Financial Industry Regulatory Authority

Investor Alerts

Auction Rate Securities: What Happens When Auctions Fail

Note: FINRA issued this Investor Alert in late 2008. Although we continue to make it available for historical purposes, please be aware that some of the information presented may no longer be the most current.

Auction rate securities (ARS) refer to long-term investments that have a short-term twist: the interest rates or dividends they pay are reset at frequent intervals through auctions, which typically occur every 7, 14, 28, or 35 days. Usually, these auctions also provide the primary source of liquidity to ARS investors who wish to sell their investment.

Recent developments in the credit market have led many of the ARS auctions to fail, which may prevent existing investors from selling their ARS holdings. As a result, ARS investors who treated these securities as a ready source of cash are finding themselves short on readily available funds. In response, some issuers of ARS have announced redemptions of shares, generally at par value. In some cases, however, the issuer only offers to redeem some but not all of the outstanding shares. This may leave some investors with holdings they are unable to liquidate.

Loss of liquidity does not mean that you cannot ever get your money back. But, if you need money in a hurry, any illiquid investment can be a financial hardship. We are publishing this Alert to let investors know about some of the options available to them in the event their ARS investment becomes illiquid. We also want investors to understand what can happen when an issuer makes a call for a partial redemption.

What are ARS?

Investors who purchase ARS are typically seeking a cash-like investment that pays a higher yield than money market mutual funds or certificates of deposit. There generally are two types of ARS, bonds with long-term maturities (20 to 30 years) and preferred shares with a cash dividend. Both the interest on the bonds and the dividend on the preferred shares are variable based on rates that are set through auctions for a specified short term usually measured in days—7, 14, 28, or 35. This is unlike a traditional bond that is issued with an interest rate set for the life of the bond or preferred stock that specifies the dividend rate for the life of the shares. Auction rate bonds are issued by municipalities, student-loan authorities, museums and many others. Some auction rate bonds, such as those issued by municipalities, may offer certain tax advantages. Auction rate preferred shares are issued by closed-end funds.

How Can ARS Become Illiquid?

Liquidity issues arise when an auction fails. To understand how an auction can fail, it helps to know how ARS auctions work. Before each auction, current ARS investors can request either to sell their ARS, to hold their existing position at a specified interest or dividend rate, or to hold at whatever new interest rate or dividend the auction establishes. The size of any given auction will depend on how many current ARS investors want to sell and how many want to hold at a certain minimum rate.

Potential purchasers then indicate how much they wish to buy and what interest rate or dividend they are willing to accept. Bids, or buy orders, with the lowest interest or dividend rates get accepted first, followed by successively higher bids until all the securities available for auction are sold. The highest rate accepted in the auction—the "clearing rate"—then becomes the interest or dividend rate that applies to all the ARS until the next auction.

ARS auctions can fail when supply exceeds demand—in other words, when there are not enough bids to purchase all the securities offered for sale in the auction. When an ARS auction fails, current investors will continue to hold their securities and will generally receive an interest rate or dividend set above market rates for the next holding period-up to any maximum disclosed in the offering documents.

Unfortunately, due to recent developments in the credit market—including downgrades in the credit ratings of bond issuers and bond insurers—a significant number of auctions have failed, leaving some investors who counted on immediate access to their funds wondering about their options.

What Alternatives are Available?

ARS investors should read the offering documents carefully to determine what, if any, provisions the issuer has made in anticipation of illiquidity and failed auctions. Some issuers of bonds or preferred shares may have reserved the right to convert the ARS into a fixed or variable rate security or to call the instrument at a certain price.

ARS investors who want to liquidate their holdings—but cannot because of failed auctions—have a variety of options. These include:

> **Continuing to Hold:** If you have no need to access the monies invested in the ARS, you may want to consider whether that above-market rate is enough for you to continue holding until the next auction, which generally will be less than a month away. There is, of course, a chance that subsequent auctions will fail as well. As noted above, the issuer may be authorized to call the instrument or convert it into a fixed or variable rate security.
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> **Borrowing on Margin:** Some firms are offering to lend customers money to help them meet their cash flow needs. This may not be for everyone. For example, you should be aware that the interest rate charged on these loans may exceed the yield you are getting on the underlying security. Also, borrowing against a tax-exempt security may cause you to lose the ability to deduct from your taxes the interest or a portion of the interest on your margin loan. If you're considering this option, be sure you understand the general considerations that apply to any margin loan, notably:
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>> **Your firm can force the sale of securities in your accounts to meet a margin call.** If the ARS in your account falls below the maintenance margin requirements under the law—or the firm's higher "house" requirements—your firm can sell the securities in your accounts to cover the margin deficiency. You will also be responsible for any shortfall in the accounts after such a sale.
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>> **Your firm can sell your securities without contacting you.** Some investors mistakenly believe that a firm must contact them first for a margin call to be valid. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. Even if you're contacted and provided with a specific date to meet a margin call, your firm may decide to sell some or all of your securities before that date without any further notice to you. For example, your firm may take this action because the market value of your securities has continued to decline in value.
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>> **You are not entitled to choose which securities or other assets in your accounts are sold.** There is no provision in the margin rules that gives you the right to control liquidation decisions. Your firm may decide to sell any of the securities that are collateral for your margin loan to protect its interests.
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>> **Your firm can increase its "house" maintenance requirements at any time and is not required to provide you with advance notice.** These changes in firm policy often take effect immediately and may cause a house call. If you don't satisfy this call, your firm may liquidate or sell securities in your accounts.
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>> **You are not entitled to an extension of time on a margin call.** While an extension of time to meet a margin call may be available to you under certain conditions, you do not have a right to the extension.

Liquidating other investments: If you have immediate cash needs, you might also consider selling other securities in your portfolio. If you're weighing this option, be sure to think about the following factors:

> **The total transaction costs that you would incur in liquidating a particular position.** For instance, if you liquidate certain class shares of mutual funds or insurance linked products prior to a defined date, you could be assessed a deferred sales charge (also known as a back-end load or a surrender charge). Other costs to look out for include commissions, fees and mark-downs.
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> **Whether the sale will trigger adverse tax consequences.** Withdrawing funds from 401(k) plans, IRA accounts or other tax deferred accounts can generate immediate taxable income and penalties. Selling securities can also require that you recognize unrealized gains, which is a particularly important consideration if your tax basis in the investment is low.
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> **How the liquidation will impact the balance of your portfolio.** Just like securities purchases, sales should be made after considering your entire portfolio and investment objective.

Before you make such decisions, you should give serious consideration to consulting with a financial services professional and an accountant or tax advisor.

Selling in the Secondary Market: You may wish to consider selling in the secondary market to a third party. Secondary market transactions, however, may be more difficult to complete. Your brokerage firm is not required to purchase your ARS in the secondary market, so you must find out whether it may be willing to do so. Your broker owes you a duty to obtain best execution, but you should keep in mind that selling outside of the auction process may make it harder to determine whether you are getting a fair value, and may result in your getting a lower price. In addition, you need to factor in the costs or fees associated with a transaction completed outside the auction.

What Happens When an Issuer Redeems ARS?

To address failed auctions, some issuers of ARS, including certain closed-end funds, have started to redeem shares, generally at par value. In many cases, the issuers are calling the entire issue for redemption. In other cases, the issuers are offering to redeem only some of the outstanding shares.

In the case of such partial redemptions, not every share will be redeemed. The process begins when an issuer notifies the Depository Trust Company (DTC) that it will call for redemption part of the outstanding shares. DTC is a company that serves as the repository for several million securities issues. DTC also handles book-entry changes for securities registered in "street name" at brokerage firms. For partial redemptions, DTC allocates redemptions among broker-dealers for which it is holding shares using an impartial system. The broker-dealers receiving allocations then identify how those redemptions are to be allocated among their customers.

Investors need to be aware that in a partial redemption, it is possible that a broker-dealer holding ARS shares may not be allocated redemptions in the DTC allocation process. If you are a customer of a brokerage firm that does not get an allocation, you will not be able to participate in the partial redemption.

You should also be aware that, in the case of a partial redemption, a brokerage firm that receives an allocation might not be able to redeem all the shares of all its customers. FINRA Rules require broker-dealers to adopt procedures to allocate redemptions in the case of partial redemptions that reasonably allocate the shares they receive among customers on a fair and impartial basis.

Where to Turn for Help

Ask your broker whether any ARS you hold are eligible for redemption. If so, and if the redemption is partial, your brokerage firm should be able to tell you what procedures it is following to allocate shares among its customers. If you have a problem related to ARS that your firm did not resolve to your satisfaction, you can file a complaint online at FINRA's Investor Complaint Center.

To obtain a copy of the offering documents, contact the broker through whom you purchased your ARS investment. Or, for a municipal bond offering, you may request a copy of the official statement from the Municipal Securities Rulemaking Board's Municipal Securities Information Library at (703) 797-6704—and, for a closed-end fund, you can download the fund's prospectus from the issuer's Web site.

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