may have invested unwittingly in auction rate securities through their mutual funds. Such individuals should not be left uncompensated.

2. The second issue is timing. Large scale securities cases do not always have the best track record for getting monies back to investors in a timely manner. In situations where investors were led to believe they would have regular access to their cash through weekly or monthly auctions, it is crucial that any repurchases happen promptly. I urge this Committee to consider this issue of timing, and take steps to ensure that any resolution happens with all deliberate speed.

3. There is another side to the auction rate issue beyond the harm to investors. The failure of this market has also caused significant harm to numerous non-profit and governmental issuers. Many of these entities, including the issuers of student loans, medical care entities, and governmental subdivisions, are now facing potentially crippling costs as they restructure or reissue their debt. Many issuers, by the terms of their auction rate issuances, must offer high default interest rates to investors because the auction markets have failed. To avoid these costs, issuers must restructure or reissue their debt, thus incurring additional investment banking expenses. Such payments divert money from the public fisc or from charitable institutions and prevent it from being used to serve the public good. I hope this Committee will review ways to lower the transaction costs for non-profit and governmental issuers or otherwise shift such costs to those who are most responsible for this crisis. This will allow our public issuers of debt to continue to provide their vital public services without unnecessary expense.

Finally, even if the Committee can find a way to fix the immediate auction rate problem, we still

need to consider the stability of the underlying assets that backed these notes. For example, certain auction rate securities were tied to questionable home mortgage loans. Many more are tied to student loans, a market that is currently experiencing significant upheaval. The packaging and re-purchase of these debts as securities presents challenges for the entire financial system. We should be careful to ensure that intermittent liquidity crises in financial markets and other problems that may arise with advances in financial technology do not disproportionately harm consumers – such as students and homeowners – who, through such innovations, have become subject to the whims of such markets. In resolving today's crisis, we need to consider how we can prevent future crises as well. Only by acting to protect homeowners, students, and other borrowers, will we be able to prevent another similar crisis in the future.

Thank you again for the opportunity to testify before this Committee.

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TESTIMONY OF WILLIAM FRANCIS GALVIN

Secretary of the Commonwealth of Massachusetts

Before the
United States House of Representatives,
Financial Services Committee

September 18, 2008

I am William Galvin, Secretary of State and chief securities regulator of The Commonwealth of Massachusetts. I want to commend Representatives Frank and Bachus for calling today's hearing to examine the causes of the failure of the market for auction rate securities and potential ways of making our regulation of the securities industry more effective. I submit this testimony based on my experience as the head of the Massachusetts Securities Division.

Today, I would like to briefly discuss the findings of the Massachusetts Securities Division's investigations into UBS's and Merrill Lynch's sales of auction rate securities to retail and other customers, lessons learned from those investigations and our investigation of Bank of America, and proposals for preventing such problems from occurring in the future. Specifically, the five themes I believe arise from the auction rate debacle are (1) that conflicts of interest need to be more aggressively monitored and, when appropriate, disclosed to investors, (2) that financial advisor incentives need to be disclosed and financial advisor training needs to be enhanced, (3) that supposedly objective research reports need to be more tightly regulated, (4) that principle-based regulation is not effective to prevent a scandal such as this one, and (5) that state regulators, in conjunction with their federal counterparts, need to continue to be actively involved in enforcement actions I believe that the need to ask ourselves difficult questions about how we can make our regulatory system more effective is especially important given this week's market events.

A. Brief Description of UBS Complaint

In June of this year, my office filed an administrative complaint against UBS, based on an investigation that exposed a conflict of interest between UBS and its customers and the devastating effect that this conflict had on those customers, who were not apprised of the conflict and how it was affecting UBS' actions and recommendations.

Beginning in mid-February 2008, the Division began receiving scores of telephone calls from shocked and outraged customers of UBS who were sold instruments that they were told were safe and liquid. These instruments were often pitched to clients as money-market instruments or cash alternatives, and the client was told that they would have access to cash at the next auction period, which was typically 7 or 28 days. These

instruments were auction rate securities ("ARS"), some of which were listed on UBS's customer statements under the titles "cash alternatives/municipal securities" and others as "cash alternatives/money market instruments."

The common theme of all of the customers that contacted the Division was that the money UBS placed into ARS was intended to be their safe money and that it would be 100 percent principal-protected and completely (subject to the 7-day or 28-day auction delay) liquid. Investors that purchased those securities ranged from retirees, who sought to invest their money in ultra-safe, liquid investments that they could access if they needed the funds, to small business owners who needed to park operational cash in highly-liquid instruments to be accessed upon short notice for continuing operations and upcoming projects.

Those investors were not told that the auctions were not, in fact, true auctions. They were not told that UBS submitted a support bid for every auction for which it was the lead or sole broker-dealer to ensure that the auction did not fail. They were not told that UBS itself set the interest rate in most of the auctions with the bids it submitted. They were not told that UBS actively managed the interest rates so that they would be just high enough to move the ARS it had underwritten but not so high as to make the issuers that were its underwriting clients unhappy. They were not told that the only products offered to them were products that UBS had underwritten and was trying to distribute. They were not told that in August 2007 UBS intentionally let certain auctions fail because there were not sufficient buyers and UBS did not want to own more of the ARS paper that it was trying to auction off.

UBS retail clients were also kept in the dark about the dangerous increase in auction rate security inventory that UBS was carrying on its books beginning in the Fall of 2007 and continuing through to February 2008. They were not informed that UBS' short-term desk had exceeded, multiple times in 2007 and in early 2008, the amount of capital it was authorized to use to support the auctions, and that the auction rate desk was forced to repeatedly request an increase in that cap. They were not told of the extreme efforts that UBS made to decrease its inventory of ARS at the insistence of its risk management department—and they certainly were not told that sales to them were the cornerstone of UBS' inventory-reduction program. UBS failed to inform its clients that beginning in the Fall of 2007, certain ARS, which UBS had structured and brought to market, were approaching their interest rate caps and were in danger of becoming unmarketable. Moreover, clients were not informed that beginning as early as September 2007, UBS was actively considering scenarios which included pulling out of its auction program altogether.

In the months following August 2007, UBS became increasingly concerned about the viability of its auction program and structural flaws in certain ARS, and began to debate pulling out of its auction market program. Numerous emails from insiders at UBS indicated an increasing awareness of the vulnerabilities of the auction market and the increased likelihood that UBS would consider pulling out of the market altogether. For example, in a September 6, 2007 email, the Global Head Municipal Securities Group and

Head of Fixed Income Americas at UBS Securities at UBS stated in an email that he "is under severe inventory pressure from client base in the auction rate markets" and he is having "legal looking into options to EXIT some business lines (to resign from supporting the programs that we have been senior manager on for 5+ years) to accommodate our firms request and what our liability in the marketplace/WM and reputational issues with issuers as well as investors would be." In another email that day, he stated, with respect to the auction rate product: "I don't want to service this product either –quite frankly and am happy to responsibly dispose of it---we are trying for sure."

In an October 31, 2007 email, that same insider referred to the auction rate program as "a huge albatross." In a December 11 email, a senior manager on UBS's Short-Term Desk sent an email acknowledging that "the auction process is flawed" and saying "I think eventually most of the book needs to be converted as the auctions aren't going to come back." Likewise, UBS' Risk Management Division also understood the dire straits that the auction program was mired in. In a December 11 email from risk management stated that: "we need to be totally comfortable from a credit perspective on all of the assets that we auction if we are going to support auctions." Even the investment banking group realized the fundamental foundations of continuing the auction rate program were in jeopardy. On December 12, the person responsible for overseeing underwriting public finance for UBS Securities, sent an email warning of "the continued deterioration of the auction rate market." Similarly, on December 12, the senior manager on UBS's Short-Term Desk referred to above sent an email stating: "the entire book needs to be restructured out of auctions" and an email stating that "[t]he auction product does not work and we need to use our leverage to force the issuers to confront this problem our options are to resign as remarketing agent or fail . . " On December 15, 2007 Global Head of the Municipal Securities Group and Head of Fixed Income Americas sent and email to UBS Securities' Chief Risk Officer indicating that he "will need some guidance from you as well as [Deputy CEO Global Wealth Management and Head of Wealth Management US] in terms of our overall position and philosophy as it relates to continuing to support these auctions. . . . . What is clear is that the fundamental mechanism of the [ARS] structure is not working in a liquidity squeezed environment..."

The same vulnerabilities in its auction rate program that were troubling UBS were causing some corporate cash clients to shun those specific instruments and were putting substantial pressure on all of UBS' auction rate instruments. As its awareness of these problems increased, UBS also had to step in with more and more of its own capital to make sure that auctions cleared, thus allowing it to continue its lucrative business of underwriting ARS through the end of 2007. In order to offset this inventory buildup, UBS began an all-out effort to market ARS generally and, in particular, troubled student loan-backed auction rate certificates (which had interest rate caps built into them that began to render them unmarketable). This marketing effort was considered necessary in order to offset sales by investors (generally corporate cash managers) who began to become uncomfortable with these instruments and thus to keep the auctions functioning without UBS extending more of its capital to support them than its risk management department was comfortable with. UBS's Global Head of its Municipal Securities Group

and Head of Fixed Income Americas stated, as the justification for these marketing campaigns, that he was "under a lot of pressure to move paper." He was being told by risk management that "we need to beat the bushes harder than ever to unload this paper." However, in order to keep offloading its inventory of ARS, UBS kept purchasers in the dark about the very vulnerabilities of its auction rate program that UBS had discovered.

In and after August 2007, UBS insiders spearheaded increased marketing efforts with respect to ARS after August 2007. They orchestrated a number of conference calls with UBS Financial Services' Wealth Management franchise's FAs to get them to focus on the value of ARS to retail clients. However, on August 22, 2007—just as he orchestrated the enhanced marketing program for ARS—the Global Head of the Municipal Securities Group and the head of Fixed Income spearheading the marketing campaign sold a large portion of his personal holdings of ARS. When asked in an on-the-record interview why he made those sales, he stated he was worried about the safety of those instruments after UBS and other broker-dealers allowed certain auctions to fail in August of that year. At the same time, this insider sold a large amount of municipal weekly ARS and purchased variable rate debt obligations. When asked why he did this, he stated: "Because I wanted to be in VRDO instruments because they had a liquidity backstop on those securities and I thought there was more protection."

In early December 2007, in order to offset the increased inventory that UBS was taking on, the Global Head of the Municipal Securities Group and Head of Fixed Income Americas, again, orchestrated another all-out sales effort in order to get retail customers to see the "value" in ARS at the prices at which UBS was willing to offer them. Yet, at the same time, on December 12, he quietly sold the remainder of his personal holdings of ARS. He subsequently explained that he made these sales because "my risk tolerance from a credit perspective was – was something that drove me to want to sell" ARS. UBS' customers (and certain UBS Financial Services FAs), who were not apprised of the information that this insider and the other UBS higher-ups knew about the escalating problems with UBS' auction rate program, were not so lucky. UBS Financial Services' FAs were encouraged to, and did, make sales of ARS to Massachusetts clients up until the last auction cleared on February 12.

On February 13, 2008, without advance notice to its customers, UBS stopped supporting its auction rate program, leaving hundreds of customers stuck with instruments that were now illiquid. This Division's investigation uncovered a profound disconnect between UBS' understanding to the ARS it was selling and its FAs' explanations of these securities to their customers. In addition, by setting up a situation where it was actively controlling whether auctions would clear and what rate they would clear at, UBS had (unbeknownst to its customers) set up a situation which put it in a fundamentally conflicted role between its desire to keep its underwriting clients happy with the promise of low financing costs and its obligation to retail customers to keep the auctions it had set up afloat. When corporate cash buyers started leaving the market and UBS' inventory started ballooning, UBS was confronted with a conflict between its customers who thought they had purchased safe, liquid, money-market instruments which without UBS' continued support would no longer be liquid, and its risk management arm

which did not want to be stuck holding the very paper UBS underwrote and pushed to its clients.

None of these conflicts were visible to UBS' retail clients. As the Deputy CEO Global Wealth Management and Head of Wealth Management US subsequently admitted in April 2008, "if at any moment UBS announced that we weren't as committed in auctions, it would have been the same as giving up on auctions." Those customers trusted the advice of their UBS financial advisers who sold them these instruments that were liquid, safe and risk free and they were blindsided by the very people who were supposed to have their best interests at heart.

B. Brief Description of Merrill Lynch Complaint

In July of this year, the Massachusetts Securities Division filed an administrative complaint against Merrill Lynch, based on a comprehensive investigation it had undertaken. The investigation focused on the manner in which Merrill Lynch conducted its auction rate securities business, as well as how it interacted with its research department. The complaint charged the firm with creating and implementing a sales and marketing scheme which significantly misstated not only the nature of ARS, but also the overall stability of the auction market. Ultimately Merrill Lynch abandoned thousands of investors holding ARS that became illiquid when it stopped supporting its auction rate program.

Particularly egregious, was the manner in which Merrill Lynch co-opted its supposedly independent Research Department to assist in sales efforts geared towards reducing its inventory of ARS. Specifically, Merrill Lynch permitted its Sales and Trading, including Auction Desk, managers to unduly influence and pressure the Research Department in a number of ways. First, it allowed Sales and Trading to directly request and advocate for written research endorsing the safety and high quality of nearly all types of ARS and recommending investors buy ARS. In one instance, a Managing Director in charge of the Merrill Lynch's auction desk, directly emailed a Fixed Income Analyst in the Research Department, stating that "[a]ny renewed research focusing on the high quality of closed end fund preferreds of ALL tax status, auction municipal bonds and student loan backed bonds, wrapped around the value added proposition with today's rates would be extremely helpful."

Further, when Sales and Trading, including Auction Desk personnel, did not agree with the tone or context of a published research piece, Merrill Lynch managers, permitted Sales and Trading to insist the published report to be retracted and replaced with a more sales friendly piece. In one instance in August 2007, a research piece was published in Merrill Lynch's Fixed Income Digest primarily for the purpose of highlighting the differences in liquidity features for auction rate preferreds ("APS") and Variable Rate Demand Obligations ("VRDOs") in light of certain recent failed auctions. The primary distinction noted by the author, a Fixed Income Analyst in the, was that VRDOs have a hard put, while APS do not. Upon reading this research report, the Managing Director of Merrill Lynch's auction desk referred to above immediately called the analyst and

demanded a retraction and clarification on the grounds that the report was misleading. The analyst initially refused to retract the report because he thought it was accurate. The Managing Director of the auction desk elevated the complaint to her boss and another, more senior Research Analyst. She also emailed persons in the Financial Products Group with the following all caps message:

> I HAD NOT SEEN THIS PIECE UNTIL JUST NOW **AND IT MAY SINGLE HANDEDLY UNDERMINE THE AUCTION MARKET.** IF YOU ARE GETTING ANY CALLS, PLEASE LET ME KNOW. I HAVE ASKED FOR AN IMMEDIATE CLARIFICATION TO BE PUBLISHED AND A RETRACTION OF THIS.

(Emphasis added). The Research Department agreed to retract and re-write the piece. The re-written piece was markedly different in both focus and scope from the original report and its conclusion contained a glowing endorsement of the ARS, "as a buying opportunity for investors who are looking for short-term instruments."
Pressure and objections from the Auction Desk had lasting effects on the Research Department's published opinions. For example in January 2008, after completing changes to a draft research piece involving ARS, the author requested someone review his work before it was published to ensure that it did not upset the Auction Desk, "I want to make sure that research cannot be accused of causing a run on the auction desk, like was the case in August."

Undue influence over the Research Department did not end there. Other times, Auction Desk personnel attempted to directly influence how Research responded to FA questions during sales calls with Merrill Lynch sales staff. In one instance in August 2007, a senior Research Analyst was a featured speaker and was answering FA questions in a "Q&A" style sales conference call. The head of the auction desk had also dialed in to the call and was listening in. After one question was asked, which apparently was not to her liking, she emailed or instant messaged the Research Analyst and stated: "Shut this guy down. Suggest he call outside this call. He is focusing attention away from your positive message." In addition, Merrill Lynch also permitted Sales and Trading managers, including Auction Desk personnel, to communicate to members of the Research Department (in violation of company policies and procedures) sensitive confidential information concerning inventory levels, marketing initiatives and enhanced sales incentives offered to Financial Advisors ("FAs") to sell ARS. Year end employment reviews of certain Research Analysts also took into account the level of support that analyst provided to his "business partners" at the Auction Desk. Further, certain managers in Sales and Trading had direct input in the year-end employment evaluations of at least one Research Analyst. This input directly had the potential to influence the level of bonus awarded to the Research Analyst.

Management regularly incorporated the supposedly independent Research Analysts into sales efforts and relied on them to actively engage and motivate sales staff to sell ARS, even in times when market conditions existed that called into question the suitability of ARS for those customers that needed ready liquidity. In participating in

these sales calls, Research Analysts routinely soft-pedaled significant negative events affecting liquidity in the auction markets, and omitted material information which a reasonable investor would need to form an objective opinion as to the suitability of the investment. These actions took place up to and including the time when Merrill Lynch intentionally withdrew from the auction market. For instance, on February 7, 2008, some five days before Merrill Lynch decided to voluntarily withdraw from the auction market, one Research Analyst participated in a conference call with FAs to discuss recent market events. In discussing whether all closed-end funds auctions were suspect or likely to fail, this Research Analyst disagreed and told FAs, that "Merrill Lynch, certainly by all indications, is committed to this product. I would have to let the desk people speak for themselves, but given the fact that through all this turmoil they continue to plod away, I think that shows that the firm is committed to it."

On the evening of February 12, 2008, Merrill Lynch decided to cease supporting its auction rate securities program and intentionally allowed the vast majority of their auctions to fail the following day. However, the market events that led to the failures in the auction market in mid-February, which left investors with illiquid auction rate securities, were no surprise to Merrill Lynch's senior management. Indeed, Merrill Lynch had known for a period of several months that the auction markets were not functioning properly and were, in fact, in significant danger of collapsing. Beginning in August 2007, tightening in the credit markets began causing disruptions in certain ARS auctions, which caused Merrill Lynch to make the decision to cease submitting support bids for some of the riskier ARS it had underwritten and was trying to remarket, resulting in a number of auction failures. The following weeks saw many institutional and corporate cash participants withdraw from the auction markets. Buyers had been exiting the market in droves and inventory was accumulating to critical tipping points. As one executive confided to a personal acquaintance in an email on November 19, 2007,

> Market is collapsing. No more $2k dinners at CRU!! The Financials are being invicerated! (sic) More firings over at Citi...Inventory flooding the street. Going to be a great '08 trading environment.

Two days later, the head of the auction desk in an email relayed the difficulty of merely clearing all Merrill Lynch's Auctions in light of the negative news and dismal auction market conditions. As inventory continued to grow, even the perceptions of Merrill Lynch's investment banking issuer clients had to take a back seat to the acuteness of the inventory problem. As the head of the auction desk stated in an email dated November 26, 2007 pertaining to the continued investor selling and difficulty of pricing inventory to sell, "The gloves are off and we are not concerned about issuer perception of [Merrill Lynch's] abilities and the competition. Gotta Move these microwave ovens!!"

Merrill Lynch managers obsessed over any event or information that might spread fear and contagion throughout the auction market. For instance, as noted above, Managing Director of the Auction Desk, the head of Merrill's auction desk expressed the opinion that one single neutral research report released by Merrill Lynch in August 2007, was enough to "single handedly undermine the auction market." On another occasion, in

late September 2007, the same person expressed the opinion that a proposed firm wide ban on offering enhanced production credits as incentives to FAs for selling ARS would be the auction desk's "death-knell" if implemented. Late in January, after having been forwarded a negative story regarding a recent auction failure, he simply forwarded the piece to her boss with the note, "[i]ts like the Sorcerer's Apprentice...cant someone make these people stop bucketing us with water..." Finally, she felt that failure of one or two broker dealers in the auction market would make it a "fait accompli" that the entire auction market would fail. These privately held opinions of Merrill Lynch's management were in stark contrast to the aggressive public sales and marketing campaign touting the safety and quality of the auction market securities that the company promoted to its sales staff and investors.

Deficiencies in the auction market were present even at its inception and set the course for ultimate failure in a liquidity challenged market. First, the auction process itself was fundamentally flawed in that true auctions were not being conducted. Instead, Merrill Lynch, who made a market in auction rate securities, regularly submitted support bids for the entire notional value of the amount of auction rate securities being offered at auction. The result was that Merrill Lynch's support bids were commonly filled in order to prevent a failed auction, thereby concealing the true level of investor demand, or lack thereof, for the products. Broker-dealer support created a false impression that there were deep pools of liquidity in the auction market and rendered potentially misleading claims that auctions never fail.

Another structural problem was that terms were structured in a manner that precluded secondary market value in the event of an auction failure. Maximum rates, those interest rates that would be applied in the event of an auction failure, were set at low levels which were favorable to issuers, but in the case of broad auction failures, provided issuers with little incentive to seek alternative financing in order to redeem the ARS shares. The establishment of low maximum rates directly contributed to issuers' efforts in successfully obtaining AAA ratings for their securities from credit rating agencies. Merrill Lynch (and, independently, UBS) stressed the AAA rating of its ARS in its marketing effort, billing them as ultra conservative investments. But when Merrill Lynch and UBS stopped supporting their respective auction programs, investors came to realize the low maximum rate which had allowed the securities to receive a AAA rating rendered their holdings unmarketable and illiquid.

On the investor side, interest rates were not high enough to compensate investors for their increased liquidity risk. Merrill Lynch had little or no incentive to negotiate for higher maximum rates to balance the market interests, as it was collecting significant underwriting fees from issuers at the outset on the investment banking side. In fact, Merrill Lynch reaped a total of approximately $90 million dollars in total profits from its auction rate program for the years 2006 and 2007. Thus, Merrill Lynch, by working the investment banking side, had a significant interest in keeping its issuer clients happy in hopes of securing future business with those clients.

Merrill Lynch's dual role in representing issuers and investors purchasing ARS created significant and inherent conflicts of interest which could not be reconciled. Time after time, when confronted with conflicts of interest, Merrill Lynch consistently placed its own interests ahead of its investor clients. For instance, Merrill Lynch marketed ARS as safe, cash like, and liquid investments. It categorized ARS as "Other Cash" on customer statements, even after the market imploded. Moreover, it trained its FAs to market ARS as a "Cash Management Tool" to their clients. Despite its promotion of ARS as "cash like," Merrill Lynch had express knowledge that without its support bids being filled, many auctions would have failed and thus, the securities were likely anything, but "cash like."

The true nature of and risks common to ARS were not adequately disclosed to Merrill Lynch customers, particularly retail customers. Merrill Lynch did not provide any notice or documentation to customers outlining risks or the nature of ARS at the time of, or prior to, sale. Rather, Merrill Lynch instead placed a vague reference on its Trade Confirmation slips which referred to a website at which customers who already purchased ARS could go to read about Merrill Lynch's "Auction Rate Practices and Procedures." Only if the investor visited the website after purchasing the ARS, would he or she be able to review Merrill Lynch's Auction Rate Practices and Procedures, which included an explanation of risks surrounding the ARS market. Merrill Lynch FAs routinely represented these instruments to clients as fully-liquid, principal protected and cash-like. Merrill Lynch failed to disclose to customers that ARS were only liquid at the time of sale because the auction market was artificially supported and manipulated by Merrill Lynch to maintain the appearance of liquidity and stability.

C. Lessons Learned and Ideas to Prevent Abuses From Recurring in the Future

Our goal is that all investors stuck in auction rate securities will be made whole and that in the not-too-distant future, the auction rate security scandal will be behind us. My office, as well as other regulators, have entered into settlements with UBS, Merrill Lynch, Bank of America and other underwriters and sellers of auction rate securities in which the firms have agreed to repurchase tens of billions of dollars worth of these securities from retail and other customers. Much work remains to be done. For example, my office is in discussions with certain downstream broker-dealers, and it is our expectation that those firms will ultimately make good on the point-of-sale promises of liquidity they made to their clients with respect to auction rate securities. We are pleased that Fidelity Investments just last week agreed to repurchase its customers' auction rate securities. However, it is not too early to step back and attempt draw lessons from this experience that might help us prevent such manifest abuse of unsuspecting retail clients from occurring in the future.

1. *Conflicts of Interest Need to be More Aggressively Monitored and, When Appropriate, Disclosed to Investors*

The UBS and Merrill Lynch cases present case studies of the conflicts of interest that can arise between a broker-dealer and its customers. Early in our investigations, it became clear that the broker was controlling the interest rates at which most of the auctions cleared through its provision of a support bid for the entire amount of the securities auctions in a given auction. In its interest-setting deliberations, the broker was beholden to its investment banking clients to whom it had promised low-cost financing, yet needed to raise interest rates just enough to be able to unload its own inventory onto unsuspecting clients. Prior to the market collapsing in February 2008, when each firm made a big push to reduce its own holdings of auction rate securities, it did so by foisting those securities (and their attendant risks) off on unsuspecting clients. In each instance of a conflict, the firm put its own interests ahead of the interests of its clients, many of whom were retail investors with limited sophistication and bargaining power. These conflicts need to be aggressively monitored to determine whether they fundamentally impair a firm's ability to responsibly attend to its clients needs. At a bare minimum, these conflicts need to be properly disclosed to investors.

2. *Financial Advisor Incentives Need to be Disclosed and Financial Advisor Training Needs to be Enhanced*

Two points which arose starkly in our investigations were (a) the significant incentives to financial advisors to move auction rate product and (b) the profound lack of training those advisors received with respect to those products and their attendant risks.

Most investors that my staff speaks to on a daily basis simply assume that the financial advisor that is selecting financial products for them or otherwise guiding them is applying his or her professional expertise with the sole or primary goal of choosing financial products that are the most appropriate for that customer's particular financial circumstances and goals. The financial advisor does nothing to dissuade them from that assumption. The client surely knows, on some level, that the advisor is being compensated for his or her efforts, but assumes that client service, not compensation, is the driving factor in product selection. In light of the fact, which was completely unbeknownst to UBS and Merrill clients, that financial advisors were both incentivized to sell ARS and completely lacking a meaningful understanding of how they work or the risks associated with them, it does not strike me as unreasonable to suggest that regulators should require more comprehensive disclosure of the financial incentives that financial advisors receive for selling different products. This would allow the consumer to better assess whether the advisor is selecting products on an informed basis that are most suitable for the needs and goals of the customer or whether the advisor is acting in a manner that simply maximizes commission revenue. The need for such disclosure is dramatically highlighted by the Merrill Lynch case discussed above, where we saw, in addition to its baseline commissions steering financial advisors towards auction rate securities, enhanced production credits at times when Merrill was especially concerned about moving auction rate inventory off of its books.

In addition, it would also be advisable to independently investigate how these complex products were allowed to be sold by financial advisors who had not received even minimal training regarding their risks, disclosure obligations, or how the auction market functioned. Another proposal that merits serious consideration is explicitly holding broker-dealer agents to a fiduciary standard of care with respect to their customers. Such a step is especially important given the fact that, as financial engineering creates ever more complicated products (such as auction rate securities), unsophisticated customers become increasingly reliant on the knowledge, expertise and training of financial advisors and increasingly vulnerable to industry misconduct. It has become all too common, when these sophisticated instruments go awry, for the brokers to blame their firms and insist that they too did not understand the true nature of the instruments. Imposing heightened fiduciary duties on them would require them to understand the products that they are selling.

3. *Supposedly Objective Research Reports Need to be More Tightly Regulated*

This part of the story is, unfortunately, familiar to us all. Five years ago a number of securities firms, including Merrill Lynch, reached a $1.4 billion settlement with regulators that was supposed to eradicate the conflicts of interest that pervaded Wall Street research. However, the global research-analyst settlement technically applied only to stock research and not to fixed-income research. Merrill was quick to make this distinction in its statement following the Division's filing of its complaint. However, the principles underlying the settlement—that research reports presented to the public as being supposedly independent should not be tainted by conflicts of interest and that any conflicts, at a bare minimum, need to be properly disclosed—obviously have not been adhered to in this instance. As a result, more rigorous rules pertaining to research reports are necessary.

4. *Principle-Based Regulation is Not Effective to Prevent a Scandal Such as this one*

I believe that the overnight disappearance of the $330 billion market for auction rate securities, and the conflicts of interest and disclosure issues highlighted above, should give pause to those who think that markets can effectively police themselves. The thought that market participants, guided by principles such as FINRA Rule 2110 (which states that "a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade"), will simply act in conformity with such principles in the absence of more detailed regulation is strongly belied by the facts described above. It is, indeed, difficult to imagine that offloading a known and worrisome risk of auction failure off of a firm's own balance sheet and onto its customers' holdings is consistent with "high standards of commercial honor". Similarly, as described above, in the absence of a specific prohibition directly on-point, Merrill clearly strayed far from the principles underling the global research settlement. I believe that a move in the direction of principle-based regulation, at the expense of

detailed, enforceable rules—as some have suggested--would simply open the door for more of the same type of innovation without adequate regulation that we have seen with the auction rate market and which has caused so many investors so much harm. This point is especially important given this week's dramatic and unprecedented market events, which, again, show, that large financial firms left to their own devices, or guided only by general principles, cannot be counted on to effectively control the risks they are taking on their own behalf and on behalf of their customers and counterparties.

5. *State Regulators, in Conjunction with their Federal Counterparts, Need to Continue to be Actively Involved in Enforcement Actions*

The Massachusetts Securities Division is proud to have brought the first action alleging fraud in connection with the sale of auction rate securities, which was against UBS, and the only complaint in this matter against Merrill Lynch. We are equally as proud to have, in conjunction with our sister states and the United States Securities and Exchange Commission, negotiated settlements with these brokers that result in multi-billion dollar repurchases of auction rate securities by the large broker-dealers. Just last week Massachusetts entered into a settlement with Bank of America in which the firm agreed to repurchase auction rate securities sold to retail investors nationwide, and it is my understanding that a SEC settlement with Bank of America is pending.

The resolution that the states were able to obtain for investors, in conjunction with our federal counterparts, underscores the important role of state securities regulators, who are often the day-to-day first responders to customer complaints and who can work with agility and aggressiveness to resolve large issues such as this one. I urge that this experience serve as a reminder of the importance of the role of the states in securities regulation and as a cautionary note that state enforcement power should not be diluted in any contemplated regulatory reform package. It is my hope that the resolution of the auction rate securities issue which is, at this point, an ongoing work-in-progress will set the groundwork for even greater federal/state enforcement cooperation in the future.

Thank you for the opportunity to provide this testimony today.

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts

Testimony Concerning
Auction Rate Securities Markets

Susan L. Merrill
Executive Vice President, Chief of Enforcement
Financial Industry Regulatory Authority (FINRA)

Committee on Financial Services

U.S. House of Representatives

September 18, 2008

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

I am Susan Merrill, Executive Vice President and Chief of Enforcement at the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today. We at FINRA have been actively involved in monitoring and working to resolve the issues relating to auction rate securities (ARS). From our examination staff to our enforcement team to our arbitration forum and investor education group, we have devoted staff from all parts of our organization to produce a comprehensive and integrated response to the recent challenges in the auction rate securities markets.

Along with our regulatory counterparts here today, FINRA is committed to continue working on these important issues, and we share the Committee's interest in holding industry participants accountable and providing investors with real and tangible relief.

FINRA is the largest non-governmental regulator for all securities firms doing business in the United States. FINRA was created in 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration divisions of the New York Stock Exchange. FINRA touches virtually every aspect of the securities business—registering and educating all industry participants, examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing important utilities, and administering the largest dispute resolution forum for investors and registered firms. All told, FINRA oversees 5,000 brokerage firms, about 172,000 branch offices and more than 676,000 registered securities representatives.

Enforcement Inquiries

In late February of this year, required regulatory filings with FINRA showed an increase in the number of complaints that broker-dealers were receiving regarding auction rate securities. In response, FINRA conducted a survey of more than 200 firms regarding their holdings of auction rates securities, both in proprietary and customer accounts. FINRA used the information gathered through that survey to inform our approach and next steps in addressing the problems that were occurring for auction rate investors.

In early spring, after consulting with the SEC in order to avoid any duplication of efforts, we sent out a sweep letter to two dozen firms. In its sweep letter, FINRA's Enforcement Department sought information concerning firms' auction-rate securities sales practices, including the firms' role as dealers in the auction rate marketplace, as well as their use of

sales and marketing materials, their supervision of the activities of firm employees in the auction rate market, and the firms' overall supervisory systems and controls as they relate to these issues. The firms that received the letters were in most instances "downstream" firms, which are firms that were not involved in the underwriting or management of the auction process but rather served as distributors placing bids on behalf of their customers at the point of sale.

The rationale behind our selection of firms was to avoid duplication with other regulators and to reach a broad range of firms with the most significant auction rate distribution activities—including those firms that had been the subject of auction rate-related customer complaints. Most importantly, we wanted to ensure that the largest possible number of investors had an opportunity to benefit from our efforts.

Following these initial actions, FINRA re-surveyed firms in July regarding auction rate holdings in customer and proprietary accounts, and our Enforcement staff sent a second sweep letter to more than a dozen firms in August. Using our internal data, the Enforcement staff has continued to identify additional firms for investigation and follow-up on-site examinations. These sweeps, together with additional referred matters, have resulted in the opening of nearly 50 enforcement inquiries, many of which are ongoing. The focus of our inquiries relates to, among other things, auction rate marketing materials and advertising communicated by the firms to its customers; supervisory issues surrounding the purchases and sales of such securities; as well as possible conflicts of interest where a firm may have been in possession of knowledge about ARS failures and

liquidated their proprietary ARS positions by selling those positions to customers or ahead of customer liquidations.

Unlike traditional industry sweep investigations, our follow-up requests to the original sweep firms as well as the requests to newly identified firms have called for the firms to produce additional categories of information for on-site inspections by the Enforcement staff. To date, 53 FINRA staff members have conducted approximately 32 on-site examinations of firms located in more than a dozen states; additional on-site examinations are continuing as we sit here today. The purpose of these visits has been to engage in "real time" enforcement inquiries in which we analyze firm data produced at the firm and interview firm employees about this data as well as other issues on-site. This has enabled Enforcement staff to get a faster and better understanding of firms' ARS activities. We continue to pursue these on-site exams both to ensure we expediently address the issues at hand and to send the message to the industry that we are and continue to be focused on ensuring that customers are treated appropriately.

We also continue to explore how we can utilize our regulatory resources to enhance our examination program for these issues. For example, as a result of recent events, we are expanding our regular examination procedures to include a more detailed analysis of auction rate securities. In the past several months, our financial and operational examiners have focused on the valuation of ARS held in securities firms' proprietary accounts. In addition, we have worked closely with the SEC to require firms to hold more capital for these securities in view of the illiquidity in the market. We have also

increased margin requirements due to the lack of marketability of these instruments. Sales practice examiners are reviewing customer disclosures as well as presentation of auction rate securities on customer statements and redemption practices.

Enforcement Actions

We anticipate announcing very shortly agreements in principle with several firms for violations relating to the manner in which firms sold ARS using advertising or marketing materials that were not fair and balanced and did not provide a solid foundation for evaluating the facts regarding purchases of ARS; as well as for supervisory violations relating to the firms' failure to establish and maintain a system reasonably designed to achieve compliance with FINRA rules surrounding the sale of these products. Most importantly, FINRA is focused on restoring funds to customers.

In any settlements, our primary motivation is to ensure that the firms will offer to purchase from all investors in the relevant class at par ARS that are subject to auctions that have not been successful as of the date of the settlement and are not subject to current calls or redemptions. We at FINRA think that by expanding our scope beyond those firms that the SEC was rightly focused on, we will be able to protect additional investors and restore funds to a broader span of customers. As for those firms that choose not to resolve the regulatory investigations and offer to buy back ARS sold to their clients, we will continue investigating aggressively with a view to bringing enforcement actions as appropriate for ARS-related misconduct and any other violative conduct that is identified.

Regulatory Guidance

FINRA has also been active in issuing Regulatory Notices regarding auction rate securities. These Notices provide guidance to securities firms on how FINRA rules apply with regard to auction rate securities, and often focused specifically on procedures that enhance customer protection. For example, in April, FINRA issued a reminder (Regulatory Notice 08-21) to firms that when allocating partial redemptions of auction rate securities among their customers, they must adopt procedures that are reasonably designed to treat customers fairly and impartially, and must put their customers' interests ahead of their own. For instance, if a redemption is offered that is favorable to holders of a particular auction rate security, firms are prohibited from redeeming positions in its proprietary accounts before all of its customers' positions have been redeemed.

In June, FINRA provided guidance (Regulatory Notice 08-30) to firms on obligations that may arise in connection with customer requests to sell generally illiquid securities and informing customers of buy interest in such securities. This guidance served to enable and speed the process for investors wishing to sell their holdings in auction rate securities to buyers who were willing to purchase them at a discount.

FINRA also notified firms (Regulatory Notice 08-17) that they should begin utilizing three new product categories in reporting customer complaints relating to auction rate securities, allowing us to better track those complaints.

Investor Education

In addition to the integrated regulatory, examination and enforcement initiatives outlined above, we at FINRA strongly believe that effective investor protection begins with education. This is why, on March 31st of this year, we published a comprehensive Investor Alert titled "Auction Rate Securities: What Happens When Auctions Fail." We issued this alert to let investors know—in plain English and without industry jargon—about some of the options available to them in the event their ARS investment becomes illiquid. We also wanted investors to better understand that when an issuer makes a call for a partial redemption, they may not always get to participate in the redemption.

The Investor Alert outlined the alternatives available to ARS investors who want to liquidate their holdings—but cannot because of failed auctions. We explained to investors that they could: continue to hold ARS investments, borrow on margin, liquidate other investments and sell in the secondary market. Because some of these options could impact their investments or trigger tax consequences, the alert also urged investors to consult with financial advisors or accounting and tax experts before choosing any one option.

The Alert also tells investors where to turn for additional help, including where to obtain a copy of the offering documents for their ARS investments and how to file an online complaint related to auction rate securities.

This particular Alert is just one of an ongoing series of investor education materials continually prepared and updated by FINRA. Using the Internet, the media and public forums, we help investors build their financial knowledge and provide them with essential tools to better understand the markets and basic principles of saving and investing. We issue alerts to inform investors about potential problems and provide plain English explanations of products and processes. In addition, we have developed a variety of interactive tools for investors to use in making financial decisions. Some of these tools allow investors to analyze mutual fund expenses, calculate savings needed for college expenses, and plan for future retirement. FINRA also reaches out to investors through public education events across the country.

In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation (FINRA Foundation) is the largest foundation in the United States dedicated to investor education. The Foundation seeks to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. To further this mission, many of the Foundation grants and educational programs carefully aimed at specific segments of the American public who could benefit from additional financial education resources—such as seniors, nurses, and military personnel and their families. Other initiatives, such as our public library program, *smart investing @ your library*, serve the public at large. Since the FINRA Foundation's inception in December 2003, it has approved more than $33 million in financial education and investor protection initiatives through a combination of grants and targeted projects.

Dispute Resolution

On August 7, in conjunction with the SEC's announcement of its settlements, FINRA announced the establishment of special arbitration processes for auction rate securities cases administered in our arbitration forum.

Under FINRA's current arbitration rules, ARS cases in which damages claimed are under $50,000 will continue to be heard by a single public arbitrator. Also pursuant to current rules, ARS cases in which damages claimed are over $50,000 will continue to be heard by a panel consisting of two public arbitrators and one non-public arbitrator. However, the non-public arbitrators in these cases will not be individuals who, since Jan. 1, 2005, have either worked for a firm that sold auction rate securities or themselves sold or supervised someone who sold auction rate securities.

FINRA updated its arbitrator biographical information and computer systems so it could easily identify arbitrators who are ineligible to serve in auction rate cases under the new process. We have contacted all parties in pending auction rate securities cases to inform them of the new process and its impact on their case. FINRA worked expeditiously with parties to put this process in place so that these cases were not unduly delayed.

The new panel composition process will also apply to any new arbitrations involving auction rate securities, except those filed pursuant to regulatory settlements. FINRA is also developing special arbitration procedures for claims of consequential damages filed by customers of firms that have entered into regulatory settlements. Detailed procedures are still being finalized, but in accordance with the settlements, a claimant can choose to

have a single public arbitrator decide those cases irrespective of the amount claimed, and the firms will be responsible for all administrative fees of the arbitration.

To date, more than 225 arbitration cases involving auction rate securities have been filed in FINRA's Dispute Resolution forum.

Conclusion

FINRA has employed a comprehensive and integrated response to the recent challenges in the auction rate securities markets. First and foremost, we are using our regulatory, surveillance and enforcement tools to detect and deter abusive sales practices in the ARS markets. We have close to 50 enforcement inquiries in this area that are active and ongoing. We are also working to educate investors to help them make the best financial decisions for their unique situation, and have established a special forum to fairly and expeditiously resolve investors' auction rate securities-based claims. FINRA will continue to aggressively pursue possible violations by firms and will continue to work with this Committee and our regulatory counterparts to advance our essential investor protection mission.

Thank you again for this opportunity to discuss these important issues. I would be happy to answer any questions you may have.

Written Testimony

of

Leslie Norwood

Managing Director and Associate General Counsel

The Securities Industry and Financial Markets Association

Before the House Committee on Financial Services

September 18, 2008

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Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. My name is Leslie Norwood and I am Managing Director and Associate General Counsel of the Securities Industry and Financial Markets Association[1]. I serve as the staff advisor to SIFMA's Municipal Securities Division. Thank you for the opportunity to testify before you on the Auction Rate Securities (ARS) market.

I. Background: Auction Rate Securities Market

Auction rate securities are investment vehicles, typically with a 20-30 year maturity, with interest rates or dividend rates that reset through bidding at predetermined intervals. There are two types of auction rate securities—debt and preferred stock. The Auction Rate Securities (ARS) market is made up of auction rate bonds (ARBs), including municipal ARBs and student loan ARBs; auction rate preferred securities (ARPS) issued by closed-end mutual funds; and collateralized loan obligations (CLOs) and collateralized mortgage obligations (CMOs). ARS were first used in 1984 and historically, state and local governments, student loan financing authorities and closed-end mutual funds routinely opted to issue ARS, because they provided the lowest cost of financing with the most flexibility. Nearly $307.2 billion in municipal ARS have been issued since 1988[2]. Auction rate bonds offered issuers an attractive cost of financing, as low as 3.66 percent in October 2007, a maturity of thirty-years or longer, and the flexibility to call the bond at any time. ARPS offered closed-end funds the ability to leverage their assets and reinvest proceeds in the funds' long-term portfolios.

[1] SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information may be found on our website: http://www.sifma.org.

[2] Source: Thomson Financial

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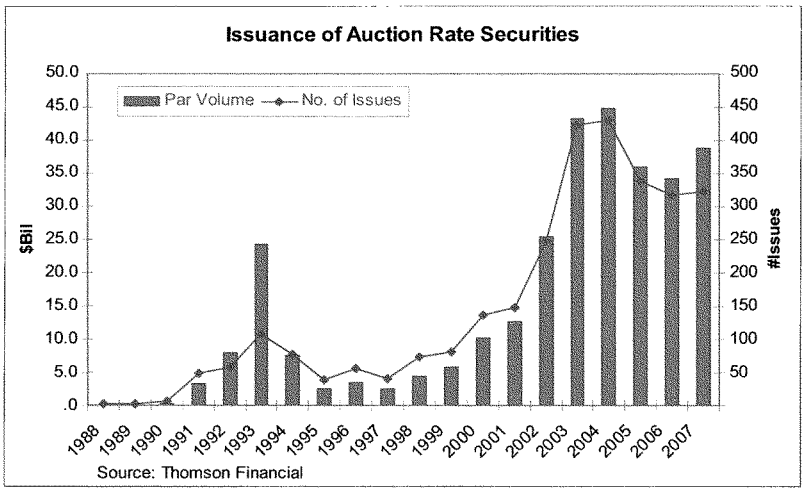
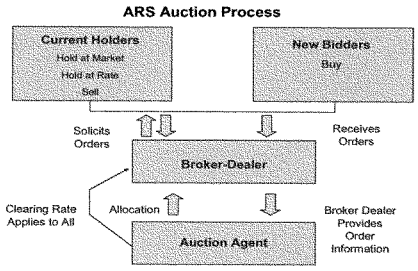


ARS investors included institutional investors and retail investors. ARS were issued and remain highly-rated investments because they are backed by state and local governments' taxing authority, revenues from student loan financing authorities, 501c3s and the assets of closed-end mutual funds. Closed-end funds are required by the Investment Company Act of 1940 to have at least $2 of assets for each $1 of preferred stock issued.

The Auction Process

The auction process was designed to offer investors the opportunity to sell ARS as frequently as daily, weekly or monthly. The frequency of the periodic auctions varies, with common interest rate reset periods being daily, 7 days, 28 days, 35 days, 49 days and six months. Under some auction rate securities programs, the issuer may change the interest rate reset period to a multi-year period. The auction is a competitive bidding process in which investors submit orders through a broker-dealer. An ARS auction is different from other types of auctions in that the bid that clears the auction is the price for everyone who owns the security. Clearing an auction means that there are now enough bids, at some level, to provide buyers for all sellers. In other

types of auctions, such as auctions for Treasury securities, customers will receive an average of the auction's accepted competitive bids.



Some Auction Rate Securities programs have a single broker-dealer and some have multiple broker-dealers. The total number of bonds or shares available to auction at any given period is determined by the number of investors who wish to sell or hold ARS. During the auction, at each interest rate reset date, ARS holders may submit orders to the broker-dealer to hold their securities no matter what the rate is; to hold them only if the clearing rate is at or above a specific number; or to sell or buy them. A "hold at any" bid indicates the ARS holder will hold the existing position regardless of the new interest rate. These securities are not included in the auction. A "hold at rate" bid signals the ARS holder will hold his/her securities at a specified minimum rate. If the clearing rate is lower than the specified rate, the holder is obligated to sell the securities they hold. If the ARS holder wishes to "sell" his securities, he/she requests to sell the existing position regardless of the interest rate set at the auction. Investors wishing to "buy" ARS specify to their broker-dealer the number of shares, typically in denominations of $25,000, they wish to purchase at the bid rate, or the interest rate payable on the securities which they are willing to accept.

The broker-dealer then conveys the bids to the auction agent. The auction agent, typically a third-party bank selected by the ARS issuer, collects all bids and ranks them from the lowest to

the highest minimum bid rate. If there are any sell orders, the auction agent then matches bids to purchase with the minimum bid rate and successively higher rates until all sell orders are filled.

The lowest bid rate at which all shares can be sold at par establishes the interest rate, or the clearing rate. The clearing rate is the interest rate or dividend rate paid on the entire ARS issue until the next auction date. If there are more offers to buy than securities to be purchased existing holders receive preference over new bidders at the same rate. Once the clearing rate has been determined, the auction agent notifies the issuer's paying agent of the rate, which will be effective the business day following the auction. The transactions are then settled by the broker-dealers representing the buyers and sellers the next day. In the case of an auction occurring daily, the clearing rate becomes effective the same day and the transactions are settled that day. Investors who bid a minimum rate above the clearing rate receive no securities while those whose minimum bid rates were at or below the clearing rate receive the clearing rate for the next period.

An auction fails if there are more sellers than buyers for the securities. In a failed auction, all of those looking to sell cannot sell and must hold the securities until the next successful auction. The interest or dividend rate resets at the maximum rate as established in the ARS program documents. For ARPS, the general guidelines for the maximum rates are established in the prospectus. General guidelines often include a rate around 150 percent of the AA rated comparable commercial paper, 125 percent of comparable LIBOR rate, or approximately 4.1 to 4.4 percent. For other ARS, the maximum rate is often determined by a certain percentage of LIBOR, an index of comparable Treasury securities, or a specified fixed percentage rate.

It is important to remember that a failed auction is not a default. It is a result of a supply and demand imbalance. Security holders continue to receive interest and dividend payments. However, they are forced to hold their securities until the next successful auction. The maximum rate is designed to compensate the investor for this loss of liquidity and to encourage the issuer to redeem or restructure the securities.

A secondary market for some auction rate bonds develops between auction dates. In the secondary market, securities can be traded between interested clients at a discount from par value with accrued interest.

2006 SEC Settlement

Beginning in 2004, the Securities and Exchange Commission (SEC) conducted an investigation of ARS underwriting practices and bidding processes. In 2006, the SEC settled with fifteen broker-dealer firms for auction practices that were not adequately disclosed to investors. Examples of the types of auction practices the SEC found include broker-dealers failing to disclose that they were intervening in auctions by bidding for a firm's proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a market rate or to prevent all-hold auctions and submitting or changing orders or allowing customers to submit or change orders, after auction deadlines.

SIFMA Best Practices for Broker-Dealers of Auction Rate Securities

In light of the settlement, SIFMA developed the Best Practices for Broker-Dealers of Auction Rate Securities[3]. The Best Practices for Broker-Dealers of Auction Rate Securities are voluntary, they are not regulations; they were developed by a task force composed of traders, lawyers and compliance officers from SIFMA member firms who acted as broker-dealers in connection with auction rate securities programs. The Best Practices describe the way the auction rate market works, the role of the broker-dealer, and how clearing rates are determined. SIFMA also prepared model auction procedures that may be used by issuers, broker-dealers and auction agents. The model auction procedures are designed to be consistent with the Best Practices and may be used as an exhibit to standard deal documents for auction rate securities. SIFMA also created sample disclosure language regarding the role of the broker-dealer in auctions and a note to bond counsel regarding certain other auction procedures for auction rate securities. SIFMA's model auction procedures, the final version of the Best Practices, the

[3] SIFMA's Best Practices for Broker-Dealers of Auction Rate Securities.
http://www.sifma.org/services/pdf/AuctionRateSecurities_FinalBestPractices.pdf

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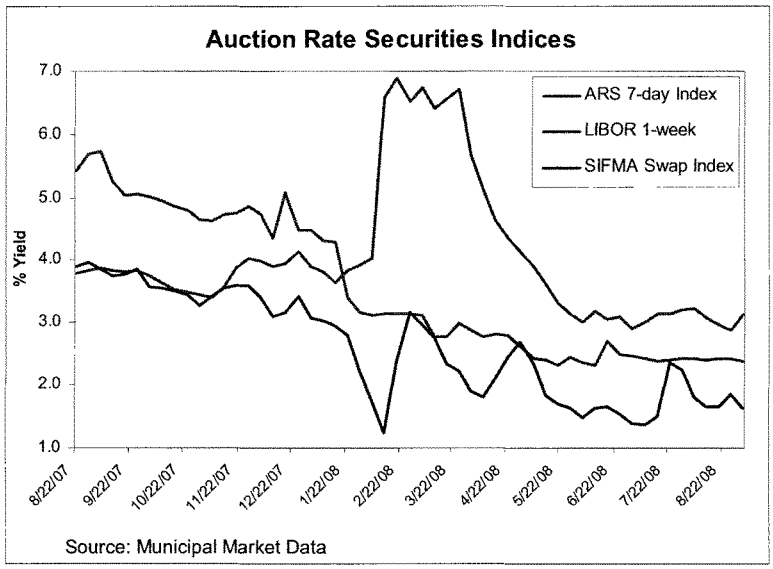
standard disclosure language and the accompanying note to bond counsel are available on our website www.sifma.org.

SIFMA Auction Rate Securities Indices

SIFMA also created the SIFMA Auction Rate Securities Indices to serve as a benchmark for issuers and investors. The SIFMA ARS Indices were constructed and are maintained through a partnership between SIFMA and Thomson Municipal Market Data (MMD), a division of Thomson Financial. MMD works with auction agents and broker dealers to collect the relevant data, maintain the data and make the index calculations. SIFMA and MMD provide tax-exempt indices—including a 7-day index, a one month index, a state index, preferred issues 7-day, preferred issues one month and a preferred issues state—and taxable indices—including a one-month index and a 7-day index. A weekly report is available to market participants and the SIFMA ARS Indices values are available on SIFMA's website. www.sifma.org



II. Deteriorating Credit Markets, the Resulting Failed Auctions, and the Increased Cost of Capital

The credit crisis over the last eighteen months is like none we have experienced before. Conditions have changed dramatically since the middle of 2007. According to the President's Working Group on Financial Markets (PWG) Policy Statement on Financial Market Developments,

> "Since mid-2007, financial markets have been in turmoil. Soaring delinquencies on U.S. subprime mortgages were the primary trigger of recent events. However that initial shock both uncovered and exacerbated other weaknesses in the global financial system. Because financial markets are interconnected, both across asset classes and countries, the impact has been widespread."[4]

As problems in the mortgage market spread into the mortgage securitization market in 2007, faith in the monoline insurers who insured mortgage bonds and collateralized debt obligations began to waiver. Investors became wary of being exposed to anything with the potential for downgrades, including any securities insured by the monoline insurers and third-party credit enhanced bonds in general. Because of the critical role the insurers and third party credit enhancers play in the auction rate securities market, demand for ARS began to decline sharply, ultimately resulting in failures across the auction rate securities market; in spite of the fact the underlying credit ratings of ARS issuers have remained high. As for the role of the broker-dealer, broker-dealers often supported the market by bidding themselves in auction to prevent a failed auction. Broker-dealers, however, were and are not obligated in any way to support an auction. In the 2006 settlement, the SEC required dealers to make disclosures about auction practices and procedures, which include information such as the fact that dealers are not required to put in a bid or order and that there is no assurance about the outcome of any auction. As the demand for ARS began to evaporate in 2007, many broker-dealers purchased ARS in order to support auctions and prevent failed auctions. As the credit crisis began to impact the liquidity

[4] President's Working Group on Financial Markets, "Policy Statement on Financial Market Developments," March 2008.

and capital of firms and their inventory of supported auctions increased, many firms did not have the capacity to continue to support the ARS market.

In the second half of 2007 as the credit markets tightened, the demand for ARS and other variable rate securities began to show signs of decline and the number of failed auctions increased. While this is not the first time auctions have failed, this is the first time a significant portion of the auction rate securities market has failed. Between 1984 and 2006, thirteen failed auctions were recorded out of thousands of auctions. In the second half of 2007, estimates show there were 31 failed auctions[5]. On February 22, 2008, 258 of 386 auctions of publicly offered bonds failed, or 67 percent. About 87 percent of auctions on February 14 failed. By February 20, the fail rate declined to about 66 percent.[6] The issues in the auction rate securities market are unprecedented and unexpected and flow from overall issues in the financial markets. For the most part, ARS issuers are still, to this day, making the interest and principal payments as they come due.

For both issuer and investor, ARS were an attractive financing tool and investment vehicle respectively. While SIFMA cannot speak to the specifics of the sales and marketing practices of individual firms, it is fair to say there were some deficiencies in the market. While I am sure you will hear many anecdotes of sales and marketing practices, it is important to remember the liquidity issues in the ARS market are a result of the ongoing credit crunch and not sales and marketing practices. As the Committee is aware, several firms have settled, or are in the process of negotiating settlements to buy back ARS to provide liquidity to investors.

The failures of ARS have left investors to hold their auction rate securities. Many state and local issuers face steep increases in their cost of capital. For instance in February 2008, auction rate securities issued by a state student loan financing authority reset at 18 percent, up from the previous clearing rate of 5 percent in January 2008. Some state and local government issuers

[5]Frantz, Blaine and Fitzpatrick, Bill. "Prolonged Disruption of the Auction Rate Market Could Have Negative Impact on Some Ratings." Moody's Investors Service. February 20, 2008. p.2.
[6] Cooke, Jeremy, "Florida Schools, California Convert Auction-Rate Debt." Bloomberg.com. February 22, 2008.

found their securities resetting at a rate as high as 20 percent. The high maximum rates on these securities were an example of the product functioning as expected in failed auctions, and as agreed to by issuers in the ARS program documents. The high interest rates compensated the holders for their loss of liquidity as well as encouraged issuers to refund these securities into a more cost effective form of debt.

While there have been a number of failures in the student loan ARB market, it is important to note the primary cause of the unavailability of student loan credit has been the higher costs of financing loans in the secondary market and the reduced federal government payments enacted last fall. Over the past six months, turmoil in the debt capital markets and the reductions of federal guarantee rates and special allowance payments of Federal Financial Education Loan Program ("FFELP") loans caused significant concern regarding the availability of student loans. Unlike most other forms of consumer credit, the interest rates charged to students on FFELP loans are set by law, so lenders are not able to recoup any additional costs in the FFELP loans they originate. But for the few issuances of securities that have been put into the market this year and backed by FFELP Stafford and PLUS loans that are already at least 97% government guaranteed, the spreads on the AAA-rated tranches have widened by 150 basis points, or roughly 15 times the levels seen in the summer of 2007. Yet, the credit performance of the student loans with a government guarantee has not deteriorated at all, further evidencing the unprecedented and extraordinary liquidity crisis the U.S. faces.

III. What Have We Done?

Regulatory Action for Municipal ARS

In response to the increased failures in the auction rate securities market and the number of municipal issuers who were considering converting their auction rate securities into other debt instruments, SIFMA sent a letter on February 13, 2008 urging the Treasury Department to simplify the reissuance standards for state and local bonds. In response to SIFMA's request, the Treasury Department released Notice 2008-27 in March providing that the conversion of bonds

from an ARS mode to a fixed rate at a maturity that occurs under the existing bond documents will not result in a reissuance. The Notice provides generally that auction rate securities will be treated as a form of qualified tender bonds, which are protected from reissuance treatment in their ordinary rate-setting procedures. This is important, because depending on the exact situation, a reissuance could have various tax consequences, from the need to file a new report with the IRS to technical changes in applicable requirements for tax exemption. The Notice also provided that the issuance of new bonds to retire existing ARS bonds would not constitute a reissuance if the transaction occurs in the context of an exchange of new bonds for the old bonds. On March 25, the IRS issued Notice 2008-41, which further clarifies Notice 2008-27. Notice 2008-41 allows an issuer of auction rate securities to purchase them and hold them for up to 180 days without causing the purchase to be treated as a retirement of the bonds and any subsequent remarketing to be treated as a reissuance. The 180-day rule is temporary and expires on September 30, 2008.

SIFMA received, in response to a February 21, 2008 request, a "no action" letter from the Securities and Exchange Commission (SEC) allowing municipal issuers and conduit obligors to bid into its own auctions or purchase their own ARS from dealer inventory. There had been, in light of the 2006 SEC settlement, concern that the participation of an issuer in an auction of their own securities would be construed by the SEC to constitute market manipulation or that a broker dealer's participation in an auction on behalf of an issuer would violate any consent order it may have with the SEC on ARS. SIFMA later met with SEC staff to get clarification on certain points in the no action letter and released a clarifying memo on April 8. This no-action letter, which we solicited, allowed issuers with capital reserves to bid for their own securities, and in many cases, those bids caused their auctions to clear again, reducing the high interest rate levels to average rates.

Regulatory Action for Auction Rate Preferred Securities

Auction rate preferred securities (ARPS) issued by closed-end funds are not marginable—broker-dealers must allocate 100 percent of net capital on amounts they lend against these

securities. To address the liquidity needs of customers holding auction rate securities, SIFMA and its member firms asked FINRA to provide temporary relief to the net capital requirements. On April 11, FINRA released an interpretive letter authorizing firms to offer non-purpose loans collateralized by ARPS backed with a line of credit from a bank and subject to certain requirements and conditions. To address the pull back by banks in extending credit collateralized with auction rate preferred securities, SIFMA and its members asked for some relief from the large amounts of net capital needed to finance such loans. FINRA temporarily allowed broker-dealers to extend credit on ARPS in amounts up to 25 percent of a firm's excess net capital without having to apply a net capital charge for the credit extended, even though the firm had not obtained a bank loan for the aggregate amount of credit extended. This made available a small amount of money to redeem ARPS.

As closed-end funds sought to restructure their outstanding ARPS, they found themselves limited by legal restrictions. Closed-end funds are restricted in their ability to redeem securities under the Investment Advisers Act of 1940. Several closed-end funds sought relief from the SEC in order to be able to issue a new class of preferred securities. On June 13, the SEC granted no action relief to Eaton Vance Management in connection with the issuance by its closed-end funds of a new class of preferred stock. The no action letter allows closed-end funds to offer liquidity protected preferred shares (LPP) to finance the repurchase or redemption of their outstanding auction rate securities. The LPP also include a put feature that would allow money market funds to purchase them. Auction rate preferred securities are generally not eligible for purchase by money market funds, or 2a-7 funds, because of maturity and quality requirements imposed on money market investments.

On June 13, 2008, the IRS provided guidance regarding the tax treatment of variable rate demand securities like LPP. Notice 2008-55 provides that the IRS will not challenge the equity characterization of auction rate securities, such as LPP. This is important, because if the auction rate securities were treated as debt for U.S. federal income tax purposes, payments on these securities will be characterized as exempt-interest dividends and not taxable interest. The IRS

issued revised Notice 2008-55, which eased some of the minimum criteria that closed-end funds and liquidating partnerships must satisfy in order to obtain the protection of the Notice.

Exemptive Relief for Individuals Invested in ARS in IRAs and Qualified Plans

SIFMA and its member companies have sought exemptive relief for individuals invested in ARS in an Individual Retirement Account (IRA). Many of SIFMA's member companies have applied for exemptive relief from the Department of Labor (DOL) and it appears the DOL has tentatively concluded it will propose relief for certain sales and exchanges at par value for certain loans bearing a reasonable rate of interest, not to exceed the interest rate paid, at each relevant point in time, on the ARS. While the DOL guidance would be helpful, it is likely that IRA investors will not take advantage of the exemption unless Treasury determines that there will not be negative tax consequences. In a July 25 letter, SIFMA respectfully requested guidance from the Treasury Department and it is currently under review by the Internal Revenue Service.

Additional Transparency in the ARS Market

SIFMA filed comment letters with the Municipal Securities Regulatory Board (MSRB) in April and June expressing its support for the MSRB's proposal to develop transparency in the auction rate securities and variable rate demand obligation (VRDO) markets. SIFMA expressed strong support for the MSRB's proposal to develop a website that would display information on the results of auctions of auction rate securities and VRDOs. We encouraged the MSRB to create and launch the website as soon as possible using information that is readily available. During its July 18 board meeting, the MSRB approved a plan to develop a system to collect and disseminate critical market information on auction rate securities and variable rate demand obligations. The MSRB will implement a phased-in system with the implementation of the first phase estimated for first quarter 2009. SIFMA strongly supports the MSRB's decision and its ongoing progress on efforts to increase transparency of certain data elements related to auction rate securities and variable rate demand obligations. The MSRB also recently released a notice clarifying the requirements of broker-dealers buying back auction-rate securities from their customers reporting the purchases to the Municipal Securities Rulemaking Board's Real-Time Transaction Reporting System.

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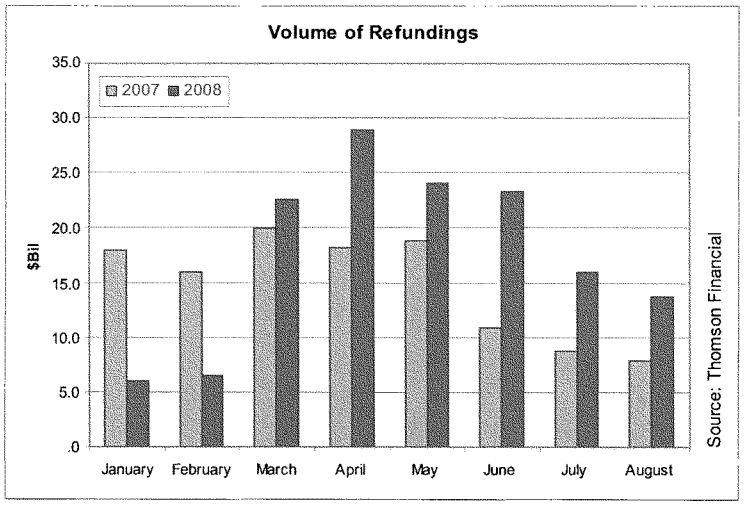
IV. Current Market Conditions

Various regulatory initiatives provided by the SEC, Treasury, the IRS, FINRA and the MSRB have aided the efforts of market participants to provide liquidity in the auction rate securities market.

In the municipal ARS market, many issuers have restructured or refinanced their ARS securities. Depending on the terms of the original bond documents, municipal issuers may restructure their auction rate security into variable-rate demand notes (VRDN). A VRDN is a variable rate bond that includes a "hard put" or "tender option" to require either the issuer or a third party agent to purchase the bonds, typically at par at certain designated times. The volume of refundings in 2008 is up significantly from 2007. In August 2008, the volume of refundings was almost two times that of the same period in 2007.



The ongoing credit crunch continues to threaten the availability of student loan credit. The combined effect of last year's significant incentive reductions with the current high cost of credit in the capital markets has increased substantially the potential for severe disruption in the availability of student loans through the FFELP.

The SEC's "no action" letter and IRS Notice 2008-55 have aided efforts by closed-end funds to repurchase and redeem auction rate preferred securities. However, the market continues to be affected by the ongoing tightening in the credit markets. Closed-end funds must find financing sources and implement solutions to balance the interests of both common and preferred shareholders. Some refinancing alternatives used by closed-end funds include establishing committed borrowing facilities, the issuance of extendible money market-eligible notes backed by a Letter of Credit, and reverse repurchase transactions.

While some liquidity is returning to investors in the ARS market and a number of ARS programs are clearing at rates lower than the maximum rates, many challenges remain. Over the last few months, a number of firms and banks have offered to buy back auction rate securities at par value from customers including retail investors, charities and small to mid-sized businesses. Many firms are facing capital limitations as a result of the continuing credit crunch. They have limited funding available to buy back outstanding ARS. Many broker-dealers also face regulatory constraints. If a broker-dealer holds inventory of a particular ARS issuer, the affiliated bank is limited in how much credit assistance it can offer a distressed issuer because of Federal Reserve Regulation W (Reg. W) implications. The credit assistance is deemed to be direct assistance to the broker-dealer affiliate, which has capital cost implications. Under Reg W, which applies to all federal insured depository institutions, covered transactions with all affiliates cannot be more than 20 percent of the bank's capital. This severely limits the ability of broker-dealer with bank affiliates to take some of the ARBs out of the market. A safe harbor for these firms would allow more banks to buy back some of the outstanding ARS.

Auction rate securities were an attractive source of funding for state and local governments, student loan financing authorities, and closed-end funds for over two decades. They provided low cost financing with the most flexibility. Until 2007, failed auctions were uncommon. But the tightening of the credit markets and the desire of investors to avoid investment options connected to the monoline insurers and third-party credit enhancers, led to a sharp decline in demand for ARS in 2007, ultimately resulting in failures across the ARS market. The broker-

dealer community is working to provide liquidity to the ARS market and to assist issuers in refinancing and restructuring their ARS into more attractive investment options as quickly as possible, but the continuing credit crisis makes it unlikely a full return of liquidity to the ARS market will happen in the near term.

Thank you for the opportunity to testify before you today.

United States House of Representatives
Committee on Financial Services

10:00 AM Thursday, 18th September, 2008
2128 Rayburn Office Building

Auction Rate Securities Market:
A Review of Problems and Potential Resolutions

Testimony by
Tara E. Payne, Vice President, Corporate Communications
The NHHEAF Network Organizations

Chairman Miller and Frank, Representative Shea Porter, Representative Hodes and Members of the Committees:

For the record, I am Tara Payne, a resident of New Hampshire, and the Vice President for Corporate Communications representing the New Hampshire Higher Education Loan Corporation (NHHELCO). The NHHEAF Network Organizations are comprised of four 501(c) (3) nonprofit organizations that provide students and families with the resources and funding to pursue higher education aspirations. Funds generated by the Organizations make their charitable mission possible as student loan earnings are reinvested in programs and services that benefit citizens of New Hampshire.

It is an honor to participate in these discussions.

I must first publicly thank the Representatives from New Hampshire who continue to be strong advocates for student access to higher education.

I have been asked to describe NHHELCO's experience with the auction rate securities market and how the break-down of that market has affected NHHELCO's ability to provide student loans.

Background and Scope
For more than 43 years, the Federal Family Education Loan Program (FFELP) has reliably provided over $735 billion in loans to students and their parents. Thousands of schools and millions of students and their parents rely on FFELP providers, like NHHELCO, to meet their tuition and other postsecondary costs. In our capacity as a nonprofit guarantor, lender and servicer for student loans, we take great pride in educating students about responsible borrowing. Consequently, we consistently have among the lowest cohort default rates in the nation. The cohort default rate measures the percentage of borrowers who enter repayment on their loan in a given federal fiscal year and default on their loans by the end of the following fiscal year.

Having a low cohort default rate means that NHHELCO's commitment to provide excellent loan counseling, support services and borrower benefits has had a very positive impact on our loan borrowers. When students successfully repay their federal education loans, everyone benefits: taxpayers don't have to shoulder the

burden of increased federal debt to cover loan losses; schools maintain their eligibility to award federal financial aid; and best of all, students realize the full benefit of the investment they have made in higher education.

The FFELP community is dedicated to promoting college access, particularly for under-served students and adults, and it does so by offering free career, college and financial aid information and advising and by organizing an extensive array of early awareness/outreach programs for students. The impact of these college access programs is enormous and widespread. Consider that in New Hampshire alone, 95% of public high schools rely heavily on the services we provide and 34,000 students and parents attend our educational school and community-based college awareness programs and workshops. We tailor specific programs to local needs and requirements such as through our Students Transitioning and Achieving Results program to New Hampshire foster youth. We created and administer a local scholarship database and provide professional development training to school counselors and teachers. Our highest priority has been to develop positive collaborative relationships with the local K-12 school systems.

And I must stress the importance of having agencies such as ours across the nation providing these services to all students and schools, regardless of which student loan program they ultimately use, and that they are services not provided by the direct loan program.

Still, the traditional and long-standing methods to fund student loans, combined with the financial impact of the Deficit Reduction Act and College Cost Reduction and Access Act, have resulted in 134 lenders suspending or terminating their participation in FFELP. One of the unintended consequences of the legislative cut to subsidies for nonprofit lenders and the current liquidity crisis is the risk of losing programs like the Center for College Planning in New Hampshire.

Access to college begins with increasing aspirations but it ultimately ends with availability of financial aid programs and funding options.

We are proud of the integrity and commitment we have made to these programs, but in this year, fulfilling our most essential mission has been extremely challenging.

NHHELCO is New Hampshire's leading provider of student loan financing and funded $184 million in federal loans and $67 million in alternative loans in FY07. In total, NHHELCO has $1,482,500,000 in outstanding bonds which has funded our programs since 1997.

NHHELCO's Experience with Auction Rate Securities

The $330-billion auction rate market has been important as the key source of liquidity for student loan lenders. For the last decade, NHHELCO borrowed money to fund loans by selling auction rate certificates. However, investors no longer are investing in the auction rate market. Thus, issuers can't raise capital to fund loans. Most investors were advised that ARS would be safe; a vehicle with no risk or loss of principal and 100 percent liquid. From what we have now all learned, they were generally sold by advisors as "cash equivalents".

The FFEL program is highly regulated. Still, regulations aside, our organization has always held itself to a high standard of financial accountability. We recognize that we bear responsibility to ensure that whatever taxpayer money is spent on our program is minimal and that access to higher education is made possible through our sustaining a strong financial base.

This strong financial base has been significantly compromised by NHHELCO's long-standing trusted financial advisor, UBS Securities, LLC. UBS was the underwriter, selling broker-dealer and marketer of NHHELCO's student loan auction rate securities. UBS also acted as an advisor to NHHELCO. In fact, the bankers at UBS have been NHHELCO's financial advisor and broker-dealer since 1997.

On August 14, 2008, the New Hampshire Bureau of Securities Regulation, announced that is was taking action against UBS Securities, LLC for fraud. The action relates to UBS' representation of NHHELCO in the sale of bonds used to finance loans to New Hampshire college students and their parents.

Essentially, the cease-and-desist order issued by the Bureau states that UBS knew that the market for these bonds was on the verge of collapse. At the same time, UBS was actively encouraging NHHELCO to extend its commitment to these bonds. UBS advised NHHELCO to reset the maximum rate on NHHELCO's taxable bonds to 17% to 18% to ensure liquidity and prevent auctions from failing. We know now that this was a "scheme" to make the securities more attractive to investors and to keep NHHELCO in the Student Loan Auction Rate Securities (SARS) market. UBS never disclosed to NHHELCO that the SARS market was at risk of freezing and that the maximum interest rate payable on the NHHELCO bonds could lead to NHHELCO's financial harm or that UBS was preparing to ends its support of the market.

Until mid-February 2008, UBS supported prices by bidding for bonds that went unsold, preventing auctions they ran from failing. At the same time, UBS was actively considering withdrawing its own holdings in the market while advising NHHELCO to stay in. On February 13, 2008, UBS stopped supporting the SARS market and it collapsed, leaving NHHELCO and investors with billions of dollars frozen. UBS had an obligation to provide NHHELCO with all available information about market conditions and to look out for NHHELCO's best interests in order that NHHELCO could fulfill its important mission. It is absolutely clear that UBS did not do so, putting its interests ahead of its long-standing client.

UBS never did approach NHHELCO with any creative solutions to the funding crisis while they were apparently transitioning some SARS issuers to other types of debt structure including variable rate demand obligations ("VRDOs"). The costs, beyond the fees, and the consequences for other areas of our business, were the increased maximum rate that reduced NHHELCO's assets from $64 million in September 2007 to $18.6 million in July, 2008.

We support the NH Bureau of Securities Administration in its assertion that UBS' actions constituted fraud and that UBS failed in its fiduciary and moral duty to NHHELCO.

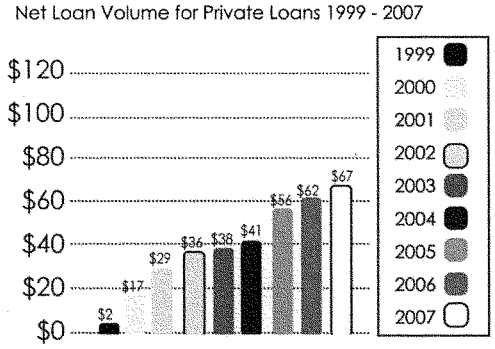
IMPACT of the ARS Market Breakdown
Federal loans are enough for many college students. In New Hampshire, where state support for higher education is among the lowest in the nation and tuition and fees are among the highest, alternative loans are a key factor in affordability and access. The amounts students can borrow through the Federal Stafford loan program are capped and fall far short of the typical tuition bill. For example, $5,500 is available for a dependent college freshman—and many families turn to private loans to make up the difference.

NHHELCO's non-federal alternative loan program, Loan for Education Assistance Funding (LEAF), provided funding to close the gap between what students receive in financial aid (including federal student loans such as Stafford or Perkins) and what the college actually costs. We have provided over $431 million to fund almost 64,000 alternative loans to NH students since 1993.

In FY07, 6,130 students borrowed $67 million through our alternative loan program.

Still, recognizing the severity of the liquidity crisis, the reduction to lenders such as NHHELCO from recent legislation, and the lack of viable solutions from our financial advisors, NHHELCO was forced to suspend its alternative student loan program in March leaving thousands of students to search for other alternatives.

This action was taken in order to focus available resources on funding federal student and parent loans, the most basic point of access. Our major concern is that college-prepared students are being "priced out" of college. We know from the Pell Institute that high-income youth are six times more likely to earn a four-year degree than are low-income youth, and the gap between them has nearly doubled in the last 35 years.[1] The more complex and more costly the private loan market becomes, that more the education gap will increase. Consider that for NHHELCO alone, there was a 76% growth in private loans in over just eight years. Today, students rely on private loan dollars to fund their educations.



Thus, it is NHHELCO's hope that the Bureau's actions will lead to meaningful relief for the students who have depended on NHHELCO as their affordable source of student loan financing for many years.

Current Liquidity

Loan Data from Mark Kantrowitz on the finiad.org site reveals that:

> *Thirty-three lenders have suspended private student loans. A total of 134 lenders have suspended federal programs. These totals include 16 nonprofit state loan agencies. Four state loan agencies (PHEAA, MEFA, MHESLA and Brazos) have suspended all FFELP originations. Every type of lender has been affected: 16 state loan agencies, 62 banks, 18 credit unions, 4 non-profit lenders, 3 school-as-lender schools (with 45 more coming soon) and 35 non-bank lenders.*

Loan Program	FY2006	FY2007
Stafford and PLUS Loans (including School-as-Lender schools)	15.9% $7.9 billion > 940,000 borrowers 34 of the Top 100	16.0% $9.1 billion > 970,000 borrowers 37 of Top 100

Any interruption in the loan program hurts college-bound students. It causes a disruption in financial aid delivery and creates another layer of complexity to a tedious financial aid process. Naturally, it would have the greatest impact on the most vulnerable students. We were fortunate that a creative *temporary* solution was arrived at even *without* the assistance of our financial advisor, which enabled us to continue to remain in FFELP.

NHHELCO appealed to community lenders in hopes that they would continue to see a critical need to support the student loan program for NH students. In March, 2008, NHHELCO asked the member institutions of the NH Bankers Association and NH credit unions to assist by providing liquidity that would enable NHHELCO to provide New Hampshire students and parents with the necessary financing for college. There was great urgency in the request as families and colleges needed immediate assurance of the availability of funds. It is truly remarkable to see the commitment of our community lenders. Currently, $94 million has been raised. I can assure you that NHHELCO would have suspended its federal program if it were not for the overwhelming support of community lenders.

Ultimately, Federal loans became safeguarded through July 2009 thanks to Congress' swift passage of the Ensuring Continued Access to Student Loans Act and the Department of Education's development and implementation of loan participation and loan sale programs for lenders.

The Participation Agreements will allow New Hampshire students and students nationwide to get their federal loans. This action protects federal fiscal interest without providing taxpayer burden as the program is cost-neutral. However, there is still no sign that credit markets will soon return to normal and that adequate future liquidity will be available. By the time Congress reconvenes, students and families will be well along the way to making decisions regarding their education and training plans for the 2009-10 academic year. The continuing uncertainty in the credit markets has stalled any improvement in the availability of private-sector capital to support the delivery of needed financial aid to students and families next year through the FFEL Program.

Therefore, as a member of the National Council on Higher Education Loan Programs, NHHELCO will be advocating for an extension of the current 14-month program to at least July 1, 2010.

(In New Hampshire we know that eighty-two percent of borrowers in repayment believe that the opportunity to go to college would not have been possible without access to student loans.[1] The credit crisis has threatened many families' ability to get a second mortgage or for students to qualify for private education loans without parents as co-signers. As a result, some low and middle income families may be running out of college funding options. We understand that some are turning to borrowing from 401k plans and putting tuition on credit cards. Alarmingly, 28% of respondents reported used a credit card to pay for tuition costs. Since students often do not have a steady source of income or are employed in low-wage jobs, establishing a pattern of paying even the minimum payments on a consistent basis may not yet be a priority for these borrowers who have had little education in personal financial matters. In an analysis of current college students, we found that 28% of freshmen had over $3,000 in credit card debt and 51% of freshmen have been reported delinquent on their credit card payments.[2])

Our nation's young adults and their parents need assurance that funding is within reach.

Thank you for your time and attention.

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1 FinAid Page, LLC. Mark Kantrowitz, Publisher of www.FinAid.org
2 *Beyond Access: College Success for Low-Income, First-Generation Students*, Jennifer Engle, The Pell Institute
3 *Borrowing for a Brighter Future: Perspectives on Financing College*, 2008, The NHHEAF Network Organizations
4 *Clothed, Fed and Over Their Heads: Credit Card Use of NH Student Loan Borrowers*, 2008, The NHHEAF Network Organizations

Testimony of James Preston
President and Chief Executive Officer
Pennsylvania Higher Education Assistance Agency (PHEAA)

U.S. House of Representatives
Committee on Financial Services Hearing:
Auction Rate Securities Market: A Review of Problems
and Potential Resolutions
2128 Rayburn House Office Building
September 18, 2008

I am Jim Preston, President and CEO of the Pennsylvania Higher Education Assistance Agency (PHEAA).

I would like to thank Chairman Frank and Ranking Member Bachus for holding this hearing and for addressing the issues that surround the markets for auction rate securities. I am especially grateful to Mr. Kanjorski for his leadership on the student loan aspect of this issue, for his support for a comprehensive solution to this matter, and for his efforts to assure students and parents that they will enjoy uninterrupted access to federal student loans.

Today, I am going to speak primarily from the viewpoint of a major not-for-profit provider and purchaser of federal student loans. However, as you are aware, student loans are but one of many financial sectors that have been negatively impacted by the problems in the markets for auction rate securities.

My background includes more than 25 years of investment banking and student loan funding experience. I first joined PHEAA in 2003 as the Executive Vice President of Client Relations and Loan Operations and was asked to serve as the interim President and CEO from October 2007 through March of 2008, at which time the Board of Directors appointed me to the position on a permanent basis.

Prior to joining PHEAA, I held various positions with L.F. Rothschild, Unterberg, Towbin, Bear Stearns and Co. and UBS PaineWebber. I received my MBA in Finance from the State University of New York at Albany.

As someone with decades of experience in this industry, I can attest that the situation we face today is unprecedented and is in urgent need of attention. Nobody knows how long it will be before the problems we face today may become too deep and too entrenched to ever be fully resolved without extensive government intervention. Modest, appropriate

steps may still be effective if taken today, but may not be as effective if delayed until six or twelve months down the road.

The collapse of the auction rate securities market and the dysfunctional nature of other capital markets that might have provided alternative sources of funding for not-for-profit student loan secondary markets have left PHEAA and its sister agencies with few, if any, avenues that they can use to raise needed funds to provide students and families with the money they need to pay for college. Many of these entities and their lender partners find themselves unable to originate or purchase federal and non-federal student loans. In May, Congress took a welcome step through its passage of the Ensuring Continued Access to Student Loans Act (ECASLA). That Act has been crucial in assuring that students and families have access to federal student loans for this fall. However, that Act is no more than a temporary solution and applies only to some federally guaranteed student loans. Unless Congress and the Administration address the underlying causes of the current liquidity difficulties, there will continue to be instability in the student loan marketplace and participants will continue to cease supporting student loans.

PHEAA is one of America's largest student loan guarantors with a 2007 annual volume of $11 billion in total guarantees. We are also one of the largest student loan servicers, with a total servicing volume of more than $50 billion in loans.

Prior to the disruptions in the capital markets, PHEAA had also been an originator and purchaser of FFELP loans, providing low-cost loans to Pennsylvania students and liquidity to other lenders on the secondary market.

For 45 years, we have been the student aid funding and public service outreach resource for Pennsylvania's students and families, having pioneered industry-leading borrower benefits programs and online planning tools for generations of our students.

Over the last decade, we have used our business earnings to fund approximately $1 billion in free programs and services in Pennsylvania - - without spending one penny of state taxpayer resources. This includes paying for the administrative costs of the state funded student aid programs, including the $407 million Pennsylvania State Grant Program.

The earnings that we have achieved in a stable and competitive FFELP marketplace have benefited Pennsylvania students, families and taxpayers by preserving scarce government dollars while enabling millions of students to afford a higher education without incurring excessive student loan debt.

But this all depends on a stable student loan marketplace, which ultimately ensures the availability of funding for American students who desire and deserve an affordable college education.

In March of this year, PHEAA reached the conclusion that we must suspend originating and purchasing federal student loans. We really had no choice in the matter. Due to the

increases in the costs of raising the capital that PHEAA uses to fund loan originations and purchases, student loans had become uneconomic – there was no way to generate a positive return on our investment in student loans. Every additional federal student loan that we put on our books meant that we were digging a deeper hole of indebtedness. In addition, traditional sources of liquidity were withdrawn and just not available. While PHEAA is a not-for-profit entity, we could not sustain limitless losses and, without access to funding, continue providing access to student loans and providing essential services to the citizens of Pennsylvania.

PHEAA is not a depository institution and receives no direct appropriations or other funding from the Commonwealth of Pennsylvania that it can use to capitalize student loans. Instead, PHEAA must rely on the capital markets to provide it with the liquidity we need to fund student loan originations and purchases. In the 2007-08 academic year, PHEAA originated over $760 million in student loans and purchased an additional $770 million in federal student loans from for-profit and not-for-profit loan providers. To support those efforts and to finance the loans we have made and purchased over the years, PHEAA maintains nearly $12 billion in outstanding debt obligations. These obligations take many forms and involve a mix of both taxable and tax-exempt debt issuances. Approximately $7.4 billion is in the form of auction rate securities. Unlike municipalities and certain other types of issuers, not-for-profit student loan providers, such as PHEAA, do not have tax revenues to rely upon. They are therefore much more limited in their ability to refinance auction rate bonds, particularly in a capital market environment such as that which exists today. Because the yield on federally guaranteed student loans is a variable rate, fixed rate securities are not generally used to finance these assets.

PHEAA uses these funds to play two principle roles in funding student loans. PHEAA is a direct originator of student loans and serves as a secondary market for student loans. This second function may be the most important role we play. By providing a secondary market – purchasing student loans from loan originators for par plus a reasonable premium based on the value of the loans – PHEAA allows hundreds of lenders to participate in the federal student loan program. These lenders, which rely on secondary markets to allow them to recycle their funds to make new student loans, now find themselves with no outlet for the student loans they originate. Their balance sheets are filling up rapidly and cannot do so indefinitely. Reviving the secondary market for student loans is a key component of any solution to the current liquidity crisis.

While auction rate securities are the focus of today's hearing, the auction rate market is not the only source of capital that has become unavailable to PHEAA and others. Markets that have supported the issuance of tax-exempt securities are also dysfunctional, as are markets for student loan-backed securities, in general. Today, we find ourselves unable to issue new debt obligations due to the lack of investors for such securities and because, even if investors are found, the price required is too high to allow student loan issuers to make or purchase loans without losing money on each new loan that is added to their balance sheet. Rating agencies and credit providers are demanding that debt issuers

add substantial capital of their own to any new security. For those of us without access to funds, it is a significant obstacle to reentering the capital markets.

PHEAA appreciates that any effort to revive the auction rate securities markets or to develop alternatives to that marketplace must serve three purposes: It must benefit the investors who find their assets trapped in these investments; it must benefit the issuers who are unable to refinance these securities; and it must be fair to the federal government, which should not bear any financial burden as a result of any such effort. PHEAA, in concert with the Access Group of Delaware and Brazos Higher Education Service Corporation of Texas, put forward in June 2008 a proposal to Treasury that we believe would accomplish all three of those objectives (a copy of the proposal is attached).

Since that date, Treasury has adopted the core principles of this proposal, but has done so, not for student loans, but for mortgage-backed securities as part of its rescue of Fannie Mae and Freddie Mac. Treasury's plan is to create a new market for mortgage-backed securities, in essence to stand in place of the global markets which are unable to supply sufficient capital to support the homeowners of this nation. One part of our proposal is for Treasury to do the exact same thing for student loans. I would like to share with you a few direct quotes from Treasury's fact sheet that accompanied their announcement on September 7, 2008:

> *Under most likely scenarios,* ***taxpayers will benefit from this program*** *- both indirectly through the increased availability and lower cost of mortgage financing, and* ***directly through potential returns on Treasury's portfolio of [Mortgage Backed Securities]****.*
>
> *Given that Treasury can hold these securities to maturity, the spreads between Treasury's cost of borrowing and GSE [Mortgage Backed Securities] indicate that* ***there is no reason to expect taxpayer losses from this program****.*
>
> *Treasury financing of purchases of GSE [Mortgage Backed Securities] will be deemed as outlays and are subject to the statutory debt limit.*
>
> ***However, Treasury will be receiving an income producing asset*** *(a portfolio of GSE [Mortgage Backed Securities])* ***in return for its invested funds****. (emphasis added)*

We believe that you could easily substitute the words "student loan" for the word "mortgage" in the above excerpt. In the case of student loans, we would add, though, that the assets that are pledged to these securities are already 97% guaranteed by the federal government. Thus, it could be said that applying this action to federally guaranteed student loans is 97% less risky for the federal government than actions that involve non-guaranteed assets. Overall, guaranteed student loans are reliable, performing assets – they are not sub-prime loans.

I also want to make you aware that everything that has stymied our ability to issue federally guaranteed student loans has also crippled the ability of for-profit and non-profit entities to fund private, non-federal student loans. Parents, students, and schools are scrambling today to try to pay the college costs that they had expected would be financed by the private student loans that have suddenly become a scarce resource.

Earlier this year, in a letter to the Pennsylvania Congressional delegation, the Secretary of the Treasury advised Congress that he does not believe that his agency has the statutory authority to purchase student loan-backed securities. It had been our hope that Treasury would have been able to interpret the provisions of ECASLA as granting it all the authority it needed. But, clearly, Treasury does not believe that this is the case. Thus, we urge you, Mr. Chairman, and the Members of the Financial Services Committee to provide Treasury with such authority. We fully support the efforts of Mr. Kanjorski to take such action via his bill, H.R. 5914. If the Committee and the Congress approve H.R. 5914, PHEAA and our student loan partners would be ready to sit down immediately with Treasury to assist in designing a program that revives the marketplace for student loans and protects the interests of U.S. taxpayers. Please give us the chance to solve this issue before too many players are forced to cease their participation in the student loan programs.

In the short term, we strongly support an extension of ECASLA as a means of providing some short-term stability to the student loan marketplace. We commend the House of Representatives for acting earlier this week to approve such an extension and we urge the Senate to follow suit. We need to ensure that students, parents, and schools can depend on student loans being available for the 2009-2010 academic year. If that can be accomplished by the end of the 110th Congress, we will know for certain that federally guaranteed student loans will be available next fall. ECASLA and the way it has been implemented by the Departments of Education and Treasury are far from perfect. When the time is right, we would be pleased to offer our suggestions for improvement. However, we believe that the consequences of allowing the Act to expire next summer could be quite serious for students, parents, schools, and the federal government programs.

Thank you again for allowing me to appear before you today. I would be pleased to answer any questions.

# # #

Written Testimony on Auction Rate Preferred Securities
September 18, 2008 in front of the Committee on Financial Services
Roger Sherr, Vice President, Sherr Development Corporation

1. Company Background
   Sherr Development Corporation is a Michigan based real estate company that has been creating construction and retail-related jobs since the mid-1980s.

2. Why We Purchased the Auction Rate Preferred Securities
   In March of 2005, our company completed and sold a number of retail projects. At that point, we had an unusually large cash position in excess of forty million dollars. Our intent was to park those proceeds for a relatively short period of time, intending to pay capital gain taxes and then redeploy those funds in other projects as opportunities were identified. Our goals for these funds were safety and liquidity. We made those goals clear to Comerica Bank, which has served as our corporate and family banker for over sixty years. Comerica recommended the purchase of specific auction rate securities as a prudent place to park funds. Comerica sold these securities as cash equivalents. There was no disclosure of any risk to liquidity or value.

   The names of the auction rate preferred securities (ARPS) that we currently own and the current dollar amounts are listed below:

Advent Claymore Income Fund	$2,500,000
Blackrock Preferred Income Strategies Fund Inc.	$ 750,000
Calamos Convertible Opportunities & Inc. Fund	$ 675,000
Cohen & Steers Select Utility Fund	$2,500,000
Dreman Claymore Dividend & Income Fund	$2,500,000
Dreman Claymore Dividend & Income Fund	$2,500,000
Ing Clarion Global Real Estate Income Fund	$1,950,000
Ing Clarion Global Real Estate Income Fund	$1,950,000
	$15,325,000

3. End of Liquidity
   In February of this year, we were stunned to learn that, as a result of the freezing of the market for ARPS, our funds placed by Comerica were no longer available to support ongoing business operations. In May, after waiting for Comerica to offer a solution, we requested the bank to follow through and give us the liquid investment that we purchased. Even though Comerica selected the specific funds and earned a healthy commission, they refused to shoulder any responsibility for their misrepresentation. Notwithstanding additional correspondence to date, Comerica has repeatedly refused to repurchase our securities or participate in any settlements encouraged by regulators.

4. How Our Firm and the Economy is Harmed
   Having cash on hand provides an important competitive advantage for a firm our size. It allows us to move quickly and pursue projects we may otherwise not have a chance to do. Moreover, to the extent real estate opportunities we pursue create jobs in America, the liquidity of our company's balance sheet is important to stability and growth of the economy in general. It may be of interest that, in the past, Sherr Development has completed more than twenty-five residential and commercial projects with an aggregate value in excess of $250 million. As a result, thousands of jobs have been created, and millions of dollars in taxes have been paid.

5. Impact on Michigan's Economy
   As you know, the Michigan economy is facing very difficult times. Comerica's failure to fully correct the illiquid condition at our company has directly contributed to the tough times in Michigan. One investment, for example, that we would have pursued is the development of a large community shopping center in the City of Detroit. It would have provided needed retail services for people living in the area along with providing 100s of high-paying construction jobs, and 100's of permanent retail positions. Because our funds are still locked up in these ARPS, we were not able to make a rapid decision and make an offer without a typical finance contingency. As of now, it appears that the development site will remain undeveloped. Residents in the area will drive unnecessarily long distances for groceries and other goods they need while others in the region may remain unemployed or underemployed.

6. Public Policy Implications
   Comerica Bank has $60 billion in assets, more than $5 billion in equity, and ranks as one of the top twenty largest banks in the country. Comerica advertises that it puts its customer's interests first and has 100s of retail branch locations to attract depositors and make loans to customers. Unlike Goldman Sachs, Merrill Lynch, or UBS, Comerica is a bank trusted to sell safe products designed to protect customers rather than make them rich. Comerica's customers have a good reason to hold them to a higher fiduciary standard of care than the standard applicable to the fast-paced world of investment banking.

   Comerica sold more than two billion dollars of ARPS to individuals, municipalities and other firms like ours that pay taxes and create jobs. Clearly, given the resources and sophistication of the bank, they should have understood and accurately communicated the type of securities that they were selling in large volumes. If they had advised us, and their other customers, of the true nature of these securities, they would not have been purchased as money market instruments. Like any retailer, they should be held responsible for misrepresenting the nature of what they sold.

   It is important to note that judicial remedies alone are not sufficient here. If we and thousands or other individuals, firms, and municipalities that own auction rate

securities, are forced to go to court for justice and wait months if not years to be heard, our economy will suffer in both the short and long term. In the short term, without access to our funds, we and other firms cannot create desperately needed jobs. In the longer term, trust and confidence in the banking and regulatory system, which is already facing a critical challenge, will be further eroded.

7. Proposed Solution
   Perhaps Banks should loose their franchise if they refuse to make their customers whole from losses stemming from patent misrepresentation of investment products. Banks should either "stick to their knitting" and focus on serving their customers with plain vanilla loan and deposit products or acquire the appropriate intellectual and managerial resources if they are to sell instruments or products they do not presently understand.

   We hope that Congress will understand that Comerica's and other security dealers' sale of these investments has significantly undermined the integrity of the American markets. Billions of dollars of these securities were sold to Americans who were expressly looking for safety and liquidity – they wanted cash equivalents. But these investments were grossly misrepresented to them by financial institutions who were legally obligated to make proper disclosures. Now thousands of Americans are left holding the bag. Congress must act now to remedy this problem and have institutions such as Comerica live up to their obligations.

The SEC's Recent Actions With Respect to Auction Rate Securities

Testimony
Before the
Committee on Financial Services
U.S. House of Representatives

September 18, 2008

By
Linda Chatman Thomsen
Director, Division of Enforcement
U.S. Securities and Exchange Commission

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for the opportunity to testify today about the Commission's efforts in response to the freezing of the auction rate securities market in mid-February 2008.

I'd like to start with the big picture: Thanks to the collective efforts of federal and state law enforcement and securities regulatory officials, tens of thousands of investors are having billions of dollars of liquidity restored to them in very short order. This relief is virtually unprecedented in type, magnitude and timing.

Our actions were necessary because broker-dealer firms that underwrote, marketed and sold auction rate securities (ARS) misled their customers. Through their sales forces, marketing materials, and account statements, firms misrepresented to their customers that ARS were safe, highly liquid investments that were equivalent to cash or money market funds. As a result, numerous customers invested in ARS their savings and other funds they needed to have available on a short-term basis. These firms failed to disclose the increasing risks associated with ARS, including their reduced ability to support the auctions. By engaging in this conduct, those firms violated the Federal securities laws, including the broker-dealer antifraud provisions.

Due to the collective efforts of the regulators, which have resulted in several settlements-in-principle, investors in ARS at a number of firms, including retail customers, small businesses, and charitable organizations, will have the opportunity to receive 100 cents on the dollar on their investments, and within short time frames. Customers who accept these offers will receive all interest payments or dividends and will be given the opportunity to sell their ARS at par, without a loss. Since the ARS market seized up in mid-February 2008, the need for investors to obtain liquidity with respect to their ARS holdings has been of paramount importance to the SEC, as well as the need to ensure the integrity of the markets. Through the Division of Enforcement's settlements-in-principle with UBS, Citigroup, Wachovia, and Merrill Lynch, over $40

billion in liquidity is expected to be made available to tens of thousands of customers in the near future.

The settlement process also featured a tremendous level of cooperation by state and federal regulators to arrive at early and comprehensive solutions to a market-wide problem. The settlements-in-principle provide quick relief to the investors most in need, and also mark a clear path forward to ultimate resolutions benefiting additional investors. And our efforts continue.

Auction Rate Securities and the SEC's Investigations and Examinations

ARS are municipal and corporate bonds, as well as preferred stocks, with interest rates or dividend yields that are periodically reset 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 five years to perpetuity. ARS were an attractive financing vehicle for issuers because they are essentially long-term obligations that re-price frequently using short-term interest rates, which are typically lower than long-term interest rates. For investors, ARS offered slightly higher returns than cash products, such as money market funds or certificates of deposit. Historically, ARS investors generally were large institutions, but several years ago many retail customers entered the market when financial services firms reduced the minimum investment to $25,000.

ARS, which were first developed in 1984, had by early 2008 grown into a $330 billion market. Until the ARS market froze in mid-February 2008, auction failures were extremely rare, and, accordingly, the market was highly liquid.

The ARS market encountered significant problems during early 2008. While it is difficult to identify every reason why the ARS market froze, we believe that there were several contributing factors. One factor is the significant increase in the size of the ARS market, which had grown to $330 billion by the time of the freeze. This larger market required the firms to find more and more customers to bid in the auctions. An additional reason for the market seizure is the rating agencies' downgrades of the monoline insurers (e.g., Ambac Financial Group Inc, and MBIA Inc.), which provided insurance for many ARS to ensure that holders would receive repayment of their principal if the issuer defaulted. These downgrades resulted in the loss of customers willing to invest in ARS. Another factor that contributed to the freeze is the sub-prime mortgage and credit crisis that unfolded throughout the second half of 2007, which limited the firms' ability to support the auctions with their own capital. In fact, firms stopped supporting the auctions in mid-February 2008, and the entire market froze in a matter of days. The securities became illiquid, leaving tens of thousands of customers unable to sell their ARS holdings.

The SEC immediately responded to the market failure in multiple ways. The SEC's Division of Enforcement began investigating possible securities law violations. Working with our Office of Investor Education and Advocacy, we deployed tremendous resources to discover and identify potential wrongdoing. In March 2008, Enforcement

staff began serving voluntary requests for information on 26 broker-dealer firms. The requests asked for information relating to, among other things: investor and issuer complaints; the number of failed auctions that the firms managed; the reasons why the firms stopped supporting the auctions in mid-February; the dollar amount of ARS held by the firms' customers; ARS marketing materials; and documents relating to the liquidity of ARS. In addition to these enforcement efforts, SEC examiners initiated examinations of numerous broker-dealer firms.

We also quickly interviewed numerous investors and other market participants, including employees of broker-dealers and issuers. We also established a dedicated email box to receive investor complaints. Since mid-February, the Commission has received more than 1,000 complaints from investors concerning approximately 50 broker-dealer firms. Investors reported such things as their brokers had led them to believe they were investing in safe and liquid investments – cash equivalents – and when the market froze, that they could not access their funds for important short-term needs, such as a down payment on a house, medical expenses, college tuition, taxes, and for some small businesses, payroll.

The Enforcement Division formed a nationwide ARS Working Group to coordinate the various investigations and to facilitate the sharing of information and experience among staff at Headquarters and our Regional Offices. We have had, and continue to have, teams of lawyers, accountants, and examiners working on ARS investigations and examinations throughout the country. All told, we have dozens of professionals working to gather the facts.

In an effort to conduct investigations as quickly as possible and avoid unnecessary duplication, we also coordinated our efforts with other regulators, including FINRA, the Office of the New York Attorney General (NYAG), and the North American Securities Administrators Association (NASAA). By way of example, when NASAA announced on April 17, 2008, the formation of its ARS task force chaired by the Massachusetts Securities Division, senior SEC Enforcement staff immediately contacted Secretary Galvin's office offering to coordinate and cooperate on our respective investigations. We had similar contacts with the NYAG and FINRA early in our investigation. The SEC's staff also granted access to its investigative files to every regulator that submitted a request for them.

Based on our analysis of the information received from broker-dealers, SEC Enforcement staff identified several firms that were the largest participants in the ARS market and the firms about which we had received the largest number of complaints. Our investigative efforts focused on those firms.

The two largest ARS market participants were Citigroup and UBS. These firms became a primary focus of the investigations being conducted by the SEC's Enforcement staff and our fellow regulators. In late April, Enforcement staff agreed to coordinate investigative efforts with the NYAG regarding Citigroup, UBS, and other firms. In early

May, we had conversations with state regulators from Texas regarding Citigroup, and subsequent discussions with other state regulators regarding other firms.

As with any enforcement matter, the Division of Enforcement recommends taking action only after investigating the relevant facts and concluding from the evidence that a violation of the federal securities laws has likely occurred. Early on in the ARS investigations, Enforcement staff had preliminary discussions with both Citigroup and UBS about the possibility of a global resolution with the SEC and other regulators. In order to fairly and rationally discuss any proposed resolutions, however, Enforcement staff first had to ascertain the dimensions of the problems. We had to understand the facts and evidence, and develop a fair and rational framework for resolution.

In conducting the ARS investigations, Enforcement staff was acutely aware that time was of the essence and we expedited our efforts accordingly. In early summer, Enforcement staff along with NYAG staff embarked on an aggressive schedule of on-the-record investigative testimony of employees of Citigroup and UBS, including persons on the firms' respective ARS desk and salespeople who sold ARS to the firms' customers. Our efforts to conduct fast and thorough investigations were made against the backdrop of an ARS market that was still frozen and during a period when we continued to hear from investors about the hardships resulting from illiquidity in the ARS market.

Our investigative record shows that both firms made material misrepresentations and omissions to their customers in connection with their marketing and selling of ARS. The SEC's investigation further shows that, until the ARS market seized, Citigroup and UBS marketed ARS to their customers as safe and highly liquid investments with characteristics similar to money market instruments. These firms misleadingly characterized ARS as "cash alternatives" or "money market and auction instruments." These representations were made in oral communications from brokers to customers and on customer account statements. Further, the investigation showed that the firms failed to adequately disclose to customers the liquidity and investment risks of ARS. Among other things, the firms failed to disclose that in late 2007 and early 2008, ARS liquidity risks had materially increased, when the firms knew that there was an increased likelihood that they and other broker-dealers would no longer support the auctions.

The Division of Enforcement's Settlements-In-Principle Provide Liquidity Solutions for Investors

After SEC investigators established facts indicating that UBS and Citigroup had engaged in violations of law, the Enforcement staff began discussions with the firms regarding resolution of our investigations, while continuing to gather additional evidence and facts.

In its initial discussions with the firms, the Enforcement staff emphasized that restoring liquidity to the tens of thousands of ARS customers was a top priority. The firms recognized that they had both a law enforcement problem and a business and reputation problem resulting from the freezing of the ARS market.

Early on, the SEC's staff, in coordination with the NYAG, took the lead in structuring, proposing, and negotiating the framework for a settlement that included liquidity solutions for tens of thousands of customers. This framework was developed in consultation with the SEC's Division of Trading and Markets, and included consultation with the Federal Reserve and other federal regulators to obtain their consideration on the potential impact that any settlement might have on the broader capital markets. Of paramount importance to the SEC's staff was providing quick liquidity solutions for retail customers, charities, and small businesses that were, from our perspective, most in need of access to their funds. The Enforcement Division's agreements-in-principle with UBS and Citigroup established a general framework for other firms' settlements.

While the SEC staff and NYAG took the initial lead in negotiating settlements with UBS and Citigroup, other state regulators--especially through NASAA under the leadership of its President Karen Tyler and its ARS Task Force, including Secretary William Galvin--quickly joined the efforts and brought their talents to bear on reaching global resolutions. Although negotiating the global settlements was not easy, all parties proceeded in good faith working virtually around the clock for weeks. All members of the enforcement teams felt that working together enabled us to maximize the relief provided to investors.

On August 7th and August 8th, the SEC's Enforcement Division, NYAG, NASAA, and the Massachusetts and Texas securities authorities announced settlements-in-principle with Citigroup and UBS, respectively. In pertinent part, both firms agreed to offer to purchase frozen ARS from retail customers, small businesses, and charitable organizations at 100 cents on the dollar and within short time frames.

In sum, customers who accept these offers will have received all interest payments or dividends and will be given the opportunity to sell their ARS at par, without a loss. Both firms will also make whole any losses sustained by customers who sold their ARS at less than par after the market freeze and will offer no-cost loan programs to certain eligible customers with immediate liquidity needs. The settlements also provide a mechanism, through FINRA, for customers to participate in a special arbitration process to pursue consequential damages. As for larger institutional investors, UBS has agreed to offer to purchase ARS at par over a longer time frame, while Citigroup has agreed to use its best efforts to provide liquidity solutions for its institutional customers. The SEC staff is now finalizing the settlement terms with the firms, which it intends to recommend to the Commission for approval.

In addition to the SEC's efforts with respect to UBS and Citigroup, SEC staff has continued to work quickly to complete investigations of other firms that sold ARS to their customers in potential violation of the securities laws. These other investigations have resulted in the SEC's Enforcement Division and the states reaching settlements-in-principle with Wachovia and Merrill Lynch. *See* Press Releases 2008-168 (Citigroup, Aug 7, 2008), 2008-171 (UBS, August 8, 2008), 2008-176. (Wachovia, August 15, 2008) and 2008-181 (Merrill Lynch, August 22, 2008).

Through the settlements with UBS, Citigroup, Wachovia, and Merrill Lynch, over $40 billion in liquidity will be made available to tens of thousands of customers in the near future. The goal of the SEC in these matters has been to return as much liquidity to investors as quickly as possible. The Enforcement Division's achievement of these unprecedented settlements within only six months after the ARS market froze -- thereby ensuring the return of over $40 billion in liquidity to investors -- represents substantial progress toward the attainment of that goal, while at the same time avoiding further disruption in the financial markets. The settlements-in-principle defer imposing financial penalties on the settling firms at this time to permit evaluation of, among other things, their performance under the settlements in restoring liquidity to their customers.

The SEC's investigations of the settling firms and many other firms are continuing. With respect to the settling firms, the focus of the investigations is shifting to the conduct of particular individuals. Investigations of other firms will encompass not only the conduct of the firms, but conduct of individuals as well. The Commission will seek to hold individuals accountable if they violated the federal securities laws. Individual accountability provides a additional and powerful deterrent to others on Wall Street who might consider engaging in similar improper conduct.

The SEC's May 2006 Enforcement Action

This is not the first time the SEC has brought enforcement actions involving ARS issues. The Commission brought prior enforcement actions against numerous broker-dealer firms relating to their failure to disclose certain of their practices in conducting ARS auctions. In May 2006, the Commission brought a settled administrative action against 15 broker-dealers for failing to disclose, among other things, that they bid to prevent failed auctions, submitted or changed orders after auction deadlines, and favored certain preferred customers by giving them an informational advantage in the bidding process.

In its May 2006 Order, the Commission noted that as a result of certain of these undisclosed practices, investors may not have been aware of certain liquidity risks. The May 2006 Order required that the firms provide all customers and all broker-dealers purchasing ARS with a written description of the firms' material auction practices and procedures. The May 2006 Order, with its requirements to disclose material auction practices, caused firms to disclose that the firms bid in the auctions to prevent failed auctions from occurring because this is a material auction practice. Subsequently, SIFMA developed guidance for its members that contains such sample ARS disclosure.

The firms certified to the Commission that they had implemented procedures to ensure that their auctions were conducted in accordance with the disclosures. In fact, the CEOs or GCs for these firms provided written certifications to the staff of the Commission that the firms had implemented procedures that were reasonably designed to prevent and detect failures by the firms to conduct the auction process in accordance with the auction procedures disclosed in the disclosure documents and any supplemental

disclosures and that the firms complied with the written notification requirements of the Order.

The current investigations and examinations, unlike the prior Commission investigation, focus not on the auction process but rather on the marketing of the securities.

The SEC Took Important Regulatory Action to Address Disruptions in the ARS Market

As I mentioned at the outset, the SEC's efforts have involved not only the Enforcement Division but other Divisions and Offices as well, including most notably the Office of Compliance Inspections and Examinations, the Office of Investor Education and Advocacy, the Division of Investment Management, and the Division of Trading and Markets.

For example, as this Committee knows from the past testimony of Erik Sirri, Director of the Division of Trading and Markets, Commission staff worked quickly to help provide market liquidity by issuing a no-action letter on March 14, 2008 allowing municipal issuers to purchase their own ARS provided certain conditions and disclosures were followed. Public sector borrowers have now refinanced or made plans to refinance at least $103.7 billion of the originally-outstanding $166 billion in municipal auction-rate debt, or 62 percent, according to data compiled by Bloomberg News.[1] In addition, an index of the yields on auction-rate securities fell to 2.98 on September 10 from as high as 6.89 on February 20.[2]

Moreover, the SEC's Division of Investment Management has been working with closed-end funds that issued auction rate preferred stock (ARP) and broker-dealers that sold ARP to retail customers to restore liquidity to those holders. At the beginning of 2008, ARP issued by closed-end funds accounted for about 20% of the $330 billion ARS market. As of September 12, 2008, closed-end funds had redeemed, or announced specific plans to redeem, about 40% of the $64 billion of ARP outstanding before the auction failures in February. The staff has issued a no-action letter and is considering additional actions to assist funds in the process of restoring liquidity.

Some funds have also applied to the Commission for temporary exemptive relief from the Investment Company Act of 1940 to allow them to issue debt, the proceeds of which would be used to repurchase their outstanding ARP. The relief, if granted would apply for a period of two years. The Commission is currently considering that request for exemptive relief and anticipates taking action on it soon.

The SEC's Enforcement Mandate

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[1] Michael Quint, "Government Payments to Wall Street for Auction-Rate Wreck Climb," Bloomberg News September 9, 2008.
[2] See http://www.sifma.net/story.asp?id=1882

While the Commission has devoted substantial nationwide resources to the ARS investigations and settlements -- as I mentioned we have dozens of staff professionals working on ARS throughout the country -- we continued to bring many other important cases in all of the Commission's program areas. Indeed, one of the Commission's most pressing priorities over the past two years has been the investigation of matters arising out of the subprime mortgage and credit market crisis, which continues to unfold.

In early 2007, the Enforcement Division created a Subprime Working Group to coordinate numerous enforcement investigations across the country relating to various aspects of the subprime crisis. In January 2008, Chairman Cox created a Commission-wide Subprime Task Force to coordinate the SEC's multifaceted efforts to address the current crisis, including both regulatory and enforcement initiatives, and to facilitate the SEC's continuing cooperation with other state and federal law enforcement agencies.

The Enforcement Division's Subprime Working Group is presently conducting more than 50 investigations in the subprime area, exclusive of ARS. They fall primarily into three broad categories: first, those involving subprime lenders; second, those involving investment banks, credit rating agencies, insurers and others involved in the securitization process; and third, those involving banks and broker-dealers who sold mortgage-backed investments to the public. At the same time that we were investigating and negotiating settlements in the recent ARS cases, we also brought a number of critically important subprime enforcement actions:

- In April 2008, just a few weeks after the demise of Bear Stearns, the Commission brought a landmark enforcement action alleging market manipulation based on circulation of false rumors as part of a short-selling scheme. This case reflects the SEC's concern that possible market manipulations involving the circulation of false rumors and related short selling may have contributed to an increase in market volatility during the subprime and credit markets crisis, which is impacting many ordinary investors. Our first enforcement action involving such rumors alleged that a trader manipulated the market in the stock of a public company by sending instant messages to brokerage firms and hedge funds containing false information about a pending acquisition. The false rumors caused the company's stock to drop by 17%, and wiped out $1 billion of market cap in the first 30 minutes. Following our enforcement action, the Commission not only imposed penalties and other sanctions on the trader, but also banned him from the industry for life.[3]
- In June 2008, the Commission brought enforcement actions against two former portfolio managers of Bear Stearns Asset Management, whose two largest hedge funds had collapsed in the summer of 2007, causing more than $1.8 billion in investor losses. We allege that the portfolio managers deceived their investors and institutional counterparties about the financial state of the hedge funds, and in

[3] *SEC v. Paul S. Berliner*, Lit. Rel. No. 20537 (Apr. 24, 2008).

particular the hedge funds' over-exposure to subprime mortgage-backed securities.[4]

- On September 3, 2008, the Commission brought an enforcement action involving both the subprime and ARS areas. The Commission charged two Wall Street brokers with defrauding customers in connection with their sales of more than $1 billion in unauthorized subprime-related ARS. The brokers allegedly misled their customers into believing that certain ARS purchased for their accounts were backed by federally-guaranteed student loans, and were a safe and liquid alternative to bank deposits and money market accounts. Instead, the securities the brokers purchased for their customers were backed by subprime mortgages, collateralized debt obligations (CDOs), and other non-student loan collateral. The brokers allegedly went so far as to add the words "student loan" or "education" to the names of the non-student loan securities listed in trade confirmations emailed to customers, and to delete the words "mortgage" and "CDO" from the names of such securities. When the ARS market froze, the ARS purchased for the customers became illiquid, and the subprime-mortgage backed securities have since declined substantially in value.[5]

Aside from our ARS and subprime cases, the SEC has continued in its mission of enforcing the federal securities laws across the broadest possible spectrum of potential violations. Since the ARS market froze in mid-February 2008, the Commission has brought a total of approximately 385 enforcement actions. Aside from ARS, other noteworthy accomplishments include enforcement actions brought in the areas of:

- Illegal stock option backdating
  - Since mid-Febuary 2008, the SEC has brought 27 new cases alleging illegal stock options backdating; 7 of them were settled actions against corporations and 20 of them were cases against individuals, including 6 CEOs, 3 CFOs and 3 General Counsel.[6]
- Financial fraud
- Violations of the Foreign Corrupt Practices Act, which prohibits U.S. companies and their employees from bribing foreign government officials to obtain business
  - Together with the U.S. Department of Justice, the SEC is on track to file a record number of enforcement actions this year based on the FCPA. Most recently, the Commission on September 3, 2008, filed an enforcement action against Albert Stanley, the former CEO of Kellogg, Brown & Root, in connection for alleged bribery

[4] *SEC v. Ralph R. Cioffi and Matthew M. Tannin*, Lit. Rel. No. 20625 (Jun. 19, 2008).

[5] *SEC v. Julian T. Tzolov and Eric S. Butler*, Lit. Rel. No. 20698 (Sept. 3, 2008)

[6] *See, e.g., SEC v. Broadcom*, Lit. Rel. No. 20532 (Apr. 22, 2008); *SEC v. Analog Devices, Inc.*, Lit. Rel. No. 20604 (May 30, 2008).

of Nigerian government officials to obtain construction contracts worth more than $6 billion.[7]

- Ponzi schemes
  - Notably, the Wextrust case involved a series of fraudulent offerings; the defendants raised $255 million, primarily from members of the Orthodox Jewish community, which they purportedly used for investments in commercial real estate ventures, but which in reality they used to pay returns to investors in prior offerings or to pay their own expenses.[8]
- Other affinity frauds, which prey on the trust between individuals in a group
  - As examples here, we stopped a fraudulent real estate investment scheme that targeted the African-American community and that was marketed on the basis of other people's subprime mortgage woes. The promoters claimed they used $18 million in investor funds to cure defaults on distressed properties and promised returns of 50% over 30-45 days, when in reality the funds were used to pay the promoters' personal expenses, including a lavish wedding, cars, jewelry, entertainment and home renovations.[9]
  - We also obtained a final judgment against a multi-level marketing scheme that sought to exploit Christians, which required the promoters to pay nearly $8 million in disgorgement and civil penalties. In this case, the promoters—one of whom held himself out as an ordained minister—ran a purported commodities futures trading scheme in which they encouraged investors they designated as "consultants" to solicit new investors from among fellow church members and other self-identified Christians. The promoters improperly diverted the investors' funds to themselves and entities they controlled.[10]
- Money laundering
- Insider trading cases
  - Our cases here include actions against a broad range of defendants, including: the former Chairman and CEO of Enron Energy Services; a former partner at the accounting firm of Ernst & Young; three Ft. Lauderdale doctors; and the mayor of Beaufort, South Carolina.[11]
- Internet frauds

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[7] *SEC v. Albert Stanley Jackson*, Lit. Rel. No. 20700 (Sept. 3, 2008).

[8] *SEC v. Steven Byers, et al.*, Lit. Rel. No. 20678 (Aug. 11, 2008).

[9] *SEC v. Jeanetta M. Standefor, et al.*, Lit. Rel. No. 20575 (May 14, 1008).

[10] *SEC v. Alanar, Inc.*, Lit. Rel. No. 20629 (Jun. 25, 2008).

[11] *SEC v. Lou L. Pai,* Lit. Rel. No. 20658 (Jul. 29, 2008); *SEC v. Zachariah P. Zachariah, et al.*, Lit. Rel. No. 20564 (May 12, 2008); *SEC v. William J. Rauch*, Lit. Rel. No. 20646 (Jul. 16, 2008).

- Municipal bond frauds

During the same time period, the Commission has also distributed approximately $700 million to injured investors in disgorgement and civil penalties paid in prior enforcement actions.

While ARS and subprime issues related to the recent market turmoil have captured significant attention over the past year, the SEC's enduring mission in securities law enforcement is to be vigilant in addressing the broadest possible range of potential violations at all times. Some of our enforcement actions make headlines, but the vast majority of our cases do not and yet, collectively, they are no less important to the integrity of our markets and investors' confidence in them. Though our enforcement priorities change to meet new challenges in the markets, the core of our daily enforcement work remains the same. We seek to cover the entire waterfront in the securities markets—combating accounting fraud, market manipulations, offering frauds and insider trading, among other things, all across the nation every day. It is our privilege to work for investors.

Conclusion

I want to thank you for this opportunity to discuss the Commission's efforts with respect to the ARS market. I would be happy to answer any questions you may have.

WRITTEN STATEMENT OF THE
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

U.S. House Committee on Financial Services

"Auction Rate Securities Market: A Review of Problems and Potential Resolutions"

September 18, 2008

Introduction to NASAA

The North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection. It was organized in 1919 and is a voluntary association with a membership consisting of 67 state, provincial and territorial securities regulators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.

State securities administrators are responsible for enforcing state securities laws, licensing of firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials. Eleven administrators are appointed by their Secretaries of State, others by their Governors, some are independent commissions, and five fall under the jurisdiction of their states' Attorneys General.

State securities regulators respond to investors who typically call them first with complaints, or request information about securities firms or individuals. They work on the front lines, investigating potentially fraudulent activity and alerting the public to problems. Because they are closest to the investing public, state securities regulators are often first to identify new investment scams and to bring enforcement actions to halt and remedy a wide variety of investment related violations.

Auction Rate Securities Investigations

State securities regulators began responding to auction rate securities (ARS) related complaints soon after the auction rate securities market froze in February 2008. State offices received complaints from a wide range of outraged investors – young families saving for a first home, small business owners, retirees, and people with parents in nursing homes – whose financial lives have literally been put on hold because the money they were told was "cash-like" was tied up in the frozen market and inaccessible to them. NASAA members have logged hundreds of complaints from individuals holding frozen auction rate securities valued at hundreds of millions of dollars.

Given the growing number and the serious nature of the complaints received around the country, state securities regulators initiated a collaborative approach to investigate the

marketing and sale of auction rate securities by various broker-dealers. On April 13, 2008, NASAA announced the formation of its Auction Rate Task Force, chaired by Bryan Lantagne, Director of the Massachusetts Securities Division. The original Task Force members included state securities regulators from Florida, Georgia, Illinois, Massachusetts, Missouri, New Hampshire, New Jersey, Texas, Virginia and Washington. These states led the national effort and continue to serve, with California and Pennsylvania, as leads in the investigative process. There are many other states functioning in supporting capacities.

From its inception, the goal of the task force members has been to restore liquidity to ARS investors and, as of today, the firms have agreed to buy back an estimated more than $50 billion of the securities from investors. When all is said and done, this will be the single largest repayment to investors in the history of the capital markets.

The investigations covered the breadth of the problem from underwriting, to the auction process, to marketing, sales practices and the conflicts of interest that arose between the firms and their customers.

Enforcement Actions

On June 26, 2008, the Massachusetts Securities Division of the Secretary of the Commonwealth filed the first ARS related enforcement action, which was against UBS Financial Services (UBS). The case highlights the profound, undisclosed conflict of interest that arose between UBS and its customers: The firm was promoting ARS securities to its clients at the same time that it was desperate to reduce its own inventory, based on concerns about potential problems in the ARS auction market. The complaint also describes the pattern of deceptive sales practices that UBS agents used to sell ARS securities to unsuspecting clients.

The Massachusetts Securities Division followed the UBS complaint with one against Merrill Lynch, Pierce, Fenner & Smith (Merrill Lynch) on July 31, 2008. This administrative complaint addresses the manner in which Merrill Lynch conducted its ARS business, as well as how it interacted with its research department. It charges the firm with separate counts of fraud and dishonest and unethical conduct for creating and implementing a sales and marketing scheme that significantly misstated not only the nature of auction rate securities, but also the overall stability of the auction market, resulting in thousands of investors being abandoned with illiquid investments.

Settlements in Principle

As of September 16, nine Wall Street firms have reached settlements in principle to restore an estimated more than $50 billion of liquidity to over 183,000 investors across the nation.

Members of the NASAA Task Force, working in conjunction with the New York Attorney General and the Securities and Exchange Commission (SEC), have negotiated

settlements in principle with Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan, Merrill Lynch, Morgan Stanley, UBS, and Wachovia. Settlement negotiations are ongoing with several additional firms. The terms of the settlements are not identical because there were different and varying degrees of alleged wrongdoing uncovered at each firm. In addition to restoring liquidity to investors, the common elements of the settlements in principle include:

- establishing a dedicated telephone assistance line, with appropriate staff, to respond to questions from customers concerning the terms of the settlement;
- establishing of a special arbitration procedure for the exclusive purpose of arbitrating any relevant class member's consequential damages claim;
- refunding of refinancing fees to municipal auction rate issuers that issued such securities in the initial primary market between August 1, 2007 and February 11, 2008, and who refinanced those securities after February 11, 2008; and
- assessing fines and penalties payable to the States reflecting the firms' dishonest and unethical marketing and sale of auction rate securities to investors.

A synopsis of each firm's settlement in principle follows:

Citigroup. The Texas State Securities Board led the investigation into allegations that Citigroup misled its clients by falsely assuring them that ARS were as safe and liquid as cash. On August 7, 2008, NASAA President Karen Tyler, Texas Securities Commissioner Denise Voigt Crawford, New York Attorney General Andrew Cuomo, and the Securities and Exchange Commission announced that a settlement in principle had been reached with Citigroup, Inc., to give thousands of Citigroup clients' access to billions of dollars in funds that have been frozen in the ARS market.

Under the terms of the settlement announced by state and federal regulators, Citigroup will offer to repurchase at par, no later than November 5, 2008, all auction rate securities from all Citigroup retail customers who held those securities at the time the auction market failed on February 12, 2008. For purposes of the settlement, retail customers are defined to include individual investors, all businesses with account values of up to $10 million, and all charities regardless of account values.

UBS. On August 11, 2008, NASAA President Karen Tyler announced that a settlement in principle had been reached between UBS Securities LLC and UBS Financial Services, Inc. (UBS) and state and federal securities regulators. Massachusetts, New York and Texas all had leading roles in investigating UBS's misconduct and in negotiating the settlement.

Under the terms of the settlement, UBS will buy back, no later than October 31, 2008, all illiquid auction rate securities from all UBS retail customers, including charities, who have less than $1 million on deposit. In addition, no later than January 2, 2009, UBS will buy back all illiquid auction rate securities from all other UBS retail customers, charities, and small to mid-sized businesses. These customers, who number approximately 40,000 nationwide, have been unable to sell their securities since February 13, 2008.

JP Morgan/Morgan Stanley. The Illinois Securities Department, the Florida Office of Financial Regulation, the New York Office of the Attorney General, and NASAA announced, on August 14, that settlements in principle had been reached with JP Morgan and its affiliates (including Bear Stearns & Co. Inc.) and Morgan Stanley. The settlements concluded an investigation led by the Illinois Securities Department and the Florida Office of Financial Regulation into allegations that both firms misled clients by falsely assuring them that auction rate securities were as safe and liquid as cash.

Under terms of the settlement, Morgan Stanley has agreed to provide immediate liquidity to its retail investors who purchased auction rate securities through Morgan Stanley before February 13, 2008, and who are unable to sell those securities because of failed auctions, by offering to buy back the securities at par. The category of retail investors includes all individual investors, all charities and non-profits, and all institutional clients with account values and household values up to $10 million. Morgan Stanley has made the offer effective immediately, and will complete all repurchases from investors who accept this offer by December 11, 2008.

Under the terms of the settlement, JP Morgan and its affiliates, including Bear Stearns & Co., Inc., will offer to repurchase, no later than November 12, 2008, all illiquid auction rate securities from all JP Morgan individual investors, charities, not-for-profit companies and institutional clients who have account values and household assets of up to $10 million.

Wachovia. A settlement in principle was reached between Wachovia Securities and state and federal securities regulators on August 15, 2008. Under the terms of the agreement, Wachovia will repurchase illiquid ARS securities from all non-profit charities, as well as all individuals and businesses with account or household values up to $10 million, no later than November 28, 2008. All other investors will be able to redeem their auction rate securities no later than June 30, 2009.

Merrill Lynch, Goldman Sachs, Deutsche Bank. On August 21, state securities regulators announced settlements in principle had been reached between Merrill Lynch & Co. Inc., Goldman Sachs Group Inc., and Deutsche Bank Securities Inc, Deutsche Bank AG. Under the terms of the settlement, Merrill Lynch agreed to buy back by October 1, 2008 all auction rate securities purchased through the firm by retail investors with accounts of $4 million or less in assets. For all other retail investors and all other investors with accounts of $100 million or less in assets, the buyback will occur by January 2, 2009.

Goldman Sachs agreed by November 12, 2008 to buy back auction rate securities for all retail investors who purchased auction rate securities through the firm and Deutsche Bank agreed to buy back auction rate securities from all retail investors who purchased auction rate securities through Deutsche by November 21.

Credit Suisse. On September 16, 2008, NASAA announced that a settlement in principle was reached between Credit Suisse Securities (USA) LLC and state securities

regulators, which concludes an investigation led by the Securities Division of the North Carolina Department of the Secretary of State, into allegations that the firm misled clients by falsely assuring them that auction rate securities were as safe and liquid as cash.

Under the terms of the settlement, Credit Suisse agreed to buy back at par value by December 11, 2008 all auction rate securities purchased through the firm by individual investors before February 14, 2008. Under terms of the settlement, "individual investors" include all individuals, legal entities forming an investment vehicle for family members, charities and non-profits, and small- to medium-sized businesses with account values of up to $10 million with Credit Suisse.

Conclusion

The auction rate securities investigations and settlements are examples of well-coordinated, collaborative efforts amongst state and federal regulators. They come only a few years after many of the same Wall Street firms were involved in the analysts' conflict of interest global settlement with the states, SEC, NYSE and the NASD (now FINRA). These examples of widespread misconduct in the financial services industry prove that now is the time to strengthen, not weaken our unique complementary regulatory system of state, federal and industry regulation. One hundred million investors – many of them wary and cynical -- expect regulators to remain vigilant – and to make sure that Wall Street puts investors first.

SUBMISSION TO U.S. HOUSE FINANCIAL SERVICES COMMITTEE HEARING ON AUCTION RATE SECURITIES -
9/18/2008 BY PROFESSOR FRANK J. PARKER - PROFESSOR OF REAL ESTATE DEVELOPMENT (MBA)- CARROLL SCHOOL OF MANAGEMENT - BOSTON COLLEGE

When The Honorable Barney Frank, The Chair of the U.S. House Financial Services Committee and the longtime member of Congress for my district, invited me personally to record my observations and reflections on The Auction Rate Securities Market for its September 18,2008 hearing, I was honored and pleased to do so. The specific focus of this hearing, "A Review of Problems and Potential Solutions" is well chosen. He and ranking minority member The Honorable Spencer Bachus are to be congratulated on the initiative at this crucial time in this country's financial affairs.

Although Auction Rate Securities had been a legitimate vehicle in the arsenal of financial instruments for a number of years, they had drawn little public notice because few major problems had been attributed to them.
All of this sense of tranquility evaporated in a moment on February 18, 2008 when no buyers appeared to buy these securities at a regularly scheduled auction. In effect, $330 Billion worth of instruments were frozen in place.
A true financial crisis had exploded on the scene from out of nowhere.

What are Auction Rate Securities? The best definition I have encountered was provided by New York Sunday Times financial columnist Gretchen Morgenson in her column on June 29,2008. "Auction rate securities are preferred shares or debt instruments with rates that reset regularly, usually each week, in auctions overseen by the brokerage firms that originally sold them. They have long term maturities, or the case of preferred shares, no maturity dates whatsoever. The securities are issued by municipalities, student loan companies, closed end funds and tax exempt institutions like hospitals and museums." (Colleges and universities, no doubt, also should be added to this list).

In brief, the institutions buying these securities assumed they were dealing with a commercial paper type instrument with a slightly higher rate of return than normal because of the constant monitoring and adjustment of rates involved in the frequent auctions. Unfortunately, in fact, these institutions had committed themselves to being issuers of long term debt with all attendant obligations mandated should the underlying security come under siege and become tainted as occurred here. Suddenly, in the wake of the sub prime mortgage crisis there were no buyers showing up to buy these reset securities at these periodic auctions. The large financial institutions involved did not reach out to assist their clients in their time of extreme need.

To make matters even worse, it recently became undeniable that a number of large financial institutions sold these illiquid debt instruments to wealthy individual investors in order to expunge these

holdings from their holdings. Again let us return to Gretchen Morgenson, this time in the May 4. 2008 issue of The New York Sunday Times. "Naturally, investment bankers who agreed to operate these auctions were paid for their services; 0.25 percent of the security's total issue for each year of its life.
Unnaturally, big firms still earn these fees even though 70% of the weekly auctions of these securities are failing. The firms also rake in banking fees when municipal issuers unwind derivative contracts that are often intertwined with the securities. Which are designed to reduce costs for the issuers by hedging their interest rate risks. Thanks to the decline in
interest rates however, they can be frightfully expensive to unspool.

A number of regulators including prominently The Secretary of State and The Attorney General of the Commonwealth of Massachusetts, William F. Galvin and Martha Coakley respectively, and The Attorney General of The State of New York, Andrew M. Cuomo, led the way in protecting a number of the institutional and high net worth individual investors involved. Major Wall Street firms compelled to make restitution under these circumstances included Lehman Brothers, Fidelity Investments, UBS, Merrill Lynch, Goldman Sachs, Citigroup and The Bank of America.

The activities of four major participants in the auction rate securities freeze should be examined. These are the purchasers, the brokers, the insurers and the financial services firm initiators. First, let us examine the purchasers. By and large the purchasers were 501C3 and the like non- profit organizations and governmental and quasi-governmental agencies. Later, in the rush to keep these instruments solvent the large financial institutions involved went to the highways and byways to attract virtually anyone and everyone of individual high net worth to purchase these instruments. This activity was unconscionable.

However, ultimately, just as with sub-prime mortgages, it is the individual purchaser who is ultimately responsible for understanding the composition of the instrument, the risk involved and the likelihood of financial reward. Today non-profits and governmental and quasi-governmental agencies are not unsophisticated financially themselves. They should not be absolved of all responsibility for their mistakes. Decision - makers in all of these organizations normally are compensated extremely well. Many in the non-profit arena have reached seven figure salaries at the pinnacle of their professions. Virtually all have access for their organizations to the highest paid and most talented of in-house staff. In addition there are scads of law firms, accounting firms, actuarial firms, independent consultants and the like whose services are readily available when needed.
Top management in the purchasers should be held accountable for their failure to understand these instruments and protect the service recipients and taxpayers for whom funds available should be used. As the credit crunch mounted, warning bells should have gone off in the meeting rooms of all these groups. Are our considerable investments in auction rate securities safe? Should we take this money elsewhere? Especially as to university trustees and financial officers and their outside advisors, rating agencies employed, auditors, accountants and portfolio consultants, none of these people seemed to have learned the lessons of earlier financial debacles like New Era Philanthropies and

The Common Fund warn them to be more prudent this time around? Apparently not.

The brokers at the large financial institutions responsible for selling auction rate securities to their non-profit and governmental and quasi governmental clients also deserve much of the blame. Perhaps they also should suffer civil and criminal consequences as well. In most cases they knew or should have known that the clients did not understand the inherent risk involved in these instruments nor their fundamental working mechanics. In this regard, the resemblances to the actions of mortgage brokers in the sub- prime and Alt-A types of residential mortgage purchase solicitations are quite striking. Especially when the broker involved is holding substantial amounts of auction rate securities in his or her own personal investment portfolio, The Financial Services Committee of The House might consider legislation mandating full disclosure of such holdings to the general public much as occurs now with Securities and Exchange Commission mandated insider trading regulation compliance by firm principals when buying and selling the stock of their own companies.. Regulations of this sort might have tipped clients holding auction rate securities that if their brokers were abandoning ship on them, when selling these instruments in their own portfolios, the client should be afforded the same opportunity.

With the international financial turmoil caused by the extreme difficulties of the world's largest insurer, AIG, it is entirely that possible that the less than admirable conduct of a number of insurers involved in the auction rate securities meltdown will be forgotten. This should not happen. There is plenty of blame to be spread around. These insurers of these financial instruments including AIG and affiliates should be apportioned their fair share. When purchasers finally awoke to the harsh reality that defaults in sub-prime mortgages were causing potential buyers of their auction securities to run to the hills they assumed the insurers with whom they had done business for many years would allow them to refinance their debt to avoid exploding interest costs. Such was not the case, almost universally. Citing their own fear of having their credit ratings downgraded because of huge potential losses in sub-prime mortgages they had guaranteed, these major insurance companies refused requests to allow these institutions to transfer their holdings in auction rate securities to still viable 'variable rate demand bonds " still favored by public sector pension funds and similarly situated institutional investors.
This lack of support from the insurance industry left the non profits and governmental and quasi governmental clients totally alone in their attempts to dig themselves out of the auction rate security mess they had made for themselves. Such blatant self-interest on the part of the insurers brought back memories of the lack of willingness of many insurers to be part of the solution at the time of Hurricane Katrina. Again, this time, cries were heard of: " Where are the insurance companies when we really need them?" As a result, the Bush Administration initiated plans to tighten Federal regulation of the insurance industry may have more backers in the coming years than otherwise would be the case.

In addition, we must not forget the major financial institutions that dreamed up auction rate securities in the first place. Granted their overall problems are larger than only auction rate securities.

Unthinkable a few months ago, more than a few of these institutions already have failed or are in danger of failing Although regulators and legislators are to be commended for their efforts to protect the general public and reclaim a substantial amount of the money lost when buyers for these auction rate securities disappeared totally from the investment auction scene, it is hoped The US House Financial Services Committee and others with similar authority remember that the underwriting, legal and other costs of replacing these bonds will be borne by the non-profit organizations and by the taxpayers as a whole. Hopefully for this particular financial crisis and for those certain to occur in the future, when the activities of the financial institutions clearly are in contravention of all acceptable ethical standards, new legislation will be in place to make the financial institutions involved directly responsible for all reasonable costs involved in replacement activities. The financial institutions causing the problems originally should not also profit in some perverse Orwellian fantasy by making even more money once from their deliberate original transgressions.

In conclusion, with all of the financial catastrophes now in play, there is a natural tendency to criticize The Gramm - Leach - Billey Act of 1999 and remember the Banking Act of 1933 (Glass - Steagall Act) with exaggerated fondness.. In my view, both reactions are overstated. Each served the country well for its time. New legislation undoubtedly is needed and will be put forth. This hearing is one small but vital step in the right direction. More fundamentally, however, there must be a return to the sort of concern for the individual manifested in the original Federal Reserve Act of 1913. (Throughout this legislation was the perception that banks were
quasi- public utilities charged with protecting the individual in return for a semi-monopoly in managing their money. It would not hurt to return to this sort of thinking in ongoing legislation.

Best selling author Martin Mayer observed in "The Greatest Ever Bank
Robbery: The Collapse of The Savings and Loan Industry: "What makes the S&L outrage so important a piece of American history is not the hundreds of billions of dollars lost, but the demonstration of how low our standards for professional performance have fallen in law, accounting, appraising, banking and politics - all of them." Unfortunately in the almost twenty years since this thought was articulated by Mr. Mayer the situation has only gotten worse. Hopefully this hearing is a small, but essential, step at righting the situation.

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AUCTION RATE SECURITIES MARKET: A REVIEW OF PROBLEMS AND POTENTIAL RESOLUTIONS

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON
FINANCIAL SERVICES

SEPTEMBER 18, 2008

Statement of the

MUNICIPAL SECURITIES RULEMAKING BOARD

Statement of the Municipal Securities Rulemaking Board

to the

U.S. House of Representatives
Committee on Financial Services
September 18, 2008

INTRODUCTION AND SUMMARY

The Municipal Securities Rulemaking Board ("MSRB" or "Board") appreciates the opportunity to submit a statement before the Committee addressing current issues concerning the municipal auction rate securities market. Part I provides a summary of the Board's structure, authority, rules, information systems and market transparency/surveillance activities. Part II provides background on the municipal securities market. Part III is a discussion of the MSRB's regulatory guidance and market initiatives, specifically our recent initiatives responding to the auction rate securities and short-term municipal market crisis.

I. BACKGROUND ON THE MSRB'S STRUCTURE, AUTHORITY, RULES, INFORMATION SYSTEMS AND MARKET TRANSPARENCY/SURVEILLANCE ACTIVITIES

A. MSRB Structure

The MSRB is a self-regulatory organization ("SRO") established by Congress in the Securities Acts Amendments of 1975 to develop rules for brokers, dealers and municipal securities dealers (collectively "dealers") in underwriting, trading and selling municipal securities. The Board also operates information systems designed to promote transaction price

transparency and access to municipal securities issuer disclosure documents. The MSRB stands as a unique SRO for a variety of reasons. The MSRB was the first SRO specifically established by Congress. Also unique is the fact that the legislation, now codified in section 15B of the Securities Exchange Act ("Exchange Act"), dictates that the Board shall be composed of members who are equally divided among public members (individuals not associated with any dealer), individuals who are associated with and representative of banks that deal in municipal securities ("bank dealers"), and individuals who are associated with and representative of securities firms.[1] At least one public member serving on the Board must represent investors and at least one must represent issuers of municipal securities. Further, the MSRB was created as a product-specific regulator, unlike most other securities regulatory bodies.

Members of the Board meet throughout the year to make policy decisions, approve rulemaking, enhance information systems and review developments in the municipal securities market. Day-to-day operations of the MSRB are handled by a full-time professional staff. The operations of the MSRB are funded through assessments made on dealers, including fees for underwritings and transactions.[2]

B. MSRB Authority

The substantive areas of the MSRB's rulemaking authority are described in Section 15B(b)(2) of the Exchange Act, which lists several specific purposes to be accomplished by

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1 Under Board Rule A-3, the Board is composed of 15 member positions, with five positions each for public, bank dealer and securities firm members.

2 These fees are set forth in Board Rules A-12 through A-14.

Board rulemaking with respect to the municipal securities activities of dealers and provides a broad directive for rulemaking designed to:

> prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling and processing information with respect to and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

Like other SROs, the MSRB must file its proposed rule changes with the Securities and Exchange Commission ("SEC") for approval prior to effectiveness.

Although the MSRB was created to write rules that govern dealers' conduct in the municipal securities market, the Exchange Act directs that inspection of dealers for compliance with, and the enforcement of, MSRB rules be carried out by other agencies. For securities firms, the Financial Industry Regulatory Authority ("FINRA"), along with the SEC, performs these functions. For bank dealers, the appropriate federal banking authorities, in coordination with the SEC, have this responsibility.[3] The use of existing enforcement authorities for inspection and enforcement of MSRB rules provides for an efficient use of resources. The MSRB works cooperatively with these enforcement agencies and maintains frequent communication to ensure that: (1) the MSRB's rules and priorities are known to examining officials; (2) general trends

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[3] These federal banking authorities consist of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the U.S. Treasury Department through its Office of the Comptroller of the Currency and Office of Thrift Supervision, depending upon the specific bank dealer.

and developments in the market discovered by field personnel are made known to the MSRB; and (3) any potential rule violations are immediately reported to the enforcement agencies.

While Section 15B of the Exchange Act provides the MSRB with broad authority to write rules governing the activities of dealers in the municipal securities market, it does not provide the MSRB with authority to write rules governing the activities of other participants in the municipal finance market such as issuers and their agents (*e.g.*, independent financial advisors, trustees, bond counsel, etc.). Municipal securities also are exempt from the registration and prospectus delivery requirements of the Securities Act of 1933 and are exempt from the registration and reporting requirements of the Exchange Act.

C. MSRB Rules Overview

The MSRB has adopted a substantial body of rules that regulate dealer conduct in the municipal securities market. In general, our rules are "principles-based" with specific guidance given where appropriate. We also seek to coordinate our rules with FINRA rules in cases where similar requirements make sense. MSRB rules address all of the subjects enumerated in Section 15B of the Exchange Act. Among the most important of these are the Board's three primary customer protection measures—Rule G-17, on fair dealing, Rule G-19, on suitability, and Rule G-30, on fair pricing. These rules require dealers to observe the highest professional standards in their activities and relationships with customers.

Maintaining municipal market integrity is an exceptionally high priority for the MSRB as it seeks to foster a fair and efficient municipal securities market through dealer regulation. The MSRB engages in an on-going review of its rules and market practices to ensure that the Board's

overriding goal of protecting investors and maintaining market integrity is not compromised by emerging practices. As an example, the MSRB implemented rules to remove the conflict of interest that can arise when political contributions may be used by dealers to obtain municipal securities business.

D. Information Systems and Market Transparency/Surveillance

The MSRB also operates information systems to improve the availability of information in the market about municipal issues. These systems ensure that investors have information necessary to make investment decisions, that dealers can comply with MSRB rules and that the inspection and enforcement agencies have the necessary tools to do their work. Since 1990, the Municipal Securities Information Library ("MSIL") system has collected issuer primary market disclosure documents (i.e., official statements and advanced refunding documents) from underwriters and made them available to the market and the general public. The MSIL system also accepts and disseminates certain secondary market information provided by municipal issuers and trustees pursuant to SEC Rule 15c2-12. In order to further increase the accessibility of municipal market information by retail investors, the MSRB has developed a free, centralized database, named the Electronic Municipal Market Access system or EMMA, which is discussed further below.

In 2005, the MSRB also implemented a facility for real-time transaction reporting and price dissemination of transactions in municipal securities (the "Real-Time Transaction

Reporting System" or "RTRS").[4] RTRS serves the dual role of providing transaction price transparency to the marketplace, as well as supporting market surveillance by the enforcement agencies. Surveillance data is made available to regulators with authority to enforce MSRB rules, including FINRA and the SEC. The market surveillance function of the MSRB's transaction reporting system provides enforcement agencies with a powerful tool in enforcing the Board's fair pricing rules. The MSRB offers a market-wide real-time feed of trade information and provides the data free of charge on EMMA, as discussed below.

II. BACKGROUND ON THE MUNICIPAL SECURITIES MARKET

A. Market Overview

When Section 15B of the Exchange Act was adopted in 1975, yearly issuance of municipal securities was approximately $58 billion. Much of this total represented general obligation debt, which reflected the simple, unconditional promise of a state or local government unit to pay to the investor a specific rate of interest for a specific period of time. The investors in these bonds tended to be commercial banks and property/casualty insurers interested in tax-exempt interest.

The municipal securities market has grown into a much larger and more complex market. Total municipal debt outstanding currently is approximately $2.7 trillion. Last year, a total of 12,595 new issues in long-term municipal securities came to market for a total par value of $430 billion.

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[4] The MSRB's transaction reporting rules require dealers to report transactions in municipal securities within 15 minutes of the time of trade execution instead of by midnight on trade date, as was previously required.

In the United States, there are approximately 80,000 state and local governments, about 50,000 of which have issued municipal securities. The market is unique among the world's major capital markets because the number of issuers is so large—no other direct capital market encompasses so many borrowers. The issues range from multi-billion dollar financings of large state and city governments to issues less than $100,000 in size, issued by localities, school districts, fire districts and various other issuing authorities. The purposes for which these securities are issued include not only financing for basic government functions, but also a variety of public needs such as transportation, utilities, health care, higher education and housing as well as some essentially private functions to enhance industrial development. In the last two decades debt issuance has become an important management tool for many municipalities, allowing flexibility in arranging finances and meeting annual budget considerations according to local needs and local priorities. The terms and features of some municipal securities have evolved over time into highly complex structures to meet a multitude of issuer borrowing and investment needs.

The municipal securities market has significant retail participation, with approximately 35% of municipal debt held by households directly and another approximately 35% through mutual funds. There is great diversity in the types of municipal securities that are issued today. Tax-exempt municipal securities have many features that make them a popular investment, including income free from federal and, in some cases, state and local taxes; relative safety with regard to payment of interest and repayment of principal; and a wide range of choices to fit an investor's objectives with regard to credit quality, sector, maturity, choice of issuer, type of bond, and geographical location.

More than 2,000 dealers are registered with the MSRB to engage in municipal securities activities. These dealers range from large securities firms with nationwide presence to smaller regional firms. Approximately 250 of these dealers underwrite new issues.

B. Trading in Municipal Securities

Municipal securities are bought and sold in the over-the-counter market rather than on a listed market. A primary characteristic of the municipal securities market is the lack of any core group of issues that trade frequently and consistently over sustained periods of time. One reason for this is the "buy and hold" philosophy of most municipal securities investors. At any given time, there is a very small likelihood that specific municipal securities are available for trading. In fact, even on the heaviest trading days, less than one percent of all outstanding municipal issues trade at all and most of those issues trade only once or twice during the day. Furthermore, MSRB transaction reporting data suggests that less than one-half of the total issues outstanding during a given year are traded even once at any time during that year.

III. REGULATORY PRIORITIES AND GOALS

A. Continuing Vigilance and Market Guidance

The MSRB continues to review and refine its rules and regulatory guidance in light of new products, changes in marketing practices and other developments. The MSRB has established as its goal the fostering and promoting of a fair and efficient municipal capital market. To help reach this goal, the MSRB seeks to exercise market leadership through rulemaking, publishing timely market guidance, providing mechanisms for information flows

and adapting to changes in conditions. Recently, the MSRB has taken a number of major actions in connection with municipal auction rate securities.

B. Market Leadership

Since early 2008, downgrades of municipal bond insurers and other short-term liquidity concerns have created extreme volatility in the market for municipal Auction Rate Securities ("ARS"). This resulted in an unprecedented number of "failed auctions," meaning that investors who chose to liquidate positions through the auction process were not able to do so. In response to these difficult market conditions, the MSRB has been actively involved in efforts to protect investors and promote a fair and efficient market through difficult market conditions.

C. Market Expertise

Throughout the past year, the MSRB has met with federal and state officials and industry stakeholders to lend our expertise and help fashion appropriate responses to the credit crisis. The MSRB also has submitted testimony to this Committee on other issues in the municipal securities market.[5]

D. MSRB Reminder re: Application of MSRB Rules

The MSRB has reminded dealers of their obligations with respect to the investor protection rules applicable to transactions in ARS.[6] As discussed above, one of the most

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[5] *See* March 12, 2008 Statement of the MSRB on Municipal Bond Turmoil: Impact on Cities, Towns and States.

[6] *See* Application of MSRB Rules to Transactions in Auction Rate Securities, MSRB Notice 2008-09 (February 19, 2008).

important MSRB investor protection rules is Rule G-17, which requires dealers to deal fairly with all persons and prohibits deceptive, dishonest, or unfair practices. A longstanding interpretation of Rule G-17 is that a dealer transacting with a customer[7] must ensure that the customer is informed of all material facts concerning the transaction, including a complete description of the security.[8] Disclosure of material facts to a customer under Rule G-17 may be made orally or in writing, but must be made at or prior to the time of trade. In general, a fact is considered "material" if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor.[9]

Aware that ARS are often sold to individual investors, who may not have the same sophistication as institutional customers in understanding the features of complex securities, the MSRB reminded dealers that it is particularly important for dealers to focus attention on the application of MSRB investor protection rules when effecting transactions in ARS. Dealers were reminded that the duty to disclose material facts to a customer in an ARS transaction includes the duty to give a complete description of the security, including features of the auction process that likely would be considered significant by a reasonable investor. Given the variety and complexity of ARS, there are a number of facts that may fall within this duty to disclose, including the duration of the interest rate reset period, information on how the "all hold" and maximum rates are determined, and other features of the security found in the official documents

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7 MSRB Rule D-9 defines "customer" as any person other than a dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities.

8 *See, e.g.*, Notice Concerning Disclosure of Call Information to Customers of Municipal Securities (March 4, 1986), MSRB Manual (CCH) para. 3591.

9 *See, e.g.*, Basic v. Levinson, 485 U.S. 224 (1988).

of the issue.[10] In light of recent events, it may be a material fact for an investor that an ARS recently was subject to a failed auction. Of course, this does not represent an exhaustive list of facts that a dealer must consider as potentially material, since this may vary with individual securities and transactions.

The MSRB also advised dealers to carefully focus on the application of MSRB Rule G-19 on the suitability of recommendations when making recommendations to customers in ARS. Rule G-19 provides that a dealer must consider the nature of the security as well as the customer's financial status, tax status and investment objectives, based upon the facts disclosed by or otherwise known about the customer when making recommendations to customers. The dealer then must have reasonable grounds for believing that the recommendation is suitable for that customer.[11] Thus, among other factors, a dealer must consider both the liquidity characteristics of an ARS and the customer's need for a liquid investment when making a suitability determination involving ARS.

E. Transparency

Even though MSRB disclosure, fair dealing and suitability requirements protect customers that transact in ARS, the MSRB remains concerned about the lack of information

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[10] If the maximum rate is a formula linked to a particular securities market indicator, such as the London Interbank Offered Rate (LIBOR), the dealer's disclosure obligations may extend to a description of the material facts concerning the market indicator, as they relate to the ARS.

[11] In the case when a low maximum rate is set for failed auctions, there may be a high likelihood for continued failed auctions. In this case, dealers were reminded to consider the non-auction secondary market prices when recommending to a customer whether to purchase the ARS through an auction or in the non-auction secondary market.

available to market participants regarding ARS. Currently, there is no source of comprehensive same-day information about ARS available to non-market professionals, even information as basic as the clearing rates set through the auction process. To increase the amount of information available to market participants, the MSRB requested comment on a published plan to create a centralized system for the collection and dissemination of critical market information about ARS.[12] The plan would require dealers that operate auction rate programs ("Program Dealers") to report auction information to a central system operated by the MSRB.

Comments received on the plan to increase the amount of information available to market participants about ARS generally were supportive. However, some commentators noted that, as a result of the extreme volatility in the market for municipal ARS, many ARS have been redeemed by issuers or converted into other types of municipal securities thus reducing the amount of information that would be collected by such a system. During the review of those comments, the question of increased transparency for municipal Variable Rate Demand Obligations ("VRDO") surfaced.

ARS and VRDOs are similar in that they both are long-term securities with short-term interest rates. In both types of securities, interest rates are reset periodically through programs operated by dealers on behalf of the issuers of the securities. VRDOs, however, are distinguished by the existence of a "put" or "tender" feature that allows holders to tender their securities back to an issuer-appointed representative, at par, on a periodic basis. VRDOs normally operate with a letter of credit or stand-by bond purchase agreement designed to ensure

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[12] *See* Request for Comment: Plan for Increasing Information Available for Municipal Auction Rate Securities, MSRB Notice 2008-15 (March 17, 2008).

liquidity. Interest rates typically are reset by a dealer serving as the "remarketing agent" for the issue at a rate that allows the securities to be sold at par.

As a result of the volatility in the market for ARS, there has been increased interest in the market for VRDOs by both issuers and investors. Given this increased interest in the market for VRDOs, the MSRB has concerns about the lack of information available to market participants on VRDOs, similar to those concerns expressed above with respect to ARS. Given the similarities in ARS and VRDO, the MSRB requested comment on a published proposal to collect and disseminate critical market information about VRDOs using the same system proposed for ARS.[13] The plan would require dealers that act as Remarketing Agents on a VRDO to report information about a VRDO to a central system operated by the MSRB. Comments received on the plan to increase the amount of information available to market participants about VRDOs generally were supportive.

At its quarterly meeting in July 2008, the MSRB approved a plan to increase transparency on ARS and VRDOs.[14] The plan includes development of a system to collect and disseminate critical market information on these securities ("ARS/VRDO Transparency System"). Information collected through the ARS/VRDO Transparency System would be made available on the MSRB's EMMA system, described below, and therefore would be available to both retail and institutional investors. The information available on the EMMA system would be displayed in a user-friendly manner and users would be able to sort by various criteria.

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[13] *See* Request for Comment: Plan for Increasing Information Available for Municipal Variable Rate Demand Obligations, MSRB Notice 2008-24 (May 23, 2008).

[14] *See* MSRB Holds Quarterly Board Meeting; Approves Market Transparency Measures, MSRB Press Release dated July 18, 2008.

The MSRB plans to implement the ARS/VRDO Transparency System using a phased-in approach that prioritizes both disclosure of ARS and VRDO interest-rate data as well as ARS documents describing auction- and rate-setting procedures. Under the first phase, which the MSRB has set a goal of first-quarter 2009 for implementation, ARS Program Dealers and VRDO Remarketing Agents would report interest rate information as well as certain descriptive information to the ARS/VRDO Transparency System on the day that an interest rate rest occurs. In addition, ARS Program Dealers would be required to provide the MSRB with documents that describe ARS interest rate setting and auction procedures. The specific data the MSRB plans to collect and make transparent in the first phase includes:

ARS Reset Rate Information

- CUSIP Number
- Name of Program Dealer(s)
- Number of days of the reset period
- Minimum denomination
- Date and time of the auction
- Interest rate for the next reset period
- Indication of whether the clearing rate is a "maximum rate," an "all hold rate," or "set by auction"
- Dollar amount of securities auctioned

- Maximum Rate

VRDO Reset Rate Information

- CUSIP Number
- Name of Remarketing Agent
- Date of interest rate reset
- Interest rate for the next reset period
- Length of the interest rate reset period
- Length of Notification Period
- Whether interest rate is "set by formula" or "set by Remarketing Agent"
- Minimum and maximum rates, if any
- Minimum denomination

VRDO Liquidity Information

- Type of liquidity facility(ies)
- Expiration date of each liquidity facility

Under the second phase of the ARS/VRDO Transparency System, ARS Program Dealers would be required to report information about the bids submitted on an auction in an ARS. The specific data the MSRB plans to collect and make transparent in the second phase includes:

ARS Bidding Information

- Number of bidders
- Par amount of securities for sale in the auction
- Number and aggregate dollar amount of bids made
- Number of bidders other than the Program Dealer(s), issuer or conduit borrower
- Number, interest rate(s) and amount of bids by a Program Dealer for its own account
- Number, interest rate(s) and amount of bids by issuer or conduit borrower
- Par amount of securities allocated to bids at clearing rate
- High bid
- Low bid
- Median bid

The third phase would require VRDO Remarketing Agents to file with the MSRB documents that describe the provisions of liquidity facilities attached to a VRDO.

F. ARS Buybacks

The MSRB continues to monitor the market for ARS and recently clarified the requirements of MSRB Rule G-14, on transaction reporting, to transactions arising from dealer-announced plans to offer to purchase customer positions in ARS at a stated price, typically par ("ARS Buybacks").[15] Many of these ARS Buyback programs have developed in response to settlement agreements with the Securities and Exchange Commission and state attorneys general. The MSRB reminded dealers that all purchase-sale transactions in ARS must be reported to the MSRB Real-Time Transaction Reporting System, including ARS Buybacks. Further, the MSRB clarified that trade reports of ARS Buybacks, as well as of other purchases of ARS from holders at current market prices, must be reported and these trade reports will be provided to the market. However, the MSRB cautioned users of the MSRB's price transparency products that ARS Buybacks may result in a higher than normal volume of trade reports in ARS and that this volume should not be used as an indication that the market for ARS has fully recovered from the unprecedented number of failed auctions that have occurred in 2008. Further, the MSRB cautioned that the prices at which ARS Buybacks are executed may not reflect the actual market value for the security.

G. Establishment of EMMA

In March 2008, the MSRB launched its Electronic Municipal Market Access ("EMMA") pilot. EMMA is an Internet-based disclosure portal that provides free public access to primary market disclosure documents and real-time municipal securities trade price data for the

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15 *See* Transaction reporting of Dealer Buybacks of Auction Rate Securities: Rule G-14, MSRB Notice 2008-36 (September 2, 2008).

municipal securities market, in a manner specifically tailored to retail investors. The EMMA website is accessible at emma.msrb.org. EMMA currently provides an easily navigable integrated display of primary market disclosures and transaction pricing data for a specific security, incorporating detailed user help and investor education information designed to make the information easily understood by retail investors. EMMA currently provides free access to the MSRB's full collection of issuer disclosure documents dating back to 1990, as well as to trade price information since January 2005.

The MSRB continues development work on moving EMMA from a pilot to its permanent full-service phase, currently scheduled for completion by year-end. At that time, all underwriters will be required to submit official statements and related documents and information to EMMA electronically for immediate free public access through the EMMA website portal. Users of the website will be able to sign-up for free optional e-mail alerts to be notified of new and updated postings of disclosure documents and other information offered on EMMA. These documents will continue to be displayed in conjunction with real-time trade price information so that users viewing trading data for a specific municipal security will have immediate access to key disclosure information about that security. EMMA's search engine is designed to assist retail investors in quickly finding the right document and information for a particular security.

When fully operational, EMMA will move the municipal securities market from the old paradigm where only the buyer of a specific new issue municipal security could be assured of receiving a copy of the disclosure document for that security when the trade is completed to a new marketplace where the general public will have free on-going immediate access to disclosure documents for all issues as soon as the documents become available. To further

ensure broad access to the disclosures provided in official statements and advance refunding documents, the MSRB will make these documents available by subscription to information vendors and other bulk data users on terms that will promote the development of value-added services by subscribers for use by market participants.

On July 30, 2008, the SEC proposed amendments to its Rule 15c2-12 to make the MSRB the central location for issuer continuing disclosure documents. Simultaneously, the SEC published the MSRB's filing to implement this enhancement to EMMA. As proposed, EMMA's continuing disclosure service would provide a user-friendly interface for free electronic submission by issuers, other obligated parties and their agents of continuing disclosure documents. As with official statements, these continuing disclosure documents will become immediately available for free to the general public through the EMMA website portal. Free optional e-mail alerts relating to new postings will also be made available in connection with continuing disclosure documents. In addition, the continuing disclosure documents will be integrated into the existing official statement and trade data display to produce an all-encompassing view of the relevant primary market, secondary market and trade price information for each security in the marketplace easily accessible through EMMA's powerful search engine.

CONCLUSION

The MSRB will continue to monitor the municipal securities market as it further evolves to include more diversified and complex new structures and techniques, and as dealers, issuers, investors and others increasingly rely on new technologies. As it has in the past, the Board will

remain vigilant and will not hesitate to modify its rules, publish guidance and develop information systems to deal with the ever-changing marketplace.

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Statement of the
Regional Bond Dealers Association

Committee of Financial Services
United States House of Representatives

Hearing on the Auction Rate Securities Market: A Review of Problems and Potential Resolutions

September 18, 2008

Submitted for the hearing record

The Regional Bond Dealers Association (RBDA) appreciates the opportunity to submit this statement for the record in conjunction with the Committee on Financial Service's hearing on "Auction Rate Securities Market: A Review of Problems and Potential Resolutions." The RBDA is the only U.S. trade organization dedicated exclusively to representing regional securities firms active in the bond markets.

The auction rate securities (ARS) market has experienced considerable disruption in the last year. At one time, ARS were widely considered to be as safe and liquid as money market investments. In the minds of many investors, ARS were substitutes for commercial paper, money-market funds and similar highly liquid, short term investments. Today, however, liquidity has all but disappeared for tens of billions of dollars of outstanding ARS. Thousands of investors own securities they no longer want and cannot sell. The anxiety of ARS investors has been magnified by bankruptcies and consolidations among auction dealer firms. In that context, the issues addressed in the Committee's hearing on ARS are vital, and we commend Chairman Frank, Ranking Member Bachus and other committee members for your attention to these concerns.

In recent weeks federal and state enforcement agencies have been aggressive in securing agreements in principle with major securities firms to settle potential enforcement actions related to their activities in the ARS market. A key element of many of these agreements is an obligation on the part of settling securities firms to buy ARS positions back from certain of their investor customers at full face value. The RBDA supports these actions by regulators. Through

agreements secured by the SEC, state attorneys general, state securities regulators and others, many thousands of ARS investors will be made whole.

However, thousands more ARS investors are not covered by most of the agreements reached thus far by enforcement agencies. Many investors bought their ARS not from securities firms who underwrote the transactions and managed and controlled periodic auctions, but from "downstream" dealers who served principally as distributors of ARS. Investors who bought ARS from these "distributing" firms are mostly left out of the settlement agreements reached thus far. While we support the actions of enforcement agencies to help stranded ARS investors, we also urge policy makers to explore fair and practical solutions that will help all ARS investors become whole.

Some of the firms that have entered into agreements in principle related to ARS have been accused of violating sales practice rules associated with selling ARS by engaging in practices such as misrepresenting securities to their customers or selling securities that were unsuitable for a particular customer's objectives and risk tolerances.[1] RBDA believes that any firm that violated sales practice rules or any other applicable regulations in underwriting or distributing ARS or in managing ARS auctions should be subject to full regulatory enforcement. With that said, there are additional steps that market participants and regulators can take to help investors liquidate ARS they no longer want to own.

Reestablishing Liquidity

Many downstream brokers have been hamstrung in their ability to help their investor customers sell or borrow against their ARS holdings. Auction rate preferred stock (ARPS), sold by closed end mutual funds, is not marginable, which makes it prohibitively expensive for broker dealers to make margin loans to their customers using ARPS as collateral. While the SEC and FINRA have taken some steps to allow dealers to lend to customers against their ARPS holdings—and some firms do provide loans against customer positions—it is still prohibitively expensive for most dealers to provide this service.

Some closed end mutual funds have begun the process of restructuring their outstanding ARPS into other instruments that would be more attractive to investors. Regulators have been somewhat accommodating in providing approvals necessary to effect these transactions. We encourage regulators to expedite their consideration of filings by closed end funds designed to take ARPS out of the market and replace them with securities that offer more liquidity protection.

One key method for restoring liquidity to the holders of the ARS securities has been mostly ignored thus far by state and federal enforcement agencies. While the regulators have been vigorous and aggressive in insisting that the major institutions that were the lead managers in the auction process repurchase these securities, they have not taken any action against issuers of ARPS, closed end mutual funds and their managers. Yet at least some closed end fund managers likely were aware last winter of the same problems in the auction process confronting the lead

[1] See, for example, Office of the Attorney General, State of New York, "Attorney General Cuomo Brings National Multi-Billion Dollar Lawsuit Against UBS for Auction Rate Securities Scandal," press release, July 24, 2008.

managers and cooperated with the managers or turned a blind eye in order to maintain this source of inexpensive financing. We urge enforcement agencies to examine the conduct of the ARPS issuers and their possible knowledge of and responsibility for the wholesale failure of the ARPS market. Like the lead managers with whom they worked, ARPS issuers should be required to take action to assist ARPS investors by redeeming outstanding ARPS. Action by the closed end fund issuers can go a long way toward resolving much of this problem. After all, fund managers have the resources to unwind immediately their present use of the cheap financing they are now using for their funds' own leverage purposes.

Some fund managers have, on their own, moved to address their ARPS investors' problems by redeeming the securities. We commend these actions. However, many have not done so, and we urge regulators to encourage closed end fund managers to take appropriate steps to assist their ARPS investors.

Also, liquidity for ARS backed by student loans could be helped by a greater degree of disclosure by issuers of the characteristics and performance of the pools of loans that back outstanding ARS. Student loan ARS issuers, both state agencies and private companies, generally have ready access to data related to, for example, auction performance and interest rate changes, waivers, default rates and forbearances for the underlying loan pools, and geographic and demographic characteristics of pool loan borrowers. These data are necessary in evaluating and pricing student loan backed ARS but are often only to current holders of securities, not to potential buyers. Making these data more readily available to the market at large could attract new investors to the sector. Appendix 1 of this statement discusses this issue more fully.

One of the focuses of federal and state enforcement agencies in resolving the ARS problem for investors has been to negotiate agreements with dealers who have sold ARS that obligate those firms to buy back the ARS they sold from their retail and some institutional customers. While those agreements will likely be successful in providing a potential resolution for many investors, negotiated buy backs may not be the best approach in all circumstances because they may not be fair or practical. Negotiated buy backs may make sense if the dealer who sold ARS violated laws or rules in its role as auction dealer or ARS distributor and if it is practical to expect that the settling dealer has the financial capacity to take customers' ARS back onto its own balance sheet. In cases where dealers did not violate rules or does not have the capacity to buy back customers' ARS positions, buy backs are not a good tool for enforcement agencies.

In many cases, distributing, or downstream, dealers did not violate sales practice or other rules related to selling ARS. In many cases, downstream dealers did not know that the ARS market was collapsing last fall and was being supported only by auction dealers taking large volumes of ARS onto their own balance sheets. The ARS market is opaque, and information on ARS auction performance is generally available only to the auction dealer—usually the lead underwriters of the ARS transaction. The auction dealer controls information related to the number and volume of bidders, whether an auction dealer's own bids were necessary to prevent an auction from failing, and the size of auction dealer's positions in particular ARS. Indeed, some auction dealers expressly prohibit their employees from disclosing certain information related to auctions that could affect the value of securities and investor demand.

In 2006 15 broker-dealers reached a settlement agreement with the SEC regarding violations of securities laws associated with their roles in the ARS market.[2] One element of the settlement requires the 15 settling dealers to publish "material auction practices and procedures" associated with their ARS activities as auction dealers. While we have not performed an exhaustive review of all the settling firms' auction practices and procedures, it is evident that at least some firms imposed on their employees an outright prohibition on communicating to the market certain details information related to auctions. For example, Merrill Lynch's auction practices and procedures state:

> Merrill Lynch prohibits Auction Desk employees from disclosing to any holder or prospective holder:
>
> - information about actual bidding in any auction by any other holder or prospective holder. For example, it is not permitted to disclose to anyone, other than the auction agent, the rate or quantity at which other holders or prospective holders have placed their bids or are likely to place their bids, or the status of any other holder's or prospective holder's auction order;
> - ***the rate or quantity at which Merrill Lynch plans to bid, or the status of any auction order for Merrill Lynch's account;*** [emphasis added]
> - the size of any other holder's or prospective holder's position, or ***the size of Merrill Lynch's position*** [emphasis added] (apart from information with respect to Merrill Lynch's inventory that Merrill Lynch makes available to customers);
> - ***whether there are sufficient bids to prevent a failed auction;*** [emphasis added]
> - prior to when the auction agent posts the results of an auction, what the auction's clearing rate is; and
> - whether an all hold auction is likely to occur.[3]

Based on the firm's own internal policies, Merrill Lynch's ARS employees are expressly prohibited from disclosing to the rest of the market the scope of Merrill Lynch's bids at auction for its own account, the size of Merrill Lynch's own positions in ARS, and whether there are sufficient bids at an auction to prevent an auction failure. Without access to this kind of information, it would have been impossible last fall and winter for other market participants, both investors and downstream dealers, to know that the ARS market was on the verge of collapsing and that auction dealers' own buying was creating a false sense of normalcy. To the extent that downstream brokers did not commit rule violations in selling ARS, they should not be

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[2] Securities and Exchange Commission, "Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934," Administrative Proceeding File Number 3-12310, May 31, 2006.

[3] Merrill Lynch, Global Markets & Investment Banking Group, "Description of Merrill Lynch's Auction Rate Securities Practices and Procedures."

subject to sanctions, including requirements to buy back positions from investors. Simply, no party should be sanctioned for violations they did not commit.

Another consideration regarding buy backs is whether downstream firms that sold ARS have the financial capacity to take securities onto their balance sheets. In many cases, downstream firms do not have the operating or regulatory capital to support a large position in ARS and cannot obtain financing for those positions.

On March 16, 2008 the Federal Reserve Bank of New York (FRBNY) announced the creation of the Primary Dealer Credit Facility (PDCF). The PDCF provides a means for primary dealers to receive overnight financing from the FRBNY using an expanded list of collateral. Although the financing is technically overnight, it can be easily rolled on a daily basis to allow for longer term financing of securities positions. The "Program Terms and Conditions" for the PDCF published by the FRBNY state that "Collateral eligible for pledge under the PDCF includes all collateral eligible for pledge in open market operations, plus investment grade corporate securities, municipal securities, mortgage-backed securities, and asset-backed securities."[4] This list of eligible collateral appears to include many examples of ARS, and the PDCF may provide an inexpensive and efficient means for primary dealers to finance ARS bought from investors. Even if certain ARS were not accepted as eligible collateral under the PDCF, primary dealers could still benefit from the PDCF in financing ARS holdings by pledging other eligible collateral to achieve similar results. Non-primary dealers, on the other hand, do not have access to the PDCF. Indeed, many non-primary dealers have found it exceedingly difficult in recent months to finance any securities positions through otherwise "normal" means such as repurchase agreements. Moreover, Federal Reserve regulations limit the ability of a bank to provide financing for borrowers whose ARS are held by a dealer affiliated with the bank and effectively limit the ability of a bank-affiliated dealer to buy back ARS from investors. In this regard, many downstream dealers do not have the capacity to buy and hold large ARS positions.

Summary

The buy backs that federal and state enforcement agencies have negotiated with some sellers of ARS have provided many ARS investors with an opportunity to exit positions that have been locked up since February. We commend the regulators for their aggressive approach to problems in the ARS market and for their focus on helping investors exit their positions. However, many retail and small institutional investors have been left out of the settlements. In particular, investors who bought ARS from "downstream" brokers are not covered under most of the settlement agreements announced so far.

We believe in full enforcement of applicable securities laws and regulations. Firms that violated rules in distributing ARS should be sanctioned. However, it is not fair to impose sanctions, including buy back requirements, on firms that did not violate rules. Moreover, many downstream brokers simply do not have the financial capacity to take on large ARS positions.

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[4] Federal Reserve Bank of New York, "Primary Dealer Credit Facility Program Terms and Conditions," www.newyorkfed.org/markets/pdcf_terms.html.

There are other steps regulators can take to help alleviate troubles in the ARS market. We urge regulators to give prompt consideration to filings by closed end funds to restructure their ARPS obligations and to encourage closed end fund managers to take appropriate actions to assist their ARPS investors. We also urge regulators to carefully consider capital requirements related to dealer ARS positions; tighter capital rules have the effect of limiting the ability of dealers to take on positions in ARS or lend against customer ARS portfolios. Other actions, such as enhancing issuer disclosures for student loan-backed ARS, can help restore investor demand.

Thank you for the opportunity to present our views. Do not hesitate to contact us if we can be of any assistance.

Appendix 1:
Disclosure Information Requested of Auction Rate Securities Issuers

Certain segments of the auction rate securities (ARS) market are still dysfunctional. For many ARS issues, auctions still regularly fail and no secondary market outside the auction process exists. One of the sectors where ARS problems are most acute are ARS backed by student loans. The fact that these securities do not trade is in part a function of lack of access to data and information on the securities themselves or on the underlying student loans that collateralize the bonds. In many cases, information on pool and loan performance is available only to existing securities holders and to auction dealers—dealers authorized to bid at the regularly scheduled auctions, generally the dealers that originally underwrote the issues—despite the fact that issuers generally have ready access to the information. Because non-auction dealers and investors who do not currently own the securities cannot access loan and pool information, it is not possible to evaluate and price the securities. Dealers and investors who may be interested in buying the securities—and providing liquidity to current investors who may be "stuck" holding them—will not without access to data and information necessary to price the bonds. Making this information available to the market at large would help alleviate some of the distress being experienced by current student loan ARS investors.

This document outlines data and information that student loan ARS issuers should disclose to the market at large in order to spur demand among investors.

Information about auctions and rate changes — In general for ARS, dealers who are not auction dealers do not have access to detailed information on auction activity and rate changes. Originally, this arrangement was designed to protect proprietary information of auction dealers. However, lack of access to auction and rate information is now having the effect of preventing non-auction dealers from participating in the market or providing liquidity to investors.

Information about waivers, default rates and forbearance — Borrowers under federally subsidized student loans can sometimes qualify for waivers which affect the timing and amount of loan repayments and the pricing of student loan-backed securities. Defaults on student loans affect the timing of payments to holders of student loan-backed securities, even if the loans are guaranteed by the federal government. Also, many student loans are eligible for forbearance, where the borrower can defer interest payments under certain circumstances. Forbearances also affect the timing of payments to securities holders and affect pricing.

Geographic and demographic information for loan pools — Aggregate geographic and demographic information for borrowers whose loans are in a pool can be important in evaluating how the loans and securities will perform.

Average life information — The expected average life of loans in a pool is necessary to price securities backed by the pool.

Rejected claims and servicer quality — A rejected claim can occur when a borrower defaults on an federally guaranteed student loan but the guarantee claim is rejected for some reason. In

some cases, the rejection can be due to actions by the servicer of the loan. Data on rejected claims and servicer quality is necessary in pricing student loan-backed securities.

Appendix 2:
Background on Auction Rate Securities

ARS are a form of long-term, variable rate debt financing designed to emulate money-market instruments. With an ARS, a designated auction agent, typically a bank, conducts periodic auctions, usually every seven, 28 or 35 days. The auctions serve two purposes. First, the auctions determine an interest rate to be paid by the ARS issuer during the period until the next auction. Second, auctions provide a source of liquidity for investors who want to sell their securities. Investors who want to sell ARS depend on bidding at auctions by other investors who want to buy them.

Most ARS can be segregated into three categories. First are ARS issued by state and local governments and non-profit entities ("municipal ARS"). Second are ARS backed by pools of student loans issued by student loan originators or wholesalers ("student loan ARS"), in some cases state student loan financing authorities and in some cases for-profit student loan financing companies. Third are auction rate preferred stock ("ARPS") issued by closed end mutual funds. (There are other categories of ARS, but these three are the most prevalent.) Although estimates vary, at the height of the ARS market there were approximately $330 billion of ARS outstanding, with municipal ARS the most prevalent category representing approximately 75 percent of outstanding volume. Municipal ARS were marketed primarily to institutional investors; student loan ARS were sold to both institutional and retail investors; and ARPS were sold principally to retail investors.

No new ARS issues have been sold by issuers in 2008. However, when they were widely used, ARS, like most debt securities, were often underwritten by syndicates of dealers comprised of a lead manager and a group of co-mangers. In any debt issuance, the lead manager plays a dominant role in underwriting and selling the bonds to investors. With ARS, however, the role of the lead manager is magnified due to the ongoing nature of the periodic auctions held throughout the life of an issue. The lead manager of an ARS transaction generally controls the auction process for that issue and earns an ongoing fee for that service that covers not just the bonds sold directly by the lead manager but also bonds in the same issue sold by other securities firms.

In an auction, current investors in an ARS issue can submit any of several types of bidding instructions regarding the disposition of their positions. With a "hold" order, an investor signals that he will continue to hold the bond regardless of the rate set at the auction. With a "hold at rate" bid, investors signal that they will hold their securities provided that a specified minimum rate is established at the auction. Otherwise, if the clearing rate does not meet the investor's minimum, the investor loses the auction and his position is sold. With a "sell" order, an investor signals a desire to sell his position regardless of the clearing rate established at the auction. With a "buy" order, an investor signals a desire to acquire or increase a position in the security provided a minimum clearing rate is established at the auction. Prospective investors can also submit bids at auctions. The lead manager generally collects bidding instructions from investors, either directly or through other dealers, and passes those instructions to an auction agent. It is the auction agent's role to review all bids, award securities to winning bidders, and transmit interest rate information to the issuer and to the lead manager.

A failed auction occurs when the volume of "sell" orders at an auction exceeds the volume of "hold" or "buy" orders. In a failed auction, some or all investors who want to sell securities are not able to, and must hold their ARS until at least the next auction. In this case, until the next auction, the yield on the securities becomes a "penalty rate" that is pre-established at the time the securities are issued.

A large majority of ARS include third-party credit enhancement, usually in the form of bond insurance provided by a monoline bond insurer. The credit enhancement is designed to protect investors in case the ARS issuer defaults on its payment obligations. The credit enhancement does not, however, provide any protection against a loss of liquidity associated with a failed auction.

There is generally no requirement that lead managers or auction agents publicly disclose the results of auctions, and in general, such information is not available to market participants. The only auction information generally available to investors and distributing firms is the clearing rate established at the auction.[5,6]

Early in the second half of 2007, global credit markets began to weaken across many sectors as a result of a downturn in the market for subprime mortgages and a general repricing of credit risk. One of the results of the subprime downturn has been the credit deterioration of several monoline bond insurers. This deterioration eventually led to a retreat among investors from products like ARS that depend on credit enhancement.

As demand for ARS among investors disappeared, lead managers supported the market for a while by bidding themselves at auctions. While this practice happened from time to time before last fall, it was generally the case that ARS bought by lead managers could be sold quickly to other investors. Last fall, however, with investor demand for some ARS issues quickly evaporating, lead managers became more and more aggressive in supporting auctions through their own purchases. A number of lead managers accumulated large positions in ARS for which auctions would have failed if not for the lead managers' bidding. As lead managers' ARS positions swelled, pressure grew within those firms to take steps to reduce inventories. In the case of student loan ARS, for example, some lead managers may have influenced issuers to authorize temporary, higher maximum reset rates on their bonds in order to make them more attractive to investors without disclosing the fact to investors and distributing firms that these

[5] A small number of lead managers have authorized Bloomberg LLC to make available to all BloombergProfessional information service subscribers the clearing yields for auctions. Even in these limited cases, however, no other information on auctions is generally available to market participants other than the auction dealer.
[6] On March 17, 2008, the Municipal Securities Rulemaking Board ("MSRB") proposed a "Plan for Increasing Information Available for Municipal Auction Rate Securities" (the "MSRB Plan"). Under the MSRB Plan, auction dealers would be required to submit to an information repository for public disclosure data regarding auction performance and outcomes for ARS under the MSRB's jurisdiction, including municipal ARS and student loan ARS issued by non-profit or state or local agencies. Required disclosures would include clearing rates established at auctions as well as the number of bidders, the number and aggregate dollar amount of bids, bids submitted by the auction dealer for its own account and other information. See MSRB Notice 2008-15. In July 2008, the MSRB announced that the MSRB Plan will likely be implemented in the first quarter of 2009. See Andrew Ackerman, "MSRB Eyes 2009 for New System," *The Bond Buyer*, July 21, 2008.

higher rates could lead to future reset rates that were actually zero. Some of our members have also expressed concerns that some managers of closed end mutual funds may have known that the weakening ARPS market was being artificially propped up by lead manager bidding at auctions but did not inform investors or other market participants.

Many lead managers began to recognize internally that they were accumulating imprudently large ARS inventories and that they would have to stop bidding at auctions. However, that information was never disclosed to the market at large, neither to investors nor to distributing dealers. By mid February 2008, the capacity of the ARS lead managers to continue to support the market by buying securities was exhausted and ARS auctions began to fail on a widespread basis.[7]

Since February, some steps have been taken to address problems in the ARS market, but liquidity is still severely constrained in certain subsectors. Among municipal ARS, a large number of issues have been taken out of the market as a result of refundings or conversions to other forms of variable rate financing. In other cases, the auctions for some municipal ARS are still functioning. For other municipal ARS where auctions continue to fail, investors generally have no way to sell their holdings.

Liquidity in the market for student loan backed ARS is virtually nonexistent. Almost all auctions have failed consistently since February, and investors have no opportunity to sell securities. Moreover, as a result of technical issues unique to student loan ARS, some securities are occasionally not paying interest, making them even more unattractive to investors.

The market for ARPS is highly illiquid. However, some mutual fund companies have begun to implement strategies to restore market liquidity, and some ARPS investors may be able to sell their securities in the coming months under those strategies.

Since the downturn in the ARS market in February, the market in many respects has become more opaque than ever. Many distributing dealers and their customers have had significant difficulty obtaining information from lead managers on the status of auctions, the performance of securities, and steps that dealers, issuers or others may be taking to try to resolve problems in the market.

[7] Jeremy R. Cooke, "Florida Schools, California Convert Auction-Rate Debt," Bloomberg.com, February 22, 2008.

Questions for Jim Preston, President and CEO, Pennsylvania Higher Education Assistance Agency

House Committee on Financial Services Hearing:
Auction Rate Securities Market: A Review of Problems and Potential Resolutions
September 28, 2008

1. **Congress has recently extended the Ensuring Continued Access to Student Loan Act (ECASLA) by one year. Please describe the impact ECASLA has had on the availability of student loans. Could ECASLA be improved in any way?**

Response: ECASLA has had a positive impact on the availability of FFELP loans for the 2008-09 academic year. Many banks and other lenders have relied upon the "put" option and the participation interests issued by the U.S. Department of Education (ED) to fund student loan originations. One significant limitation is that lenders using ECASLA have been required to have access to capital to originate loans, before they can receive any funding from ED. This means that agencies like PHEAA that do not have deposits or other ready sources of capital have had to attempt to obtain letters of credit or other "bridge loans" to disburse loans. In some cases this has resulted in delayed disbursements to borrowers while lenders waited to obtain such funding or while they waited for funding from ED, which was then used to finance subsequent loan disbursements.

We have also been disappointed that ED has chosen not to use the authority granted it in ECASLA and allow loans to remain with their current loan servicer. Rather, ED is requiring that loans that are put to ED be transferred to its direct loan servicer (Affiliated Computer Services – ACS). The result is a cumbersome, costly process for lenders putting loans to ED and unnecessary confusion and burden for borrowers whose loan payments may not be applied in a timely manner and who, in the future, may have to communicate with and make payments to multiple loan servicers. Our concern is that this confusion could lead to inadvertent student loan delinquencies and defaults – resulting in extra costs to taxpayers and extra complications for borrowers.

We also believe that ECASLA should be modified to allow the Secretary of Education to provide direct advances to lenders that will be used to make student loan disbursements, to include all loans made under Part B of the Higher Education Act (including consolidation loans and rehabilitation loans, which are currently excluded from ECASLA), and to mandate that loans sold to ED retain their current loan servicing arrangements and maintain the services provided by their current guaranty agency.

2. **What else can be done by Congress and the Administration to unlock the liquidity that is currently trapped in the student loan market?**

Response: In June 2008, PHEAA, along with the Access Group of Delaware and Brazos Higher Education Corporation of Texas, submitted a proposal to the Secretaries of Education and Treasury that we believed would unlock the liquidity for student loans that is currently frozen inside auction rate and other securities backed by student loans. This plan is very similar to efforts currently being designed for mortgage-backed securities as part of the recently enacted Emergency Economic Stabilization Act (which was enacted after the Committee's hearing on auction rate securities). That plan is attached to the writing testimony PHEAA submitted for the September 18 hearing. We urge the Secretary of the Treasury to designate student loan-backed securities as "troubled assets" under this Act and to immediately begin a program to purchase student loan-backed securities from banks and other entities that currently hold these instruments – making a market for such securities. This will relieve investors who are unable to sell their investments in student loan backed securities. Banks will also benefit as these frozen assets are turned liquid and can be used for other purposes to assist the economy. We are ready and willing to begin detailed discussions with Treasury to begin this process.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-0500

OFFICE OF GENERAL COUNSEL

September 12, 2008

The Honorable Melvin L. Watt
Chairman, Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 205150-6052

Dear Chairman Watt:

On behalf of Secretary Steven C. Preston, the Department of Housing and Urban Development (HUD) thanks you for the invitation to testify before your subcommittee on HUD's draft final rule that would amend HUD's Real Estate Settlement Procedures Act (RESPA) regulations for the purpose of simplifying and improving the process of obtaining mortgages and reducing settlement costs.

Unfortunately, the Department must respectfully decline this invitation. HUD's draft final rule was submitted to the Office of Management and Budget (OMB) on August 21, 2008, for review under Executive Order 12866 (Regulatory Planning and Review). Under the requirements of the executive order, signed by President Clinton on September 30, 1993, HUD may not discuss the content of the rule while under OMB review.

The executive order provides, in section 6(b), that only the Administrator of OMB's Office of Information and Regulatory Affairs (OIRA) can respond to oral communications initiated by persons outside of the Executive Branch of the Federal Government concerning the substance of a rule under OMB review. Accordingly, HUD would be unable, during the hearing, to discuss the content of the final rule, and, specifically, to advise of the changes that HUD made in response to public comments.

I can assure you, however, that HUD carefully reviewed the many thoughtful public comments received on the proposed RESPA rule, published on March 14, 2008, and HUD made changes to its proposed rule in response to public comments. Upon OMB's approval of the rule, HUD will make itself available to appear before your subcommittee to discuss the final rule.

Sincerely,

Robert M. Couch
General Counsel

cc: The Honorable Gary Miller

Order Code RL34672

CRS Report for Congress

Auction-Rate Securities

September 17, 2008

D. Andrew Austin
Analyst in Economic Policy
Government and Finance Division

Prepared for Members and
Committees of Congress

Congressional
Research
Service

Auction-Rate Securities

Summary

Many municipalities, student loan providers, and other debt issuers have borrowed funds using auction-rate securities (ARSs), whose interest rates are set periodically by auctions. ARSs combine features of short- and long-term securities; ARSs couple longer maturities with interest rates linked to short-term money markets. Most ARSs are bonds, although some are preferred equities. Since ARSs were introduced in the mid-1980s, volumes grew rapidly. By 2007 ARSs comprised a $330 billion market.

Turmoil in global financial markets that erupted in August 2007, combined with vulnerabilities in the structure of ARSs, put mounting pressure on the ARS market. In addition, downgrades of some bond insurers increased stress on segments of the ARS market. In early February 2008, major ARS dealers withdrew their support for ARS auctions, most of which then failed. Widespread auction failures in the ARS market left many investors with illiquid holdings and sharply increased interest costs for many issuers, such as student lending agencies, cities, and public authorities. In particular, ARS failures, according to some, have made it more difficult for student lenders that had used ARSs to raise funds. These issues are discussed in CRS Report RL34578, *Economics of Guaranteed Student Loans*, by D. Andrew Austin.

Many major investment banks, in the wake of lawsuits filed by state attorneys general as well as pressure from state and federal regulators, have announced plans to repurchase outstanding ARSs for certain relatively smaller investors and to make efforts to liquidate ARS holdings of larger and institutional investors. Lawsuits alleged that some investment banks sold ARS products as cash equivalents, but failed to disclose liquidity risks and the extent of bank support for auctions — the main liquidity channel for ARSs. Many major investment banks involved in the ARS market have announced settlements and agreements to buy back ARSs from some investors.

Some segments of the ARS market, such as municipal issues and closed-end mutual funds, have started to restructure their debt, as issuers have redeemed ARS securities and switched to other financing strategies. In other segments, such as the student-loan-backed ARS (SLARS) market, only a small portion of existing debt issues have been refinanced.

In the past, Congress has expressed concern about policy areas that the ARS market's collapse has affected. For example, the House Financial Services Committee held a March 2008 hearing to examine how financial market developments may have increased interest and other financing costs of state and local governments. In April 2008, Congress passed the Ensuring Continued Access to Student Loans Act of 2008 (H.R. 5715, P.L. 110-227) to allow the Secretary of Education to provide capital to student lenders, whose ability to borrow in some cases had been constricted by ARS failures. More generally, many Members of Congress have stepped up oversight of financial markets and have shown interest in reconsidering the structure of federal financial regulation. This report will be updated as events warrant.

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Auction-Rate Securities

Introduction

Auction-rate securities (ARSs) couple long-term maturity borrowing with interest rates linked to short-term money markets by periodic auctions, and thus combine features of short- and long-term securities. Most ARSs are long-term bonds, although some auction-rate securities are structured as preferred shares and so have no maturities.[1] Municipalities and public authorities, student loan providers, and other institutional borrowers have raised funds using auction-rate securities since they were first created in the mid-1980s.[2] By 2007, auction-rate securities had become a market worth more than $330 billion, with state and local borrowing composing nearly half of that total.[3]

Many institutional borrowers viewed auction-rate securities as a cheaper way of raising funds, compared to alternative borrowing strategies. Interest rates for auction-rate securities are tied to short-term market interest rates, even though the securities themselves have longer maturities. In past decades, interest rates on short-term variable-rate securities have on average been lower than interest rates on long-term fixed-rate securities because investors usually require compensation to bear interest-rate risks embedded in long-maturity assets.[4] While ARSs allowed issuers to borrow more cheaply in normal times, the role of ARS auctions created inherent liquidity risks to investors and interest-rate reset risks to issuers.[5]

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[1] Douglas Skarr, "Auction Rate Securities," California Debt and Investment Advisory Commission Issue Brief, Aug. 2004, available at [http://www.treasurer.ca.gov/Cdiac/issuebriefs/aug04.pdf].

[2] ARSs were also widely used by closed-end mutual funds, asset-backed securities and collateralized debt obligations (CDOs). Treasury Strategies, Inc., Press release, "Treasury Strategies Addresses the Auction-Rate Securities Debacle," Apr. 3, 2008, available at [http://www.treasurystrategies.com/resources/pressReleases/ARSpr040308.pdf].

[3] Statement of Erik R. Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, in U.S. Congress, House Committee on Financial Services, "*Municipal Bond Turmoil: Impact on Cities, Towns, and States*," 110th Cong., 2nd sess., Mar. 12, 2008.

[4] An investor who buys a long-term security cannot react to changing circumstances until the security matures or is sold. In financial terms, when an investor buys a long-term asset, she forgoes "option value," which is the value of being able to react to new information or conditions. In a competitive market, the asset's yield relative to a short-term alternative will reflect the expected value of that forgone option value.

[5] This point is discussed in more detail below.

Following the extraordinary turmoil in global financial markets that erupted in August 2007, several interest-rate auctions for ARS failed, which temporarily left investors unable to sell their ARS holdings. While ARS markets appeared to return to normalcy that fall, some large institutional investors had begun to withdraw funds from ARS markets. A large number of ARS auctions in 2007 and early 2008 avoided failure only because investment banks stepped up their support for ARS auctions, which required them to take on larger ARS inventories on their own accounts.

In mid-February 2008, key investment banks declined to support auctions, causing widespread auction failures. Liquidity essentially evaporated as auctions failed in most ARS markets, shutting off investors' ability to sell their holdings in an orderly way and casting doubt on the future viability of auction-rate securities.[6] The collapse of the auction-rate securities market raised borrowing costs for many issuers, including student lenders, municipalities, and public authorities. Many economists expect turmoil in financial markets to continue, suggesting that ARS markets may be unlikely to function as smoothly as they did before August 2007.[7]

Congressional Concerns. In the past, Congress has expressed concern that the collapse of the ARS market could elevate costs of state and local government borrowing, disrupt higher education finance, and raise important questions about federal financial regulation and oversight.

State and Local Finance. ARS markets helped raise funds for a wide variety municipal infrastructure projects, including some required by federal mandates. Congress has shown concern that turmoil in the ARS market could hinder state and local government borrowing and infrastructure project financing, and that increases in municipal borrowing costs could lead to cuts in public services. Some policymakers and macroeconomists have looked to infrastructure investments to stimulate economic activity while increasing future economic productivity. Yet, many state and local governments saw financing costs jump due to failures of interest auctions for their ARS debt, just as the economic slowdown that began in late 2007 began to depress their revenues. After widespread ARS auction failures in February 2008, the House Financial Services Committee held a hearing to examine how financial market developments may have increased borrowing costs to state and local governments.[8]

Student Loans. Congress has shown concern about possible disruptions to federally guaranteed loan programs.[9] Student lenders and state student loan agencies

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[6] One senior financial journalist dubbed the auction-rate securities market a "historical relic." Aline van Duyn, "Little Chance of Quiet Farewell for Auction Rate Securities," *Financial Times*, Aug. 2, 2008.

[7] James Politi, "Tighter Loan Rules Dash Hopes of End to Squeeze," *Financial Times*, Aug. 12, 2008.

[8] U.S. Congress, House Committee on Financial Services, "*Municipal Bond Turmoil: Impact on Cities, Towns, and States*," 110th Cong., 2nd sess., Mar. 12, 2008.

[9] For further information on student loan markets, see CRS Report RL34578, *Economics*

(continued...)

had used ARSs extensively to raise funds that were then used to make loans to students. In early 2008, about $80 billion of the total $350 billion in outstanding Federal Family Education Loan program (FFELP) loans were financed using ARSs.[10]

Congress held two hearings in spring 2008 to examine how turmoil in financial markets might affect the availability of student loans. On March, 14, 2008, the House Committee on Education and Labor held a hearing entitled "Ensuring the Availability of Federal Student Loans."[11] The Senate Committee on Banking, Housing, and Urban Affairs held a hearing on April 15, 2008, entitled "Turmoil in U.S. Credit Markets Impact on the Cost and Availability of Student Loans."[12]

On May 1, 2008, Congress passed the Ensuring Continued Access to Student Loans Act of 2008 (ECASLA, H.R. 5715, P.L. 110-227) on a 388-21 vote less than a month after it was first introduced. ECASLA allows the Secretary of Education to provide capital to student lenders, whose ability to borrow in some cases could have been constricted by ARS failures. The Secretary of Education has not implemented ECASLA in a way that would directly affect existing SLARS debt. Rather, the Secretary of Education has focused on providing facilities that would allow the purchase of newly originated loans. While most students have been able to obtain federal student loans for the fall 2008 semester, according to some media reports, concern remains that student lenders remain under stress.[13]

Oversight and Financial Regulation. The collapse of the ARS market may help spur broader changes in the oversight and regulation of financial institutions and markets. Many Members of Congress have stepped up oversight of financial markets and have shown interest in reconsidering the structure of federal financial regulation. Changes in financial regulation could strongly affect how new financial products that may replace ARSs will evolve.

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[9] (...continued)
of Guaranteed Student Loans, by D. Andrew Austin; and CRS Report RL34452, *Proposals to Ensure the Availability of Federal Student Loans During an Economic Downturn: A Brief Overview of H.R. 5715 and S. 2815*, by David P. Smole.

[10] Testimony of Chuck Sanders, President and CEO, South Carolina Student Loan Corporation, in U.S. Congress, House Committee on Education and Labor, *Ensuring the Availability of Federal Student Loans*, hearing, 110th Cong., 2nd sess., March, 14, 2008, available at [http://edlabor.house.gov/testimony/2008-03-14-CharlieSanders.pdf].

[11] House Committee on Education and Labor, *Ensuring the Availability of Federal Student Loans*, hearing, 110th Cong., 2nd sess., March, 14, 2008, available at [http://edlabor.house.gov/hearings/fc-2008-03-14.shtml].

[12] Senate Committee on Banking, Housing, and Urban Affairs, *Turmoil in U.S. Credit Markets Impact on the Cost and Availability of Student Loans*, hearing, 110th Cong., 2nd sess., Apr. 15, 2008, available at [http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=08955ff1-d3cc-434c-b32a-60972599a048].

[13] For example, Moody's warned that it might downgrade its credit rating for the largest student lender, Sallie Mae (SLM). "SLM May Face Ratings Cut," *Wall Street Journal*, Aug. 29, 2008, p. C3.

Structure of the Auction-Rate Securities Market

Market Composition. Municipal bonds and bonds backed by student loans have been the most prominent parts of the ARS market. Tax-preferred and taxable municipal bonds accounted for nearly half of the market at the end of 2007 and securities backed by student loans accounted for another quarter. Some closed-end investment funds used ARS bonds to leverage investments in municipal bonds.[14] **Table 1** shows the composition of the ARS market at the end of 2007.

Table 1. Composition of Auction-Rate Securities Market

Type	Amount Outstanding 12/13/2007 ($Billions)
Tax-Exempt Municipal Bonds	$146
Taxable Student Loan Bonds	56
Taxable Preferred (closed end)	33
Tax-Exempt Preferred Bonds (closed end)	30
Tax-Exempt Student Loan Bonds	29
Taxable Municipal Bonds	19
Corporate Preferred (DRD)	9
Other (Including ABSs)	8
Total	**$330**

Source: Banc of America Securities LLC. ABSs are asset-backed securities. DRDs are dividend-received deduction preferred stock or related securities.

Mechanics of Auction-Rate Securities. An issuer of auction-rate securities, such as a student lender, typically engages a broker/dealer, usually a major investment bank, to underwrite and distribute securities. As in bond markets, broker/dealers sell securities for the issuer, who receives the net proceeds. Issuers typically receive bond ratings from agencies such as Fitch or Moody's Investors Service, which are meant to reflect a security's credit quality over its maturity. Some issuers also have obtained bond insurance, guaranteeing timely payments to investors in the event of default or delayed payments. Typically, a broker/dealer would receive an initial fee equal to 1% of the amount underwritten and an annual fee equal to 0.25% of the amount managed.[15]

Unlike a traditional bond with a fixed interest rate, an auction mechanism determines who holds the securities and sets the interest rate they receive. The

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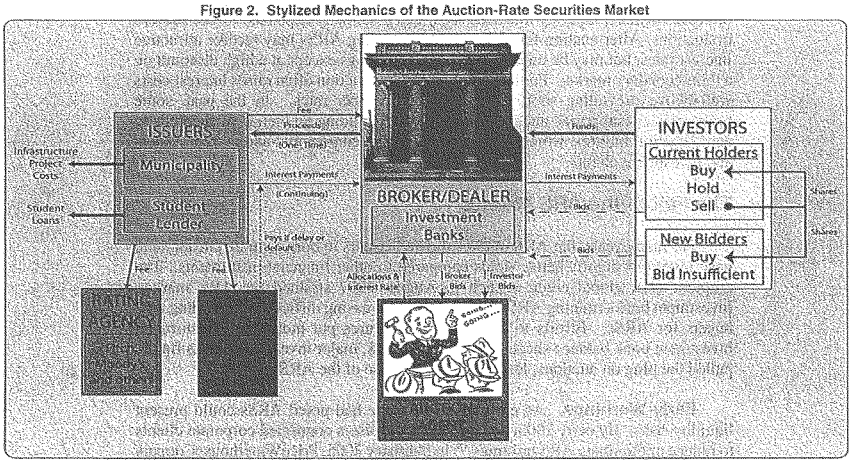
[14] The manager of a closed-end mutual fund sells a fixed number of shares, which are traded like stocks on exchanges after their initial sale. Closed-end funds typically hold specialized investment portfolios.

[15] Complaint, In the Matter of UBS Securities, LLC and UBS Financial Services, Inc., case 2008-0045, filed June 26, 2008 at the Office of the Secretary of the Commonwealth [of Massachusetts] Securities Division, pp. 37-38.

broker/dealer and issuer choose an auction agent, typically a bank, to run the auctions.[16] Investors wishing to hold ARSs submit bids in the form of interest rates along with the amount of assets they wish to buy. **Figure 1** provides a stylized view of the mechanics of an ARS market.

[16] ARS auctions are sometimes called "remarketings."

Figure 2. Stylized Mechanics of the Auction-Rate Securities Market



Interest-rate auctions usually are held every 7, 14, 28, or 35 days, as specified in the security contract. Before each auction, investors interested in acquiring ARSs state how much of an issue they wish to hold and specify the lowest interest rate they are willing to accept. Investors interested in selling ARSs also send instructions to the broker/dealer. The broker/dealer transmits bids, which may include its own bids, to the auction agent who parcels out available holdings to investors with the lowest interest-rate bids until the entire issue is taken up. The interest rate of the last bidder assigned a portion, termed the "clearing rate," is then paid to all holders until the next auction. Bids with interest rates above the clearing rate receive none of the issue. This type of auction is often called a "Dutch auction."[17]

Auction Failures. If bidders' requests are insufficient to take up the whole issue then the auction fails. The interest rate is then set by terms specified by the securitization contract, and investors holding a portion of the issue retain their stake. Because investors lacked a guaranteed option to sell ARS holdings back to issuers or broker/dealers, liquidity for those securities essentially depended on the success of auctions. After auction failures, investors holding ARSs may receive attractive interest rates, but may be unable to sell those holdings except at a high discount on a thin secondary market. For issuers, failure of an auction often raises interest costs well above prevailing short-term commercial paper rates. In the past, some broker/dealers supported auction-rate markets by bidding on their own accounts to avoid auction failures, which could have antagonized potential and current issuers and investment clients.

The Fall of the ARS Market

For many years, the ARS market allowed issuers to borrow more cheaply and gave investors slightly better yields compared to other financial instruments. The eruption of a global credit crunch in August 2007 strained the ARS market. Investment banks running ARS markets faced increasing difficulties in finding new buyers for ARSs. Efforts to avoid auction failures put mounting pressures on investment bank balance sheets. In February 2008, major investment banks finally pulled the plug on auctions, leading to the collapse of the ARS market.

Early Warnings. As early as 2003, some had noted ARSs could present liquidity risks. By early 2005, some financial advisors counseled corporate clients to reduce or eliminate ARS holdings.[18] In February 2005, PriceWaterhouseCoopers and other major accounting firms stated that corporations should, in general, classify

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[17] Auctions in which the price falls and the first bid wins, as in Amsterdam flower markets, are also called Dutch auctions. Falling-price auctions were first invented to avoid Napoleonic-era taxes on traditional, rising-price auctions. A falling-price auction, under certain conditions, is theoretically equivalent to a sealed-bid, first-price auction. ARS auctions are typically sealed-bid, first-price auctions with multiple units, although some ARS broker/dealers see investors' bids before submitting their own.

[18] Lance Pan, "Forecasting a Perfect Storm: New Developments Aggravate the Potential Fall of the Auction Rate Securities Market," Capital Advisors Group Research Newsletter, Mar 1, 2005, available at [http://www.capitaladvisors.com/pdf/Forecasting_a_Perfect_Storm.pdf].

ARSs as "investments" rather than "cash equivalents" in financial reports.[19] Some contended that this view of ARSs was overly conservative. For example, the head of the Association for Financial Professionals in June 2005 claimed that "auction rate securities have proven to be highly liquid investments and there is no substantial evidence that the risk of an auction failure is other than a remote possibility."[20] This claim, however, apparently failed to affect the accounting profession's view of ARSs.

The major accounting firms' stance, that ARSs should not be viewed as cash equivalents, reduced the attractiveness of ARS assets on corporate balance sheets.[21] In addition, some corporations had to trade ARS assets for more traditional cash equivalents to maintain contractually mandated minimum cash reserves.

While the shift in the financial accounting treatment of ARSs may have indirectly affected the ARS market as a whole, some observers doubt that it was a proximate cause of auction failures in 2007, as most sophisticated investors and corporate cash managers were well aware of issues concerning ARSs.[22] On the other hand, according to court filings, Merrill Lynch managers expressed concern that research highlighting liquidity risks associated with ARSs could undermine the entire ARS market.[23]

SEC Consent Decree. The Securities and Exchange Commission (SEC) in 2006 sanctioned 15 broker/dealers for irregularities in auction-rate securities markets, including the failure to disclose dealer/broker interventions in auctions.[24] Some analysts expressed concern that the resulting consent decree might inhibit dealer support for auctions, which they believed could elevate liquidity risks.

Were Auctions Administered or Arms-Length Transactions? The 2006 SEC consent decree highlighted broker/dealer support of auctions. Many ARS contracts allowed broker/dealers to see investor bids before they were submitted to

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[19] PriceWaterhouseCoopers, *Capital Markets Accounting Developments Advisory 2005-04*, Mar. 4, 2005. Financial Accounting Standards 95 (FAS 95) essentially defines the term "cash equivalent" as liquid assets with a maturity of three months or less.

[20] James A. Kaitz, President and CEO of the Association for Financial Professionals, letter to the Financial Accounting Standards Board, June 28, 2005, available at [http://www.afponline.org/pub/pdf/cl_20050628_smith.pdf].

[21] Association for Financial Professionals, "AFP Calls on Financial Accounting Standards Board (FASB) to Update FAS-95 Definitions of Cash Equivalents: 'Big-4' Accounting Firms Imposing Rule Changes without Authority," Press release, July 19, 2006, available at [http://www.afponline.org/pub/pr/pr_20060719_fasb.html].

[22] Conversation with Federal Reserve official, Sept. 8, 2008.

[23] Complaint, In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., case 2008-0058, filed July 31, 2008, at the Office of the Secretary of the Commonwealth [of Massachusetts] Securities Division, available at [http://www.sec.state.ma.us/sct/sctml2/ml_complaint.pdf], p. 3.

[24] SEC Administrative Proceeding File No. 3-12310, In the Matter of Bear, Stearns & Co. Inc., et al. (cease-and-desist order, May 31, 2006), available at [http://www.sec.gov/litigation/admin/2006/33-8684.pdf].

the auction agent. Knowing other bids could have allowed broker/dealers, by bidding on their own account, to influence prices and allocations of ARS shares to investors. For auctions with a higher number of bids relative to available shares, the ability of broker/dealers to influence prices would have been limited. When auctions had relatively few bids and were at risk of failing, however, broker/dealers could effectively set interest rates within a range determined by maximum interest rates set in the bond contract or by bids of other investors. Numerous internal emails quoted in court documents strongly imply that broker/dealers effectively set prices for many auctions at risk of failing.[25]

If broker/dealers set prices for some auctions, their role would have resembled that of "market makers" in the London stock markets before the arrival of electronic trading. A market maker controlled an order book of bids and offers for a particular stock, held some inventory on his own account, and executed trades at prices chosen to balance supply and demand.[26] Some broker/dealers held ARS inventories, acquired by their own bids, and for some auctions could, within limits, set interest rates that would balance needs of issuers against those of investors. ARS broker/dealers that could see external bids before submitting their own, like market makers, had an important informational advantage that could in some cases produce trading profits.

The August 2007 Credit Crunch. Before the global credit crunch erupted on August 9, 2007, failures of interest auctions were considered unusual.[27] In August and September 2007, however, more than 60 auctions failed.[28] Interest-rate spreads between government securities and money market rates (shown in **Figure 2**) abruptly widened after August 9, 2007 as concerns emerged that mortgage-backed liabilities could threaten the survival of some financial institutions. This may have affected ARSs in three ways. First, some ARSs were backed by collateralized debt obligations (CDOs) that were linked to mortgages. Second, some ARS issues carried maximum interest-rate caps linked to London Interbank Offered Rate (LIBOR) or Treasury base rates, which made returns on those ARS issues less attractive than comparable short-term alternatives. Third, more and more corporations were becoming aware of ARS liquidity risks, which tight credit conditions could trigger.

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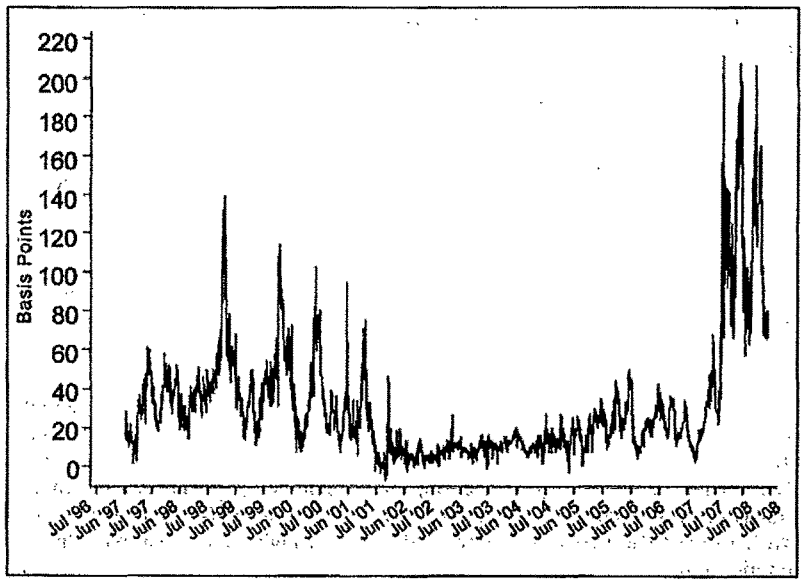
[25] Summons and complaint, Cuomo v. UBS Securities LLC, et al., case 650262-2008, filed July 24, 2008, in the Supreme Court of New York (New York County), p.3, available at [http://www.oag.state.ny.us/ press/2008/july/UBS.pdf]; Complaint, In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., case 2008-0058, filed July 31, 2008, at the Office of the Secretary of the Commonwealth [of Massachusetts] Securities Division, available at [http://www.sec.state.ma.us/sct/sctml2/ml_complaint.pdf].

[26] Lance Pan, "True Colors of an 'Auction' Market: What the SEC Unveiled in the Auction Rate Securities Market," Capital Advisors Group, *Credit Commentary*, June 30, 2006.

[27] The credit crunch was precipitated when BNP Paribas, a major French bank, suspended withdrawals from funds backed by subprime mortgage loans. For a chronology of the credit crunch, see Stephen G. Cecchetti, "Monetary Policy and the Financial Crisis of 2007-2008," *CEPR Policy Insight* 21, April 2008, available at [http://www.cepr.org/pubs/PolicyInsights/ CEPR_Policy_Insight_021.asp].

[28] Megan Johnston, "Firms Caught in Money Lockup — Failed Auctions Make Cash Stashes Illiquid; as Much as $6 Billion Tied Up." *Financial Week*, Sept. 17, 2007, available at [http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070917/REG/70914033].

Figure 2. Spread Between 3-Month Financial Commercial Paper and 3-Month Constant Maturity Treasury Rates



Source: Federal Reserve. Spread is difference between 3-Month AA Financial Commercial Paper Rate and 3-Month Treasury Constant Maturity Rate. One basis point is 1/100th of 1%.

The global scramble for liquidity in August 2007 put pressure on many major investment banks, which were highly leveraged and in many cases, severely exposed to mortgage-backed securities and their derivatives.[29] Many banks and financial institutions faced strong demands to de-leverage, which required liquid assets.

Trends in the ARS market put additional strains on investment banks that were major ARS broker/dealers. Those banks had routinely supported auctions, by bidding on their own accounts, in order to avoid auction failures that could cast doubt on the liquidity of ARS assets. When investment banks had taken ARSs onto their own balance sheets to support an auction on one date, they had typically been able to unload those ARSs in subsequent auctions. After August 2007, more aggressive support was needed to avoid auction failures. At the same time, some major investors were withdrawing from the ARS market, putting more ARS assets on the market. ARS inventories in some investment banks rose sharply in late 2007, as support for ARS auctions intensified, even as banks were reluctant to add to ARS inventories on their already strained balance sheets. For example, court documents

[29] Before August 2007, investment banks held, on average, assets 24 times larger than their equity base. Barry Eichengreen, "Securitization and Financial Regulation: Pondering the New Normal," working paper, July 2008, available at [http://www.econ.berkeley.edu/~eichengr/securitization_7-28-08.pdf]; published as "Reformen sind möglich," *Finanz und Wirtschaft*, Aug. 9, 2008, p. 1.

indicated that UBS increased its holdings of auction-rate securities fivefold from June 2007 to January 2008.[30] In the first half of 2007, UBS, the second largest broker/dealer in the ARS market, held between $1 billion and $2 billion of auction-rate securities.[31] By February 8, 2008, UBS held nearly $10 billion in auction-rate securities, raising serious risk-management concerns at a time of mounting mortgage-backed securities losses.

According to court filings, some large investment banks began to market ARSs more aggressively to small investors in an attempt to reduce their inventories.[32] Sales to small investors, however, failed to increase demand sufficiently to allow many auctions to run without broker/dealer support.

Widespread Auction Failures in Mid-February 2008. On February 13, 2008, most major broker/dealers ceased their support of interest-rate auctions, leading to failures in the vast majority of auctions held that day. As a result, the ARS market has largely seized up, leaving investors with illiquid investments in long maturities. When auctions fail, interest rates are set by terms of the securitization contract. In some cases, default interest rates revert to high levels that have caused some issuers financial stress, while in other cases interest rates are more in line with normal short-term rates. While many investors holding ARSs earn interest rates higher than usual money market rates, the lack of liquidity has decreased the value of many of those holdings.[33] Small investors locked into ARSs who have had to borrow to meet short-term obligations typically pay higher rates than what those securities return.

Even though over 85% of the ARS market experienced auction failures in mid-February 2008, some auctions have since continued to operate more or less normally.[34] In particular, auctions for municipal ARS assets, which often lack maximum-interest-rate caps, have been less likely to fail than student loan ARSs (SLARSs), that typically have such caps.

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[30] Summons and complaint, Cuomo v. UBS Securities LLC, et al., case 650262-2008, filed July 24, 2008 in the Supreme Court of New York (New York County), pp. 3, 29, available at [http://www.oag.state.ny.us/ press/2008/july/UBS.pdf].

[31] UBS was formed when the Union Bank of Switzerland merged with the Swiss Bank Corporation in June 1998.

[32] Summons and complaint, Cuomo v. UBS Securities LLC, et al., case 650262-2008, filed July 24, 2008 in the Supreme Court of New York (New York County), p.3, available at [http://www.oag.state.ny.us/ press/2008/july/UBS.pdf].

[33] When auctions fail, the investor is left holding a long-maturity asset, unless there is some reason to believe that future auctions might not fail. Because long-term interest rates are generally higher than short-term interest rates for securities of equal credit quality, and because bond prices are inversely related to interest rates, the value of such illiquid ARS falls. For a description of early developments in the ARS market after the February 2008 collapse, see Gretchen Morgenson, "It's a Long, Cold, Cashless Siege," *New York Times*, Apr. 13, 2008.

[34] Jeremy R. Cooke, "Florida Schools, California Convert Auction-Rate Debt (Update5)," Bloomberg News, Feb. 22, 2008, available at [http://www.bloomberg.com/apps/news?pid=20601103&refer=us&sid=awCJRyi5ngcQ].

What Caused the Collapse? The February 2008 collapse of the ARS market caught many by surprise.[35] Some may have assumed that the high quality of the assets backing many ARSs would ensure smooth functioning of those markets. Other factors, however, combined to undermine the viability of ARS auctions.

Default Risk vs. Liquidity Risk. While fears that an issuer may default on payments often sharply reduce liquidity for an asset, liquidity risks may also stem from other causes. That is, default risk and liquidity risk are distinct. For example, an asset entitling its owner to a stream of interest payments paid by a municipality, and backed by that municipality's power to tax, may present a very low risk of default. However, that asset may be structured in such a way that may limit, in some circumstances, the asset owner's ability to sell to a third party. This would present a liquidity risk.

Auction failures have occurred for asset-backed securities such as student loans and municipal debt where the financial risks embedded in the underlying loans appear minimal.[36] No Moody-rated municipal general obligation or water & sewer obligation has defaulted since 1970. Furthermore, historical default probabilities for other investment-grade municipal debt is lower than Aaa-rated corporate debt, while recovery ratios are much higher.[37] Moody's and Fitch have announced plans to recalibrate municipal ratings in order to make them more comparable to corporate credit ratings.[38]

Nonetheless, even guaranteed assets carry some financial risk. For instance, even though federal guarantees for student loans protect lenders or their assignees from most losses due to default, administrative and legal procedures required by the default process could delay payments to asset holders. That is, federal guarantees ensure *eventual* payment of most lost earnings due to default, but not *prompt* payment. In some cases, bond insurers provide guarantees of *timely* payment to holders of asset-backed securities. Concerns about the financial condition of bond insurers, therefore, might trigger investor concerns about timely payment, even if eventual repayment were federally guaranteed.

Problems in most auction-rate markets, however, probably stem from how auction-rate securities are structured, rather than from the quality of underlying

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[35] Ibid.

[36] Concern over the financial condition of some bond insurers has been cited as a factor in the failure of auctions for municipal securities. "Auction Rate Securities Unwinding," *Financial Times*, Apr. 29, 2008.

[37] Moody's Investors Service, Public Finance Credit Committee, "Request for Comment: Mapping of Moody's U.S. Municipal Bond Rating Scale to Moody's Corporate Rating Scale and Assignment of Corporate Equivalent Ratings to Municipal Obligations," June 2006, available at [http://www.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/2005700000427679.pdf].

[38] Michael McDonald, "Moody's Set to Begin Upgrading States' Bonds in Rating Overhaul," Aug, 20, 2008, *Bloomberg.com.*

assets.[39] For ARSs backed by municipal taxing authority or by federally guaranteed student loans, the risk of default is minimal. Rather, the breakdown of ARS markets appears to stem, in large part, from features of their fundamental design that introduce liquidity risk, that is, the risk that an owner of an auction-rate security would be left holding a hard-to-sell long-maturity asset. If an issuer sought to obtain short-term interest rates for long-term borrowing by selling and rolling over traditional short-term bonds, the *issuer* retains those bonds if a placement or auction fails. With auction-rate securities, once the initial placement succeeds, *asset holders* retain the assets if an auction fails.

Auction-rate securities provide investors with liquidity so long as auctions function normally. When potential investors fear that auctions may fail, however, which would lock them into illiquid positions, they may hesitate to bid, especially when short-term credit has become more difficult or costly to obtain. Fears of auction failure may be self-fulfilling: concerns that auctions may fail will deter bidders, thus increasing the chances of failure.

The dynamics of widespread auction failures resemble those of a pre-deposit-insurance-era bank run. In a traditional banking model, banks earn profits by borrowing short (via demand deposits) and lending long (such as funding for multi-year projects). Similarly, ARS fund long-term debt via short-term investments — or perhaps more accurately, investments that investors hope are short-term. The fear that a bank would be unable to redeem deposits (because funds were tied up in long-term loans) might encourage depositors to withdraw funds or discourage others from making deposits in the first place. Similarly, the fear that auctions may fail appeared to encourage some investors to exit the ARS market and discourage others from entering.

Deposit insurance provided by a third party, that ensures that depositors can withdraw funds, is a classic solution to preventing bank runs. In ARS-type markets, an analogous solution would be a third-party guarantee to investors that they could redeem their investments after giving appropriate notice. The ability to redeem investments is called a "put option" in financial markets. Many issuers have restructured ARSs into alternative investment vehicles such as Variable-Rate Demand Obligations (VRDOs) that incorporate a put option, giving investors guaranteed liquidity.

Bond Insurance Downgrades. Some issuers, as noted above, have used bond insurance to boost the credit quality of their offerings. An insured debt issue takes on the credit rating of the bond insurer, which until 2007, generally had AAA credit ratings. When severe problems in mortgage markets led to ratings downgrades for several bond insurance companies in late 2007 and early 2008, credit ratings for

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[39] Credit ratings for ARSs are intended to reflect the long-term credit quality rather than short-term liquidity risks. For details, see Lance Pan, "When AAA Does Not Mean Roadside Peace Of Mind: A Credit Perspective on Rating Limitations of AAA-Rated ARS Bonds, Capital Advisors Group Research Newsletter, Nov. 12, 2004, available at [http://www.capitaladvisors.com/about_capital_advisors_group/downloads/whitepapers/Limitations_of_ARS_AAA_Ratings.pdf].

debt insured by those companies were automatically downgraded as well, disrupting some debt markets.[40] Thus, many municipalities and other public borrowers, which have historically had extremely low default rates, had their debt downgraded due to rating agencies' perception of financial weakness in bond insurers.[41] Because many financial institutions, such as certain pension funds, can only hold highly rated debt, the downgrades forced sales of debt issued by high-quality borrowers. Those sales, in turn, increased the market strain upon firms, such as issuers of letters of credit or standby bond purchase agreements (SBPAs), that provide liquidity to the variable-rate debt market.

One email, sent by a senior Merrill Lynch trader on January 9, 2008, warned that possibly impending downgrades of two bond insurers could affect the bank's support for ARSs insured by those firms, and that subsequent market reaction would affect the broader ARS market.[42]

Interest-Rate Caps. Interest rate caps may have played a role in the collapse of the ARS market. Many student loan-backed auction rate securities have included interest rate caps added to enhance bond ratings. While ARS issues vary considerably, many student loan ARS were issued by trusts that hold loan assets and which are off the balance sheet of the sponsoring bank.[43] Some issuers obtained better credit ratings by imposing interest rate caps, so that the trust could make payments even in the event of an auction failure.

Caps were often considered important for securities backed by guaranteed student loans. Borrower interest rates and lender yields for federally guaranteed student loans are and have been established by law. Under current law, these lenders receive a yield equal to a short-term commercial paper rate plus a legislatively

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[40] CRS Report RL34364, *Bond Insurers: Issues for the 110th Congress*, by Baird Webel and Darryl E. Getter.

[41] One financier concluded that "states and cities and towns in this country are triple A credits without triple A ratings and the financial guarantee companies have triple A ratings without being triple A credits." David Einhorn, President, Greenlight Capital, "Remarks at the 17th Annual Graham&Dodd Breakfast," October 19, 2007, available at [http://nakedshorts.typepad.com/nakedshorts/files/EinhornOnCredit.pdf].

[42] The email from Jim Brewer of Merrill Lynch to Edward Curland (GMI NYMUMI) noted that "(i)t seems increasingly likely that these two monoline insurers are going to be downgraded. We anticipate that if that happens there will be a wave of selling in these issues that we will be unable to support causing the auctions to fail. If any of these issues fail one can make the assumption that it will spread to the other sectors of our market regardless of the insurer or ratings." Complaint, In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., p. 66.

[43] Testimony of John F. (Jack) Remondi, Vice Chairman and Chief Financial Officer, Sallie Mae, in U.S. Congress, Senate Committee on Banking, Housing and Urban Affairs, *Impact of Turmoil in the Credit Markets on the Availability of Student Loans*, 110th Cong., 2nd sess., Apr. 15, 2008, p. 3, available at [http://banking.senate.gov/public/_files/OpgStmtRemondi041508SallieMaeJohn_Jack_RemondiSenateBankingTesti_.pdf]; Tom Graff (Managing Director, Cavanaugh Capital Management), "Despite Impressions, Most Auction Rate Securities Are Healthy," TheStreet.com, Aug. 8, 2008.

determined add-on (i.e., a Special Allowance Payment or SAP), which can vary by type of loan and by type of lender.[44] Cash flows generated by the pools of student loans used to make payments to investors holding auction-rate securities thus depend on commercial paper rates and the level of federal subsidies to lenders (SAPs).

Rating agencies often have considered caps as a critical safeguard against high payout rates that could exhaust the loan pools' ability to make later payments. Some ARSs carried caps that applied directly to auction interest rates. For example, a cap might specify that interest rates could not exceed 7% or could not exceed some fixed spread above a benchmark rate such as LIBOR or a given Treasury rate. Caps for tax-exempt student loan ARSs were typically set as a percentage above a benchmark municipal debt yield index.[45] Some taxable student loan ARSs also included a cap structured to ensure that income from the trust's loan pool could pay on average a fixed spread over a given benchmark rate. These caps often tied the maximum interest rate to a level that would ensure that trusts could pay minimum cash flows. Thus, many student loan-backed ARSs had maximum-interest-rate caps and related restrictions to govern maximum auction reset (interest) rates, but also that could limit cash flows generated by the loan pool.

Municipal ARSs have been less likely to include maximum-interest-rate caps. Because municipal ARSs were typically backed by the power to tax, there has been less need for interest-rate caps to ensure that income streams would be sufficient to pay interest to ARS holders. In addition, state governments have at times intervened to head off impending defaults by local governments or public authorities. While the absence of caps implies that municipal interest costs for many ARS issues have risen substantially, a significantly smaller proportion of municipal ARS auctions have failed persistently.[46]

While most interest-rate caps were well above pre-August 2007 historical levels, the sharp expansion of short-term interest spreads pushed yields in some cases up against interest-rate maximums. Some broker/dealers were able to convince rating agencies to allow issuers to waive temporarily interest-rate maximums in order to reduce the chances of auction failures. Without those waivers, some ARS would have offered investors yields that were not competitive with short-term money

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[44] This commercial paper index, compiled by the Federal Reserve, is the 3-Month AA Financial Commercial Paper Rate (series ID: CPF3M) available at [http://research.stlouisfed.org/fred2/series/CPF3M?cid=120].

[45] Email from Ross Jackman (UBS) to Chris Long (UBS), Feb. 10, 2008, in Complaint, In the Matter of UBS Securities, LLC and UBS Financial Services, Inc., case 2008-0045, filed June 26, 2008 at the Office of the Secretary of the Commonwealth [of Massachusetts] Securities Division, Exhibit 3, available at [http://www.sec.state.ma.us/sct/sctubs2/ubs2_complaint.pdf].

[46] Ben Campbell and Lance Pan, "Developments in the ARS Market Collapse," Research presentation, Capital Advisors Group, May 6, 2008, available at [http://www.capitaladvisors.com/about_capital_advisors_group/downloads/whitepapers/ARS.Call_05.06.FINAL.pdf].

market alternatives. In extreme cases, the interest-rate maximums triggered by cash-flow caps for some student loan ARSs were near or at zero.[47]

Some investment banks, whose inventories of ARS debt was rapidly expanding as they supported auctions in late 2007 and early 2008, realized that when temporary maximum-interest-rate waivers expired, the reimposition of those caps would hold some ARS yields below those banks' cost of capital, which could result in substantial financial losses. According to internal emails quoted in legal filings, the realization that interest cap waivers would begin to expire in February or March 2008 was one factor that led UBS to withdraw support for ARS auctions in mid-February 2008. A mid-December 2007 internal UBS email noted that

> 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 (no supporting) which triggers a chain reaction of selling across all auction products, regardless of them being Student Loans, Municipals or Auction Preferred Stock.[48]

The Aftermath

The collapse of the auction-rate securities market put substantial strains on investors who had thought they were investing in highly liquid cash equivalents.[49] Once ARS markets began to fail in large numbers, many investors were left with illiquid assets with maturities of 10 years or more.[50] Many issuers, such as municipalities, universities, and student lenders, were faced with steeply higher interest costs.

What Were Investors Promised? Many investors and financial professionals claim that they were not alerted to liquidity risks presented by possible auction failures. Some major investment banks, according to court documents, told investors that auction-rate securities were "cash equivalents." Many financial professionals claim that they were led to believe that dealers would play a more active role in preventing auction failures. One survey found that about two thirds of corporate treasurers in firms that held auction-rate securities said that dealers had

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[47] Ibid., p. 6.

[48] Christopher Long, Executive Director of UBS Securities, Email, Dec. 19, 2007, included in Complaint, In the Matter of UBS Securities, LLC and UBS Financial Services, Inc.

[49] Gretchen Morgenson, "It's a Long, Cold, Cashless Siege," *New York Times*, Apr. 13, 2008.

[50] Summons and complaint, Cuomo v. UBS Securities LLC, et al.

implied support for auction securities to avoid auction failures, and 17% of treasurers said that dealers had explicitly promised such support.[51]

On the other hand, major accounting firms had insisted in early 2005 that financial reports reflect possible ARS liquidity risks. Moreover, some financial institutions had warned investors in previous years of possible liquidity risks in auction-rate securities markets.[52]

Litigation, Settlements, and Buy-Back Offers. Litigation initiated by state attorneys general and by class-action suits plays an important role in the restructuring or unwinding of ARS markets.[53] The U.S. Securities and Exchange Commission (SEC) and some state securities regulators, according to press accounts, have also opened investigations.

Most major investment banks active in the ARS market have reached agreements with state attorneys general and financial regulators to buy back ARSs from some classes of investors. Citibank, the largest ARS broker/dealer, agreed to buy back about $7.5 billion in auction-rate securities from small investors as part of an agreement with the New York State Attorney General, and committed to unwind auction-rate securities holdings of larger investors as well.[54] UBS, the second largest ARS broker/dealer, agreed in principle to buy back $22.1 billion in auction-rate securities.[55] Merrill Lynch agreed in principle to buy back $10-12 billion in auction-rate securities starting in January 2009 after an earlier offer was rejected by the New York State attorney general.[56] Deutsche Bank, Goldman Sachs, JP Morgan, Morgan Stanley, and Wachovia, have also announced agreements with the New York State attorney general to repurchase ARSs sold to retail customers, charities, and small- to mid-sized businesses.[57] Fidelity reached an agreement in September 2008 with New

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[51] Joanna Chung, "Investors Expected Bond Bail-Out," *Financial Times*, June 30, 2008, p. 1.

[52] SVB Asset Management, *Fixed Income Advisory: Auction Rate Securities Update*, June 2006, available at [http://www.svbassetmanagement.com/pdfs/AuctionRateSecurities0606.pdf].

[53] Aaron Pressman, "Auction-Rate Securities: How to Get Unstuck," *Business Week*, May 22, 2008, available at [http://www.businessweek.com/magazine/content/08_22/b4086076696407.htm].

[54] Heather Landy, "Citigroup to Return Billions to Investors, Pay $100M in Penalties," *Washington Post*, Aug. 7, 2008.

[55] UBS AG, Press Release, "UBS Announces Comprehensive Settlement, in Principle, for All Clients Holding Auction Rate Securities at the Estimated Cost of U.S. $900 Million," Aug. 8, 2008, available at [http://www.ubs.com/1/e/about/news.html?newsId=148497].

[56] Patrick Temple-West, "Merrill Lynch in ARS Deal," *Bond Buyer*, Aug. 25, 2008. On September 14, 2008, Merrill Lynch agreed to be bought by Bank of America. Francesco Guerrera, "Bank of America to Buy Merrill Lynch for $50bn," *Financial Times*, Sept. 14, 2008, updated Sept. 15, 2008.

[57] Office of the New York Attorney General, Press releases, "Attorney General Cuomo Announces Settlements with JP Morgan and Morgan Stanley to Recover Billions for

(continued...)

York Attorney General Andrew Cuomo and Massachusetts Secretary of State William Galvin to buy back $300 million in ARSs bought by its clients.[58] Fidelity, a mutual fund group, had not originated ARSs, but sold some ARSs to clients. **Table 2** summarizes these settlement announcements.[59]

Table 2. Summary of Proposed ARS Buy-Back Settlements

Financial Institution	Approximate Number of Accounts	Approximate Amount of Buy-Back (billions)
Citigroup	38,000	$7.3
Deutsche Bank	unknown	unknown
Fidelity	unknown	$0.3
Goldman Sachs	unknown	$1.0
JP Morgan Chase	6,000	$3.0
Merrill Lynch	unknown	$12.0
Morgan Stanley	19,500	$4.5
UBS*	40,000	$21.1
Wachovia	43,000	$8.8
Total	**>146,500**	**$57.7**

Source: NY State Attorney General, Press release, Aug. 15, 2008, Restricted Stock Partners.

* UBS settlement includes $8.3 billion for individual investors, $3.5 billion for "Other\Tax-Exempt ARPS, and $10.3 billion for institutional investors. The buy-back start date for latter is June 30, 2010.

If these buy-backs proceed as announced, ARS broker/dealers will again have large holdings of ARSs on their balance sheets. While some deep-pocketed broker/dealers may wish to hold ARSs to maturity, those with liquidity concerns might sell ARSs to major institutional investors or hedge funds at a discount.

Partial Buy-Backs. Some have expressed concern that investment banks might buy back illiquid ARS assets from favored clients, without offering similar

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[57] (...continued)
Investors in Auction Rate Securities," Aug. 14, 2008, available at [http://www.oag.state.ny.us/press/2008/aug/aug14a_08.html]; "Attorney General Cuomo Announces Settlement with Wachovia to Recover Billions for Investors in Auction Rate Securities," Aug. 15, 2008, available at [http://www.oag.state.ny.us/press/2008/aug/aug15a_08.html].

[58] Joanna Chung, "Fidelity in $300m ARS Settlement," *Financial Times*, Sept. 13, 2008.

[59] For details, see Restricted Stock Partners, "Auction-Rate Securities (ARS) Broker-Dealer Settlements/Offers," available at [https://www.restrictedsecurities.net/announced-bd-settlements.pdf].

relief to others. The Financial Industry Regulatory Authority (FINRA) issued guidelines in April 2008 regarding partial buy-backs of auction-rate securities intended to ensure fair treatment of investors.[60]

Proposed ARS buy-back settlements have focused on individual, non-profit, and other non-institutional investors, while some large and institutional investors have been offered more limited or more delayed relief.[61] Investment banks may come under pressure to address concerns of major corporate customers holding illiquid ARS assets.

Restructuring the Auction-Rate Securities Market. Untangling the auction-rate securities market will likely be complex, even when the quality of underlying assets, such as federally guaranteed student loans, is high. Different parts of the ARS market will face different challenges. So far, some evidence suggests that the restructuring of the municipal ARS market has proceeded farther and more smoothly than that of the student loan ARS market.

Municipal Debt. Even though by the end of April 2008 roughly half of municipal ARS auctions were not failing, municipal issuers pushed to exit the ARS market. Some municipalities have restructured auction-rate securities debt and other issuers have redeemed portions of security issues. As an example, auction failures for some Port Authority of New York and New Jersey ARS debt issues pushed its interest rates as high as 20%, prompting the Authority to redeem its ARS debt.[62] Washington, D.C. redeemed $800 million in ARS and VRDO debt in May 2008, saving an estimated $10 million per year in interest costs.[63]

Market volumes for short-term, variable-rate issues with put options, such as variable rate demand obligations (VRDOs), boomed in the first half of 2008, while

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[60] Financial Industry Regulatory Authority, Regulatory Notice 08-21, *Partial Redemptions of Auction Rate Securities*, Apr. 2008, available at [http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038407.pdf].

[61] Hilary Johnson, "ARS deals snub corporate buyers," *Financial Week*, Aug. 25, 2008, available at [http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080825/REG/860812].

[62] Port Authority of New York and New Jersey, Press Release 24-2008, "Port Authority Announces Sale of $700 Million of Consolidated Bonds," Mar. 12, 2008, available at [http://www.panynj.gov/AboutthePortAuthority/PressCenter/PressReleases/PressRelease/index.php]; Ted Phillips, "N.Y. Issuers Eye Exit From Auction Market," *Bond Buyer*, Feb. 22, 2008.

[63] Natwar Gandhi, Chief Financial Officer, Washington, D.C., "Over $100 Million Saved: $10 Million This Fiscal Year by CFO Debt Management Strategy," Press release, May 27, 2008, available at [http://newsroom.dc.gov/show.aspx/agency/cfo/section/2/release/13845/year/2008].

interest in new auction-rate security deals vanished.[64] By the end of April 2008, about a third of municipal ARS debt had been refinanced.[65]

Student Loan Debt. The student loan ARS market has shown sparse signs of recovery. At the end of April 2008, nearly all auctions continued to fail. Contractually mandated maximum-interest-rate caps appear to have played a role in a significant number of these failures.[66] By August 2008, only $3 billion of the $80 billion in auction-rate debt held by nonprofit student lenders had been restructured.[67]

The nature of educational finance may complicate efforts to refinance student loan-back ARS debt.[68] First, the structure of student-loan-backed ARS (SLARSs) may complicate refinancing. Second, finding new funding to refinance existing ARS debt may be harder for student loan issuers compared to municipal and closed-end fund issuers.

Trusts. A key element in the structure of a SLARS is the trust that holds the underlying student loan assets. When an investment bank underwrites a SLARS, it typically places student loans from the issuer in a trust administered by a third party bank. The trustee bank uses income generated by the trust's student loan assets to make interest payments to investors holding SLARSs. Ordinarily, other sources of income are not available to pay interest. The flow of income from the trust is variable, because individual student borrowers may default on repayments or may prepay, and because lender subsidies (SAPs) in recent years have been tied to a commercial paper interest rate benchmark. The issuer and the trustee bank, however, have little control over that income flow because lender yields for federally guaranteed student loans are established by law. Thus, SLARS trust's income streams flow unsteadily and essentially uncontrollably.

Credit ratings agencies, whose imprimatur is typically indispensible for SLARS issuers, usually impose conditions on trust structures and payout rates designed to minimize default risk. These conditions are typically based on financial analysis using "stress tests." Stress tests are hypothetical scenarios, which assume a variety of unfavorable conditions. For example, one stress test might assume that student repayment default rates and commercial interest rates both rise sharply. A credit rating agency's financial analysts would then assess whether a SLARS could sustain interest payments, at least for some period of time, under such adverse circumstances. The credit rating for an issuer's SLARS would then be tied to specific protections,

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[64] Dakin Campbell, "Flight From ARS Fuels Market Volume Surge," *Bond Buyer*, June 2, 2008.

[65] Ben Campbell and Lance Pan, "Developments in the ARS Market Collapse," Research presentation, Capital Advisors Group, p. 4.

[66] Ibid.

[67] Patrick Temple-West, et al., "UBS AG in $22.1 Billion ARS Settlement," *Bond Buyer*, Aug. 11, 2008.

[68] Kate Haywood, "Hunkering Down With Student Loan ARS," Dow-Jones News Service, June 20, 2008; Tom Graff, "Auction-Rate Securities: You Are Now Mine!," *Accrued Interest Blog*, posted Aug. 12, 2008.

such as maximum-interest-rate caps, that would limit default risks in infelicitous conditions by capping interest rates or limiting payouts from trust income flows in extreme situtations. The particular mechanisms resulting from credit rating agencies's stress tests are more idiosyncratic than standard.

Refinancing ARS Debt. Some issuers had viewed auction-rate securities as a cheaper means of borrowing funds compared to other variable-rate securities, such as VRDOs. In light of the collapse of the auction-rate securities in February 2008 many debt issuers and investors have sought alternatives to auction-rate securities for new debt issues and have looked for ways to refinance existing ARS debt.[69] A significant proportion of municipal debt has been refinanced, using "plain vanilla" fixed-rate long-maturity bonds as well as variable-rate securities such as VRDOs or similar instruments.

The Return of the Put Option. The melding of characteristics of long-maturity and short-maturity securities was a key attraction of auction-rate securities. The way in which ARSs combined those characteristics, however, also created an intrinsic vulnerability to tight credit conditions or liquidity fears because auction-rate securities generally lack a put option (i.e., the right to sell back securities to the issuers or a designated third party on short notice). Periodic interest auctions, so long as demand was sufficient to supply liquidity, tied ARS interest payments to typically cheaper short-term rates. Because investors holding ARSs lacked a put option, they accepted (knowingly or unknowingly) a risk that liquidity could evaporate if auctions failed. Following widespread auction failures, many investors and issuers returned to financial instruments that include a put option.

Omitting a put option allowed issuers to avoid certain underwriting costs. VRDOs, which, like auction-rate securities, generally have long maturities with interest rates linked to short-term money markets, include a put option that allows investors to resell, or tender, assets after a short notice period set by contract. Issuers typically would arrange for a letter of credit or a stand-by bond purchase agreement (SBPA) provided by a bank or other financial institution in order to make funds available were VRDO investors to demand repurchase. Acquiring a letter of credit, according to one 2004 estimate, added about 65 basis points to lending costs.[70] In 2008, many issuers converted ARSs into VRDOs, although some issuers have had difficulty obtaining letters of credit or SBPAs, or have had to pay fees well above historical levels. Costs of obtaining letters of credit increased partly because many issuers demanded them and partly because the wider credit crunch had raised risk premia generally, thus make insurance-like products like letters of credit more expensive.

While obtaining a letter of credit raises borrowing costs, it also provides investors with a guarantee of liquidity. Conversely, auction-rate securities allowed

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[69] For example, Nuveen Investments and Eaton Vance Management announced plans to develop new forms of variable-rate securities. "Fund Manager Is to Refinance Stalled Auction-Rate Notes," *New York Times*, May 22, 2008, p. C8.

[70] Douglas Skarr, "Auction Rate Securities," California Debt and Investment Advisory Commission Issue Brief, Aug. 2004.

issuers to borrow more cheaply, at least in normal times, but left investors with no guarantee of liquidity. In 2008, however, investors have also sought to withdraw large volumes funds from VRDO markets, putting pressure on issuers and their tender agents.[71]

Hurdles to Refinancing Student Loan ARS Debt. Few student loan issuers have refinanced ARS debt, while municipal issuers have refinanced a large proportion of their existing ARS debt. To refinance existing debt, ARS issuers must choose a new financial instrument and must find willing investors to provide new funds to redeem old debt. Issuers must pay new fees to rating agencies, investment banks, legal advisors, and others.

Because income flows from student loan ARS trusts are variable and not controllable, and because the student loans those trusts hold are generally the only source of income, designing fixed-rate bonds with desirable risk properties for student loan issuers is technically difficult. Some have contended that maximum-interest-rate caps and related restrictions have kept interest payments for some SLARSs at below-market levels, which some argue has dampened student loan issuers enthusiasm for refinancing.[72]

Refinancing Municipal Debt. Municipal ARS issuers, by contrast, usually have made interest payments directly from their own resources, rather than via a trust. Municipalities have a much wider range of revenue streams, such as taxes, fees, and cuts in operating expenses, that can be used to pay interest expenses. Municipalities, whose debts are either explicitly or implicitly backed by the power to tax, may be better suited to plain-vanilla fixed rate bonds. In addition, municipalities' ability to tax may simplify the credit rating process, by providing an ultimate backstop against default, and may allow municipal issuers to obtain letters of credit on more reasonable terms.

Closed-End Funds. Some closed-end funds have used tender option bonds (TOBs) to obtain funds to redeem outstanding ARSs.[73] TOBs are short-term floating rate securities that give bondholders the right to require the issuers or a designated third party to buy back holdings under certain circumstances.

Asymmetric Risks Present Challenges. The problems encountered by the ARS market since August 2007 may relate to wider challenges facing financial markets, such as the management of asymmetric risks. ARSs introduced a liquidity risk with serious consequences for both issuers and investors were auctions to fail. In effect, ARSs bundled small, albeit not insignificant, benefits during normal economic times with serious costs in the event of unusual financial turmoil. Thus,

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[71] Frank Sulzberge and Andrew Flynn, "Lessons From Tough Times: Understanding VRDO Failures," *Bond Buyer*, July 21, 2008.

[72] Kate Haywood, "Hunkering Down With Student Loan ARS," Dow-Jones News Service, June 20, 2008.

[73] Seligman Select Municipal Fund, Inc., "An Update on Auction Rate Securities," Aug. 2008, available at [http://www.seligman.com/pdf/general/selectars.pdf].

the basic structure of ARSs incorporated important asymmetric risks. Some argue that asymmetric risks can present serious challenges to financial markets.[74]

The attractiveness of ARSs stemmed from the difference between short-term and long-term interest rates. In normal economic times, the yield curve (which plots interest rates against maturities) slopes upward, allowing issuers to pay short-term rates on long-term debt. So long as auctions ran smoothly, issuers, investors, and investment banks benefitted from the use of ARSs: issuers paid slightly lower interest rates, investors received interest rates slightly higher than short-term money market rates, and investment banks earned underwriting and remarketing fees.

Not all asymmetric risks are inherently problematic. For instance, the core role of insurance markets is to handle asymmetric risks. Insurance professionals have developed sophisticated tools to understand and manage asymmetric risks. In some other markets, however, asymmetric risks that are poorly understood or that are difficult to assess may present important challenges. Because financial markets can be strongly affected by events that, from the analysis of historical patterns, had appeared extremely unlikely, managing asymmetric risks can be difficult.[75]

Asymmetric risks embedded in ARSs appear to have been imperfectly understood by some market participants. Machinery developed to assess credit risks has largely focused on long-term default risks, not short-term liquidity risks such as auction failures.[76] In some cases, arrangements such as maximum-interest-rate caps on SLARSs designed to strengthen long-term default risks appear to have exacerbated short-run liquidity risks, as the presence of caps on some ARSs heightened the chances that auctions would fail. On the other hand, trust administrators and credit ratings agencies may have judged that without such caps, income streams might become inadequate to ensure continued payments to bondholders.

While credit agency ratings provided investors with vital information regarding default risks, assessing short-term liquidity risk was difficult, given the relative non-transparency of ARS auction mechanics. Despite a 2006 SEC consent decree ordering major ARS broker/dealers to inform clients more fully about the workings of ARS auctions, investors were not given key information about ARS market trends in 2007 and 2008 according to court documents.[77]

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[74] Alexander M. Ineichen, *Asymmetric Returns: The Future of Active Asset Management* (New York: Wiley Finance, 2007).

[75] Ibid.

[76] Lance Pan, "When AAA Does Not Mean Roadside Peace Of Mind: A Credit Perspective on Rating Limitations of AAA-Rated ARS Bonds," Capital Advisors Group Research Newsletter, Nov. 12, 2004.

[77] SEC Administrative Proceeding File No. 3-12310, In the Matter of Bear, Stearns & Co. Inc., et al. (cease-and-desist order, May 31, 2006); Summons and complaint, Cuomo v. UBS Securities LLC, et al.; Complaint, In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc.; Complaint, In the Matter of UBS Securities, LLC and UBS Financial Services, Inc.,

Asymmetric risks may also present challenges to corporate governance. If managers benefit in normal times from slightly lowered costs or slightly augmented profits made possible by assets or strategies that carry large downside risks whose costs are largely borne by others, then managers may face temptations to pursue overly risky strategies.[78] Careful design of corporate governance procedures and compensation schemes may reduce the strength of those temptations.

Should Issuers and Investors Have Known Better? Auction-rate securities, since their creation in the mid-1980s, have given thousands of issuers a way to lower borrowing costs relative to long-term fixed rate debt, and for much of the past decade, at a lower cost than alternative variable-rate financing methods. **Figure 3** compares ARS interest rates with variable-rate bond interest rates paid by New York State and an index reflecting average borrowing costs in the municipal finance market. ARS rates were well below (i.e., 10-30 basis points lower) variable-rate bond rates for much of the past five years. Since subprime and other mortgage-related concerns first roiled world financial markets in August 2007, auction-rate securities have led to sharp increases in financing costs to student lenders, municipalities, and other public borrowers. In addition, ARSs created major liquidity problems for many holders of ARS debt.

The savings that ARSs generated before August 2007, in some cases, may well outweigh the increased costs they caused afterwards. The choice to use ARS financing, from the standpoint of what a responsible and well-informed financial manager knew before mid-2007, may well have been reasonable if one assumed that market liquidity conditions would remain within historical bounds.

On the other hand, restructuring ARS debt could be a long and expensive process that may put severe pressure on some municipalities and may complicate the financing of student loans. While some issuers contend that ARSs represented a best industry practice that was recommended by financial experts at leading international investment banks, Arthur Levitt, former SEC Commissioner, reportedly strongly criticized issuers for failing to exercise critical judgement in choosing financial instruments like ARSs.[79]

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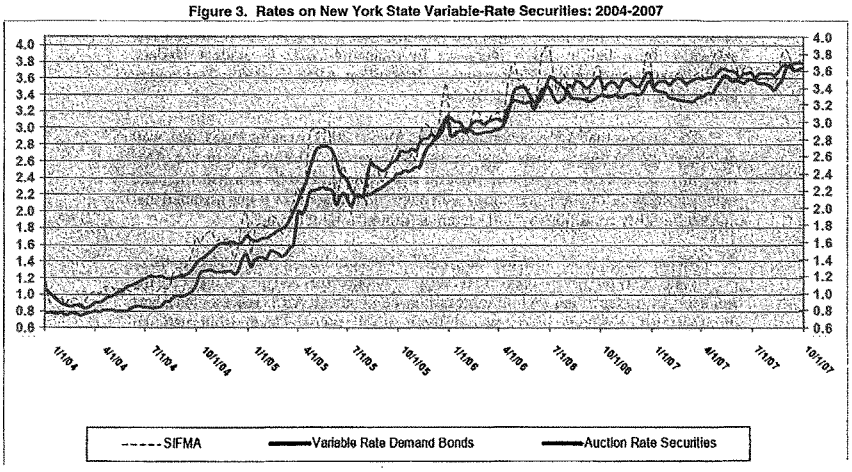
[78] Dean P. Foster and H. Peyton Young, "Hedge Fund Wizards," *Washington Post*, Dec. 19, 2007.

[79] Andrew Ackerman and Lynne Funk, "Cox: All ARS Dealers Scrutinized," *Bond Buyer*, Aug. 20, 2008.

Figure 3. Rates on New York State Variable-Rate Securities: 2004-2007



Source: New York State Budget Office, *Comprehensive Variable Rate Debt Report*, Dec. 2007. The Securities Industry and Financial Markets Association (SIFMA) compiles indices of average borrowing costs.

Auction-rate securities are one example of relatively new financial instruments developed in the past few decades. Financial innovation, according to many experts, introduced more efficient ways of matching investors to borrowers and parceling out risks to those best suited to bearing them. The increased complexity of some new financial instruments, however, has created new types of risk that may be difficult to assess. In addition, the risks introduced by novel financial arrangements may strain existing corporate governance and ratings structures. While the structure of ARSs is simple compared to many exotic derivatives, unforeseen changes in financial markets in late 2007 and early 2008 fundamentally changed the risks associated with ARSs.

Issues for Congress

Recent turmoil in ARS markets has affected several policy areas of Congressional concern.

Financial Regulation, Disclosure, and Oversight. Traditionally, the federal government has sought to ensure that dealings in publicly traded securities are transparent and fair, and that material risks are fully disclosed to financial markets. State attorneys general in New York, Massachusetts and other states have filed suits alleging that investment banks active in the ARS market failed to inform clients about rising liquidity risks, especially between when the global credit crunch emerged in August 2007 and when the ARS market collapsed in February 2008.

Legal Remedies. While state attorneys general have acted aggressively to compel investment banks to buy back ARSs from smaller investors, other investors have expressed concern that existing remedies, such as civil suits or mediation, may not adequately protect their interests.

SEC Role. The SEC regulates investment banks, brokerages, and credit rating agencies, which have played central roles in the ARS market. A 2006 SEC consent decree directed ARS broker/dealers to disclose more information about ARS auctions. SEC oversight of the ARS industry following the consent decree may be an area of congressional interest. The SEC Chairman, Christopher Cox, said that all firms involved in selling ARS to individual investors would be investigated.[80] The SEC participated in the negotiation of the proposed Citicorp, Merrill Lynch, UBS, and Wachovia settlement.[81] Those settlements are subject to SEC approval.

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[80] Andrew Ackerman and Lynne Funk, "Cox: All ARS Dealers Scrutinized," *Bond Buyer*, Aug. 20, 2008.

[81] U.S. Securities and Exchange Commission, "Citigroup Agrees in Principle to Auction Rate Securities Settlement," Press release 2008-168, Aug. 7, 2008; "SEC Enforcement Division Announces Preliminary Settlement With Merrill Lynch to Help Auction Rate Securities Investors," Press release 2008-181, Aug. 22, 2008; UBS Securities LLC and UBS Financial Services, Inc. Agree in Principle to Auction Rate Securities Settlement, Press release 2008-171, Aug. 8, 2008; "Wachovia Agrees to Preliminary Auction Rate Securities Settlement That Would Offer Approximately $9 Billion to Investors," Press release 2008-176, Aug. 15, 2008.

The SEC also charged two Credit Suisse brokers with securities fraud. The brokers allegedly mislabeled $0.8 billion of ARSs sold to foreign clients.[82]

Some have contended that the SEC and Chairman Cox have been passive in confronting the consequences of recent financial turmoil.[83] Major ARS settlements appear to many to be the result of initiatives of state attorneys general. The SEC (as of Sept. 15, 2008) has yet to announce actions against major ARS market participants that have not been targets of state regulators.[84] Former SEC Chairman Arthur Levitt, widely viewed as an aggressive advocate for financial regulation, is said to have defended SEC's actions as appropriate.[85]

Who Pays? The collapse of the ARS market, as noted above, put financial strains on towns, cities, hospitals, and has threatened to disrupt students' ability to finance higher education. Arthur Levitt reportedly warned that taxpayers may end up footing the costs of refinancing ARS debt, and argued that

> Instead of placing the burden of a bailout on the backs of taxpayers and the colleges, hospitals, and charities, we could require the firms who sold these securities to absorb the losses and the consequential damages caused by their actions rather than simply, and passively, [to] refinance and pass the costs on to taxpayers.[86]

On the other hand, some may argue that the severity of the credit crunch that began in August 2007 is unprecedented in recent times, and that its consequences could not have been foreseen. Furthermore, placing additional financial burdens, whether deserved or not, on investment banks during tumultuous economic times could exacerbate systematic financial risks.

Senator Grassley, Ranking Member, Senate Finance Committee, has noted that fines paid by investment banks resulting from settlements of state lawsuits could reduce banks' federal tax liabilities, and urged SEC Chairman Cox to "gross up" any possible future SEC-imposed fines to offset any federal tax deductions.[87]

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[82] U.S. Securities and Exchange Commission, Litigation Release No. 20698, Sept. 3, 2008, regarding SEC v. Julian T. Tzolov and Eric S. Butler, Case No. 08 Civ. 7699, Southern District of New York.

[83] Kara Scannell and Susanne Craig, "SEC Chief Under Fire as Fed Seeks Bigger Wall Street Role," *Wall Street Journal*, June 23, 2008, p. A1.

[84] A search of the [http://www.sec.gov] website conducted Sept. 14, 2008, turned up no press releases in 2007 and 2008 mentioning ARSs except for those cited in footnote 81.

[85] Roy Harris, "Reports of the SEC's Death Are Greatly Exaggerated: Former [SEC] Chief Levitt Says Congress Will Stand Up," CFO.com, June 25, 2008.

[86] Andrew Ackerman and Lynne Funk, "Cox: All ARS Dealers Scrutinized," *Bond Buyer*, Aug. 20, 2008.

[87] Sen. Charles Grassley, "Grassley Says Taxpayers Should Not Be Left to Pay SEC Penalties Aimed at Financial Institutions," Press release, Aug. 15, 2008, available at [http://finance.senate.gov/press/Gpress/2008/prg081508.pdf].

Role of Bond Insurers and Rating Agencies. The collapse of the ARS market has raised Congressional concern that higher interest costs and the challenges of refinancing ARS debt could hinder state and local government borrowing and infrastructure project financing. Furthermore, Congress has expressed concern that state and local governments and other public borrowers might not receive credit terms that fully reflect their credit quality, which would raise borrowing costs.[88]

Most, but not all, municipal issuers have used bond insurance to reduce perceived risks of default with the aim of lowering costs of borrowing. In some cases, however, downgrades of bond insurers led to instances in which interest rates for insured bonds *exceeded* rates for essentially identical uninsured bonds. Federal legislation affecting bond insurers would probably have important effects on municipal debt markets.[89]

Rating agencies, by providing accurate and authoritative information on credit quality, can lower the costs of borrowing by reducing risk premia demanded by investors. The Credit Rating Agency Reform Act of 2006 (P.L. 109-291) required rating agencies to file reports with the SEC.[90] Rating agencies have generally focused on long-term default risk rather than short-term liquidity risks, such as those posed by auction-rate securities. In some cases, measures intended to bolster credit quality by reducing the risk of default over the long term may have increased short-term liquidity risks. Encouraging rating agencies to examine a broader range of risks might provide investors with valuable information that might increase the efficiency of capital markets.

The Student Loan Market. While some segments of the ARS market have begun to unwind, the student loan ARS market has remained frozen. Some issuers and bondholders could contend that restructuring the student loan market requires federal intervention. For example, some contend that amending the Higher Education Act (P. L. 89-329) in a way that would lead to the federal purchase of older guaranteed student loans could provide liquidity to the student loan ARS market. Whether such an intervention could unfreeze the SLARS market may depend on specific terms of bond contracts. On the other hand, many in and outside of the government have expressed concerns about using federal funds to do what private capital markets might do on their own.

Conclusion: Looking Beyond the Credit Crunch

Municipal securities backed by the power to tax and federally guaranteed student loans have comprised the largest segments of the auction-rate securities market. Both municipal securities and securities backed by federally guaranteed

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[88] U.S. Congress, House Committee on Financial Services, *Municipal Bond Turmoil: Impact on Cities, Towns, and States*, 110th Cong., 2nd sess., Mar. 12, 2008.

[89] CRS Report RL34364, *Bond Insurers: Issues for the 110th Congress*, by Baird Webel and Darryl E. Getter.

[90] CRS Report RS22519, *Credit Rating Agency Reform Act of 2006*, by Michael V. Seitzinger.

student loans are generally considered to be extremely high quality assets. Investor demand for such assets have traditionally been strong, even as investment vehicles evolve over time. The need for financial intermediation between investors requiring safe investments on one side and public borrowers and student lenders will continue, despite disruptions caused by the collapse of the ARS market.

Some experts believe markets learn from financial crises, while others believe the gains that sophisticated financial engineering techniques can deliver in less tumultuous times and the natural turnover of financial market personnel make it unlikely that markets learn from past mistakes.[91] Whether or not financial markets learn from the past, decisions made by Congress and regulatory agencies regarding financial reporting, oversight, and enforcement policies will continue to affect both the structure of financial markets and the behavior of market participants.

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[91] Barry Eichengreen, "Securitization and Financial Regulation: Pondering the New Normal," working paper, July 2008, available at [http://www.econ.berkeley.edu/~eichengr/securitization_7-28-08.pdf]; published as "Reformen sind möglich," *Finanz und Wirtschaft*, Aug. 9, 2008, p. 1.