

MSRB Proposal for Auction Rate Securities (ARS) Transparency Should Be Amended

ARS Bidding and Other Information Should be Released in Readily Usable Electronic Form

Saber Partners, LLC, is a leading expert in auction rate securities and the financial markets. As part of the municipal securities rulemaking process, Saber made specific proposals to the Municipal Securities Rulemaking Board (“MSRB”) for bringing comprehensive information transparency to the distressed auction rate securities (“ARS”) market. Specifically, in a July 2008 letter Saber recommended that the MSRB complete implementation of a long-promised, comprehensive electronic ARS disclosure system, and identified specific items for disclosure under a framework based on the proven US Treasury market model. The MSRB appeared to accept those recommendations, but the proposals in its most recent filing are insufficient and, we believe, contrary to the public interest. The relevant information is already available in electronic form, and should be made available in that fashion to market participants.

According to Bloomberg, two years after an enormous liquidity shock in February 2008, more than **\$100 billion** in generally illiquid ARS remain outstanding – **over 70% of which are municipal securities** (See Bloomberg News March 8, 2010 Municipal Regulator Seeking Expanded Floating-Rate Disclosure).

The MSRB was slow to react to this crisis, and this proposal continues its piecemeal, overly-bureaucratic response. If the MSRB will not take all the actions necessary, with a sense of urgency, someone else should.

Electronic Systems Are Already in Place, Yet the MSRB Proposes that Critical Information Essential to Transparency be Submitted through Documents That Would be Difficult to Access and Compare¹

The MSRB proposal would only require bidding and other information to be submitted in “documents,” rather than as data elements, citing alleged programming and reporting costs of the latter approach. But this seems to ignore the fact that all authorized broker-dealers in auction securities have electronic systems already in place to handle submission of bids to the auction agents in auction securities. There are fewer than 5 auction agents who manage all auctions and interact with broker-dealers electronically. For example, according to the Napa Group, a leading technology provider of auction rate security trading systems, a majority of auction rate and variable rate trading desks use Napa software to conduct their daily business. IPREO is another leading provider of electronic auction rate platforms. In preparing this comment, we communicated with these providers. While there may be integration issues, they are not likely to be substantial. The point is that dealers and agents already maintain and use the information electronically.

The fact that the proposed submissions would be word-searchable is also insufficient, particularly in the absence of a standard reporting format, as the information will be available, but in a form that is inconvenient and burdensome for investors and analysts to convert back into readily usable form.

An opaque market inhibits liquidity. Greater transparency about the auctions, as detailed in the July 2008 Saber letter (and by the SEC’s own direction in March of 2008 for auctions in which the issuer may wish to bid) would address some of the investor confidence issues created by the 2008 crisis. It would encourage secondary market trading through other additional broker-dealers and perhaps through other innovative private-sector initiatives. This could provide a foundation for the full modernization of municipal securities trading. All well-functioning markets require information to be easily accessible and comparable. Under the MSRB proposal, critical information will be disclosed but in non-standard formats made difficult to find and compare. This is inadequate and insincere disclosure.

More Electronic and Accessible Disclosure Addresses Confidence and Liquidity Issues

The SEC and other regulators have found that ARS were often inappropriately sold as short-term instruments and as alternatives to cash. Unless the auctions match sellers and buyers at a fixed price of 100, within the interest rate range specified under the unique terms and structure of each ARS security, many current ARS holders cannot easily sell their investments except at a significant loss. Certain ARS may be suitable investments for some investors. However, potential buyers cannot make those evaluations because they can't easily find reliable information about the auctions.

Information about ARS market risks, and the widely differing liquidity risk profiles of specific ARS securities and their auctions, was not and is still not adequately disclosed to most investors. Reading the prospectus or supplemental broker practices alone are insufficient. Many auctions failed in February 2008, and many continue to fail. Market opacity has disadvantaged new broker-dealers from entering the market and hindered new private sector initiatives that could broaden liquidity. Some new investors appear to have entered the market simply to take advantage of that opacity through predatory bidding. Not all auctions are failing or ever failed. Investors in these auctions are still at the same risk as before the crisis.

If the failed auctions are ever going to succeed for the distressed ARS securities again, the auctions need more bidding, and more bidding at something approximating fair market value. To get more bidding, investors need more, and reliable, information about ARS and the liquidity of the auctions.

If auctions that are currently succeeding are going to be considered fair to all sides, then information on the bids and bidding process are necessary for appropriate competition and efficient pricing. This was a lesson of the auction crisis in the first place.

Disclosure and the ability to compare data in spreadsheets or other analytical platforms allows for improved decision-making. Disclosure in cumbersome formats forcing transferring data from one medium to another inhibits decision making with the information because it places a high cost burden to getting the information in a useable format.

Transparency is one part, but a critical part of any solution. Data dumps or cumbersome disclosure is not transparency.

Slow Regulatory Action in a Continuing Crisis

The MSRB did not act when the SEC first signaled concerns about the ARS markets in 2004, or when the SEC did so again in 2006. In late 2007, as many market professionals – but not investors – knew liquidity risks were increasing in certain segments of the ARS markets, the MSRB began to 'discuss' studying transparency. In 2008, after the upheaval, and in response to a Saber Partners, LLC proposal based on the U.S. Treasury auction model, they promised transparency. In 2009, they gave participants minimal information, implementing only part of that proposal. It's 2010, and we still do not have a fully transparent system. Most other regulators – the SEC, the Internal Revenue Service, and State securities regulators – have moved swiftly, within their authority, and within months of the 2008 crisis, to address investor concerns. Why does the MSRB still lag the 'market'? Saber's proposal to the MSRB is available at: http://saberpartners.com/oped/saber_letter_msr.html

The US Treasury Prices Securities with Auctions in a Transparent System – Responsible Regulatory Action Is Within Reach with a Tested Model

The Treasury Department uses the same type of auction mechanism as in municipal auctions but with full transparency to maintain market integrity and allow investors adequate discovery of the price, yield and liquidity (bid to cover ratios) of each auction. The Treasury model is what many investors understand by the term auction.

The US Treasury model is known and well-understood. Implementing it for auction rater securities is clearly feasible. The technology exists. And the expenses (already offset by profits) would not be unreasonable, particularly given the costs that a lack of transparency has imposed on issuers and investors.

If the MSRB does not have adequate funds, perhaps it could ask members for a contribution of just 1 of the 15-25 basis points per annum that they continue to receive for ARS auctions (even failed ones). This would generate \$10 million per year, based on ARS currently outstanding, an amount sufficient to develop and maintain a system.

SEC Should Insist On Establishing the Rules for Auctions and Not Assist in the Demise of a Market Because Some, Not All, Brokers Have Made a Business Decision To No Longer to Support It

Brokers have a right to decide what business lines they wish to be in. If some have decided not to underwrite future auction securities that is their legitimate business choice. However, business decisions taken today may be changed tomorrow, and regulators should create appropriate rules for markets to function fairly and for business choices to be made on a level playing field. Moreover, brokers who underwrote and continue to receive profits for this business would not be burdened by taking their existing electronic systems and modifying them to meet simple market transparency rules. They already track this data electronically, as previously noted.


Consequently, it's not a question of if this can get done, but when. This is a crisis for brokers, investors and issuers. The MSRB needs to stop "promising and deferring", and take concrete steps to provide a transparent system and level playing field so that informed market participants can make good decisions.

In its proposal, the MSRB appears to credit some commenters' claims that the ARS are "a product that is winding down" as a basis for requiring less than complete and meaningful disclosure. It may well be that the MSRB hopes that the ARS problem will just go away, but 'hope' can't be a regulatory strategy. Two years ago, some observers similarly predicted that the ARS market would contract to zero on its own. But it is now 2 years later, and \$100 billion is still outstanding –including over \$70 billion in municipal securities. That's a lot of investor, taxpayer and ratepayer money.

Modern Tools to Solve Modern Problems

We should learn from the crisis that the absence of meaningful market information led to a terrible calamity. Transparency is vital, for today's illiquid ARS, as well as for tomorrow's products (recall that the auction product markets endured a substantial contraction in the past, before recovering and rapidly re-expanding in the 2000s). But if we do not use modern tools to address modern problems, then we are harming investors and issuers alike. There appears no legitimate reason for the MSRB not to use the technology already present to give markets the ability to function. Issuers and investors should have a choice and not be forced into one direction or another because of a regulator's decision not to act.

Sincerely,



Joseph S. Fichera
Senior Managing Director &
Chief Executive Officer

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“The ARS bidding information document would be required to be submitted to the SHORT System as a word-searchable portable document format (“PDF”) file.

- Interest rate(s) and aggregate par amount(s) of orders to sell at a specific interest rate and aggregate par amount of such orders that were executed;
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- Interest rate(s) and aggregate par amount(s) of orders to hold at a specific interest rate and aggregate par amount of such orders that were successfully held;
- Interest rate(s) and aggregate par amount(s) of orders to buy and aggregate par amount of such orders that were executed;
- Interest rate(s), aggregate par amount(s), and type of order – either buy, sell or hold – by a Program Dealer for its own account and aggregate par amounts of such orders, by type, that were executed; and
- Interest rate(s), aggregate par amount(s), and type of order – either buy, sell or hold – by an issuer or conduit borrower for such Auction Rate Security and aggregate par amounts of such orders, by type, that were executed.”



July 9, 2008

Justin R. Pica
Uniform Practice Policy Advisor
Municipal Securities Rulemaking Board
1900 Duke Street
Suite 600
Alexandria, Virginia 22314

Dear Mr. Pica:

It was President Kennedy who said, "Our task is not to fix the blame for the past but to fix the course for the future." Fixing the course for the future is the position the Municipal Services Rulemaking Board (MSRB) is in at its upcoming July meeting in the floating rate securities market and in particular auction rate securities (ARS). Clear, decisive and substantive action is needed to restore investor confidence and allow liquidity to return to this market. If the MSRB acts in an ambiguous or indecisive way, it will only add to the damage to investor and issuer confidence that has occurred. If the MSRB responds with excessive requirements that purport to be "full disclosure" but that lead to further confusion and obfuscation, the damage will worsen and an important opportunity will have been missed.

Some have suggested that the MSRB should simply permit the demise of the ARS market that is shrinking, a market that has been declared "dead" by some of those who have created it. This will just burden issuers who struck a fully disclosed bargain with investors with additional costs and expenses to restructure and refinance - without ever addressing the problems that have been uncovered by the crisis. Neither taxpayers nor the customers of colleges, universities, and hospitals should be burdened with higher costs even if they decide to transition away from this market. And investors should not be forced to languish in illiquidity when there are practical steps that could be taken to improve the process.

Rather, the MSRB should take actions that level the playing field and allow auctions to be true auctions and not managed bidding systems. Markets should be allowed to work based on transparency and competition. There is nothing wrong with an auction if it is an auction. The private reality must match the public face of the use of the term "auction". An "auction" has a meaning and what the MSRB should do is ensure that the meaning of an auction is its reality as well. This is the essence of integrity and confidence in markets and the mission of the MSRB.

Through the MSRB's leadership if one can establish a transparent fair and competitive system with full disclosure, then market participants can make the decision as whether this is a cost-effective financing alternative for issuers and investors. Investors coming together in a true investor auction can determine the appropriate liquidity premium (increase in the interest rate compared to a benchmark) for that auction. No one should try to impose a solution on the market. In the absence of this leadership, a bad situation will be made only worse and the damage to integrity and confidence will be profound. There is no one size fits all solution and to suggest one is a disservice to the clients both issuers and investors we serve.

Let us focus on two key items for the MSRB: 1) Transparency to Restore Investor Confidence and 2) Liquidity

Transparency to Restore Investor Confidence

First, the MSRB should require fundamental economic transparency in all auctions.

Give simple and understandable information to let investors judge their liquidity risks and make their own decisions as to whether to participate in an auction. If they do participate, let them determine how much they want to be compensated within the terms of the structure to absorb the liquidity risks of each auction. The single most common complaint has been, it appears from published reports and anecdotal evidence, that no one knew what the liquidity was in the auctions. Were there 4 investors or 400? Did the broker step in some times or all the time?

But to be effective, transparency needs to be *simple, accessible and understandable*.¹ Using the EMMA platform, it should be easy to devise a simple matrix of key data on each auction that allows investors to know and understand the liquidity issues.

We suggest that the model for transparency should be the straightforward and clear disclosure found in the US Treasury auctions. It is what investors require from the Department of the Treasury to promote investor confidence. The Treasury Department conducts Dutch auctions using the same mechanism as in ARS.

The process is two step. First there is an announcement of the auction and then an announcement of the auction results. Each auction has a press release and web access for the results.

The auction results are summarized with some specific details so that market participants can evaluate the “success” of the auction. Success is defined not just by raising the amount required --- that’s only part of the story.

The Treasury Department releases the following information on each auction compared to the information available in corporate and municipal auctions:

Information Released	US Treasury	Corporate/Municipal Auctions ARS ²
Winning Yield	✓	✓
Amount of Competitive Bids ³	✓	
Amount of Competitive Bids Accepted	✓	
Amount of Non-Competitive Bids ⁴	✓	
Amount of Non-Competitive Bids Accepted	✓	
Amount of Bids at the Winning Yield	✓	
Median Yield	✓	
Lowest Yield	✓	
Amount of Competitive Tenders at or below Median Yield	✓	
Amount of Tenders at Lowest Yield	✓	
Bid to Cover Ratio	✓	

¹ One state issuer experimented with releasing all the data that was provided by an auction agent to the issuer. This amounted to a confusing situation known among market participants as a “data dump” which is not the essence of good disclosure.

² Released to investor not to market

³ Competitive Bids are bids that specify a rate similar to a Hold at or Buy at rate in ARS.

⁴ Non-Competitive Bids are bids that do not specify a rate only an amount and indicates the investor is willing to accept whatever the winning rate of the auction is similar to a Hold Order in ARS.

In giving this transparency one needs to require the terminology used be consistent. Some auction agents interchange the use of “shares” and “bonds”. Some talk about bids by numbers which are then defined by bond or share denominations as opposed to the dollar amounts. This confusion needs to be eliminated. The transparency proposed should be by the dollar amount bid by *unique* investors.

The one addition to the US Treasury model that is necessary is the separation of the broker-dealer’s amount bid for its own account from other investors.

The role of the broker-dealer as a market maker bidding in the auction is completely legitimate and should be accepted by all market participants as the broker’s complete discretionary option, not a requirement. Their discretion to bid or not to bid and how they wish to use their capital is solely their business. If this is to continue as a pure secondary market activity, the principle that a broker’s participation in the auction is completely at their discretion, must be preserved and protected. These are not remarketings or underwritings and the distinction must be clear.

The MSRB should consider adding the key term of a “bid to cover ratio” which has been missing from previous discussions as opposed to “failed” or “successful” auctions, terms that give limited and possibly misleading connotations. This one statistic, for example, can give great insight into the liquidity of any auction. This ratio represents the amount of bonds that were bid (either competitively or noncompetitively (hold orders)) for the amount of securities in the particular series otherwise known as “coverage”. A bid to cover ratio of 0.8 clearly indicates an auction that did not succeed in clearing the entire issue. A bid to cover ratio of 1.1, shows marginal coverage but all securities placed. A bid to cover ratio of 2.3 would show robust demand. Indeed, this is how the market interprets data presented in other auctions like the Treasury Department. When this one statistic is combined with other simple and understandable disclosures such as the low, high and median rate bid, a more complete understanding of the auction is made available for investors to consider and to price this information in when evaluating subsequent auctions or secondary market activity.

Finally, how this information is presented is as important as the information itself. Much of what discussed above is already required for those issuers bidding in their own auctions in accordance with the safe harbor guidance by the SEC released in March. Yet, how this information has been released to the market has been in an awkward and a less than useful format. The MSRB should show leadership in providing the basic electronic, accessible information without providing so much information that it becomes useless to investors. The experience of one state issuer showed the uselessness of a “data dump” in multiple pages and links of confusing data and terminology.

Liquidity

The essence of liquidity is competition with minimal barriers to that competition. The liquidity crisis for many auction issuers is based not on credit but lack of confidence as noted above. It is made worse because of an inability by other investors to access the securities directly, even if they are not customers of the designated broker-dealer.

Unfortunately, a large part of the municipal auction securities market has auctions with only a single broker-dealer or market maker permitted in the auction. This severely limits the number of investors bidding in the auction. If the Treasury Department required all bids in their auctions to go through a single broker-dealer, most would question whether that was really an “auction” by what we all consider that term to mean.

Besides limiting the number of investors competing for the securities, this sole broker-dealer system creates confusion with variable rate demand bonds (VRDBs) that reprice through a remarketing agreement. The two are substantively different but have been merged in common practice. A broker’s legal responsibilities and relationships are different in a broker-dealer agreement compared to a

remarketing agent agreement. To blur the use of the word “remarketing” to apply to both remarketings *and* auctions creates confusion and expectations among investors which only complicate the functioning of the market.

As further support for this confusion, the role of the auction agent versus the broker-dealer has routinely been confused. Reference to the broker-dealer as “running the auction” or “managing the auction” are inappropriate from the structure of the security though the practice may have deviated from the structure. Hence, there is created misunderstanding and consternation among issuers and investors.

These distinctions do matter, and while they may be technical in a discussion among members of our profession, the confusion it presents to issuers and investors is real and should not be denied.

To think innovatively as to how to address this problem, we might consider what the common market practice is for “competitive bidding in an auction”. Generally speaking, market participants would agree that three independent bidding channels would create a “competitive” pricing. This would be similar to the IRS safe harbor for determining fair value and to how competitive “auctions” for new issues are thought of. Liquidity means investors competing for investments. Anything that limits competition limits liquidity and therefore the more barriers that are eliminated, the better potential liquidity for investors.

Consequently, the MSRB might consider limiting the use of the word “auction” to describe situations that clearly meet investor perception, expectation and definition of an “auction”. Only those securities that have at least three independent broker-dealers and market makers should be considered “auctions.” (We would strongly prefer that as many broker-dealers be allowed to bid in as many auctions as possible.) This means that the MSRB should encourage broker-dealers to give up the proprietary model of approach to ARS, which confuses the role of a broker-dealer in an auction with the completely different and independent role of a remarketing agent in variable rate demand obligations.

Clearly, broker-dealers do not control how many other broker-dealers are in an auction. That is the issuer’s decision. Nevertheless, the broker has a great deal of influence with issuers. And the MSRB could encourage the dramatic expansion of auction distribution channels to assist in the liquidity crisis for investors in auction rate securities. This would benefit issuers and investors.

Conclusion

The market is looking for leadership now, not further litigation. The MSRB could help provide that leadership and help fix the course for the future. The MSRB has the opportunity and we hope it will use it to make markets work effectively and efficiently.

Thank you for your consideration of this material and for your concern in this matter. It is unfortunate that we could not discuss these matters last Fall when we first contacted you. Please do not hesitate to call us with questions or requests for clarifications now.

Best regards,



Joseph S. Fichera
Senior Managing Director and CEO

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