Regulatory Notice 08-21

Partial Redemptions of Auction Rate Securities

FINRA Issues Guidance to Broker-Dealers on Partial Redemptions of Auction Rate Securities

April 2008

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topic(s)
- Auction Rate Securities
- Partial Redemptions
- Securities Callable in Part

Referenced Rules & Notices
- MSRB Rule G-17
- NASD Rule 2110
- NYSE Rule 402.03

Executive Summary

In response to current market conditions, some issuers are offering partial redemptions of auction rate securities. This *Notice* reminds 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.

Questions regarding this *Notice* may be directed to Kathryn Mahoney, Director, Office of Emerging Regulatory Issues, at (212) 858-4101; or Ivette Lopez, Vice President, Office of Investor Education, at (202) 728-8928.

Background and Discussion

Auction rate securities (ARS) are long-term or perpetual variable rate securities with interest rates that reset at short-term intervals—usually seven, 14, 28 or 35 days through a "Dutch auction" process. Recently, many investors have not been willing to participate in the auctions for these securities due to concerns about the current credit market environment. As a result, many auctions have "failed," leaving investors holding these securities unable to liquidate their positions. In some cases, failed auctions have resulted in issuers paying high interest rates, or dividends in the case of auction rate preferred shares.

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In response, some issuers of ARS, including certain closed-end funds, have announced redemptions of shares, generally at par value. In some cases, the issuer only offers to redeem some but not all of the outstanding shares. In the case of such partial redemptions, the Depository Trust Company (DTC) allocates redemptions among broker-dealers for which it is holding shares. Broker-dealers receiving allocations of redemptions from DTC then sub-allocate them among their customers holding the securities. In a partial redemption, it is possible that a broker-dealer holding shares may not receive an allocation for redemption in the DTC allocation process.

NASD Rule 2110 requires firms to observe high standards of commercial honor and just and equitable principles of trade when conducting business with their customers. At a minimum, in the context of partial redemptions of auction rate securities, NASD Rule 2110 requires a firm to adopt procedures that are reasonably designed to allocate the shares it receives among its customers on a fair and impartial basis.

FINRA member firms that are also members of the NYSE are subject to incorporated NYSE Rule 402.30 for securities callable in part, which specifies the use of "an impartial lottery system in which the probability of a customer's bonds or preferred stocks being selected as called is proportional to the holdings of all customers of such securities held in bulk by or for the member organization." While NYSE Rule 402.30 is directly applicable only to such dual members, the procedures outlined in it illustrate one way to satisfy other firms' obligations under NASD Rule 2110.

In addition, when a redemption is offered on terms favorable to shareholders, both just and equitable principles of trade and NYSE Rule 402.30 prohibit a firm from redeeming shares for its proprietary accounts, or those of an affiliate or employee, before all of its customers' shares have been redeemed. Likewise, if a redemption or call is made on unfavorable terms, a firm may not exclude its positions from the pool of those that may be called or put itself "last in line." We also note that the Municipal Securities Rulemaking Board (MSRB) Interpretive Notice Concerning Application of Rule G-17 to Use of Lotteries to Allocate Partial Calls to Securities Held in Safekeeping states that a municipal securities dealer which uses a lottery that excludes the dealer's proprietary accounts when the call is exercised at a price below the current market value is acting in violation of Rule G-17, the MSRB's fair dealing rule.

Finally, NYSE Rule 402.30 requires that firms subject to it disclose to their customers the procedures that the firm will follow when an issuer of auction rate securities initiates a partial redemption of an issue. Other firms are encouraged to adopt that policy as well. The related disclosure should also cover the rights of customers relative to these procedures, and the possibility that the firm may not receive allocation rights in the DTC process.

Conclusion

When allocating redemptions in the context of a partial redemption of ARS, firms must follow procedures that are reasonably designed to treat customers fairly and impartially, and that put their customers' interests ahead of their own.

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