

# Best Practices for Broker-Dealers of Auction Rate Securities



Exposure Draft Dated May 31, 2006

Comments from any source are invited. Interested parties should send their comments via e-mail to [ARSPractices@bondmarkets.com](mailto:ARSPractices@bondmarkets.com) no later than Friday, June 30, 2006.

## Acknowledgements

These Best Practices were developed by a task force comprised of traders, lawyers and compliance officers from member firms of The Bond Market Association that act as Broker-Dealers in connection with Auction Rate Securities Programs. The task force also received input from several of the banks that act as Auction Agents for such Programs. The drafters also have taken into account comments received from staff of the Division of Market Regulation of the United States Securities and Exchange Commission. The Association appreciates the time and effort taken by the SEC staff to review these Best Practices. This Exposure Draft, however, represent the views and recommendations of the Association and its members and not those of the SEC or its staff. In addition to the significant time, effort and intellectual contributions supplied by the members of the task force, the Association wishes to acknowledge the valuable assistance and expert insight provided by Orrick Herrington & Sutcliffe LLP, the Association's counsel for this project.

## TABLE OF CONTENTS

Introduction.....	1
1. Purposes of the Best Practices. ....	1
2. Overview of Auction Rate Securities. ....	1
3. Definitions.....	3
4. Best Practices.....	5
4.1 Purpose of the Auction.....	5
4.1.1 <b>The objective of the Auction is to establish a Rate for the next Rate Period.</b> .....	5
4.2 The Broker-Dealer’s Obligations.....	5
4.2.1 <b>The Broker-Dealer’s obligation to the issuer is to solicit Bids.</b> .....	5
4.2.2 <b>The Broker-Dealer’s obligation to Holders and Prospective Holders is a normal dealer obligation to persons purchasing securities from a Broker-Dealer.</b> .....	6
4.2.3 <b>A Broker-Dealer should have policies and procedures, and a system for applying them, designed to help assure that its Auction Rate Securities business complies with applicable laws and regulations.</b> .....	6
4.2.4 <b>A Broker-Dealer should educate issuers and investors as to the material features of Auction Rate Securities.</b> .....	6
4.3 Bidding by the Broker-Dealer.....	7
4.3.1 <b>A Broker-Dealer should submit an Order to sell in an Auction all Auction Rate Securities for that Auction of which it is the beneficial owner.</b> .....	7
4.3.2 <b>A Broker-Dealer may place a Bid for its own account in an Auction at any time until the Submission Deadline, as long as any Bid it places is an Estimated Market Bid.</b> .....	7
4.3.3 <b>A Broker-Dealer may place one or more Cover Bids for all or part of the Auction if each such Bid is an Estimated Market Bid.</b> .....	8
4.3.4 <b>A Broker-Dealer may submit its own Bid in an Auction at any time until the Submission Deadline.</b> .....	8

4.3.5	<b>A Broker-Dealer should disclose to Holders and Prospective Holders that it may place one or more Bids in an Auction, and, if true, that it routinely places Bids in Auctions generally, with knowledge of other Orders.</b> .....	8
4.3.6.	<b>Except for the aggregation of Bids at the same Rate into a single Bid at that Rate for the aggregate amount, a Broker-Dealer must separately submit all Orders to the Auction Agent.</b> .....	9
4.4	<b>Bidding by Investors.</b> .....	9
4.4.1	<b>A Broker-Dealer may provide oral or written Price Talk to Holders and Prospective Holders. Price Talk generally should be established before the start of the Auction.</b> .....	9
4.4.2	<b>A Broker-Dealer should not provide Price Talk to other Broker-Dealers in the program, but may provide Price Talk to brokers, other than such Broker-Dealers, who are acting on behalf of Holders and Prospective Holders.</b> .....	10
4.4.3	<b>A Broker-Dealer should not inform Bidders that there are no Bids at a specific Rate in order to avoid an All Hold Rate.</b> .....	10
4.4.4	<b>If the program documents do not provide for all-or-none Bids, a Bidder should not be able to place an all-or-none Bid.</b> .....	10
4.4.5	<b>A Bidder should not be able to place “market order” Bids.</b> .....	10
4.4.6	<b>A Bidder may give a Broker-Dealer investment discretion to place all aspects of a Bid consistent with applicable rules regarding investment discretion. The individual authorized to exercise such discretion should not have access to information about Orders in a given Auction (other than Orders placed through such individual) or to the Broker-Dealer’s placed or planned Bids for its own account.</b> .....	11
4.4.7	<b>A Broker-Dealer should prohibit the flow of information about Order flow from the Auction Desk to the sales desk and should prohibit disclosure of the Order of any Bidder to any other Bidder.</b> .....	11
4.4.8	<b>A Broker-Dealer should maintain adequate documentation with respect to each Order for Auction Rate Securities.</b> .....	11
4.5	<b>Relationship Between Brokers-Dealers and the Auction Agent.</b> .....	12
4.5.1.	<b>A Broker-Dealer may be the bank designated as the Auction Agent or an affiliate of such bank.</b> .....	12

4.5.2.	<b>Prior to the Submission Deadline, an Auction Agent should be permitted, but not required, to inform each Broker-Dealer that there are insufficient Bids to prevent a Failed Auction.</b>	12
4.5.3.	<b>A Broker-Dealer should be able to correct clerical errors made by the Broker-Dealer between the time an Order is submitted to the Auction Agent and one hour after the time the Auction results are first posted. Auction Agents and Broker-Dealers should verbally or electronically confirm receipt of Orders between the Auction Agent and the Broker-Dealer.</b>	12
4.5.4.	<b>There should be a grace period after the Auction results have been first posted in order to correct clerical errors by the Auction Agent.</b>	13
4.6	<b>Post-Auction Sales of Auction Rate Securities by a Broker-Dealer.</b>	13
4.6.1	<b>A Broker-Dealer may buy or sell Auction Rate Securities outside the Auction at, above or below par as long as the purchase or sale price is at a then current yield.</b>	13
4.7	<b>Program Documents.</b>	14
4.7.1	<b>Disclosure documents describing the Auction Procedures and Broker-Dealer Agreements for Auction Rate Securities programs should reflect current auction practices.</b>	14
4.7.2	<b>Each Broker-Dealer should establish its own deadline for Bid submissions to help ensure that it can comply with the applicable Submission Deadline.</b>	14
4.7.3	<b>Holder and Prospective Holders should be able to change their Orders after they have been submitted to the Broker-Dealer and before the Broker-Dealer’s internal submission deadline.</b>	14
4.7.4	<b>The All-Hold Rate should continue to be a below market Rate, to encourage Bidders to place Bids at a specified Rate, but a Broker-Dealer should advise an issuer client to consider whether the current discount is in the best interest of its program.</b>	15
4.7.5	<b>Broker-Dealers should not be required to submit Holder information with their Bids. The Broker-Dealer may be considered the Holder.</b>	15

## Introduction

These Best Practices for Broker-Dealers of Auction Rate Securities are the result of a joint effort by members of The Bond Market Association who are participants in the market for Auction Rate Securities. These Best Practices were prepared in order to confirm the relationship between a Broker-Dealer and other market participants and to articulate a set of Best Practices with respect to the Auction Rate Securities transactions between the Broker-Dealer and other market participants. Capitalized terms used herein have the meanings set forth in Section 3 unless the context clearly indicates otherwise.

### 1. Purposes of the Best Practices.

These Best Practices for Broker-Dealers of Auction Rate Securities are intended to provide guidance with respect to all types of Auction Rate Securities, including tax-exempt, taxable municipal and corporate, and auction rate preferred securities. They principally address the conduct of a Broker-Dealer in Auctions and do not apply to syndicates setting an initial rate for an Auction Rate Security. They occasionally refer to language in existing Auction Procedures. Many existing programs use substantially the same Auction Procedures. The terms of particular Auction Procedures, however, may vary. In the event of a conflict between these Best Practices and the Auction Procedures for a particular Auction, the Auction Procedures control. These Best Practices are not regulations. They constitute the opinion of a group of dealers as to appropriate conduct with regard to Auction Rate Securities in most circumstances. In appropriate circumstances, a Broker-Dealer may deviate from the Best Practices without engaging in inappropriate conduct or a violation of law.

### 2. Overview of Auction Rate Securities.

Auction Rate Securities are securities whose interest or dividend rate is reset periodically. They usually have a long-term maturity (or, in the case of preferred securities, no maturity). They may be issued by municipalities or their authorities in the form of tax-exempt or taxable bonds or by corporations in the form of bonds or preferred stock. For ease, reference is made herein to the ‘issuer.’ Certain municipalities and governmental authorities serve as conduit issuers for not-for-profit and for-profit corporate borrowers which bear the ultimate responsibility for repaying the Auction Rate Securities. In the case of a conduit financing, certain references to the issuer might more appropriately be to a ‘borrower.’

The interest or dividend rate on Auction Rate Securities is reset periodically to the rate produced in an Auction that is governed by a set of Auction Procedures established by the issuer and its Auction Agent and described in the offering documents. The frequency of the periodic auctions varies, with common reset periods being daily, 7 days, 28 days, 35 days, 49 days and six months. Under some programs, the issuer may change the reset period to a multi-year period. Any change in the reset period usually requires that there be a successful auction after the issuer notifies the holders of such proposed change. Because the Rate ordinarily is reset frequently, the coupon is expected to move in relation to money market rates for instruments with a maturity of the relevant reset period and similar credit quality.

The Auction Procedures generally provide for investors to submit orders through a Broker-Dealer. Some Auction Rate Securities programs have a single Broker-Dealer and some have multiple Broker-Dealers. Existing Holders may advise the Broker-Dealer of (a) the par amount of the securities they wish to continue to hold, regardless of the Clearing Rate; (b) the par amount of securities they will hold or buy as long as the Clearing Rate is no lower than a specified Rate (and if the Clearing Rate is lower than the specified Rate, they are obligated to sell the securities they hold); and (c) the par amount of securities they wish to sell irrespective of the Clearing Rate. If an Existing Holder fails to place an Order, most Auction Procedures provide that such Holder will be deemed to have elected to continue to hold its Auction Rate Securities regardless of the Clearing Rate, unless the Auction is one in which the frequency of the Auctions is being changed, in which case such Holder will be deemed to have elected to sell its Auction Rate Securities regardless of the Clearing Rate. Prospective Holders may submit a Bid for the par amount of securities they wish to hold as long as the Clearing Rate is no lower than a specified Rate. The Auction Procedures for most Auction Rate Securities allow Bids in the Auction by a Broker-Dealer acting for its own account. The Broker-Dealer submits all Bids to the Auction Agent. Auction Procedures generally provide that Orders must be placed with the Auction Agent by the Submission Deadline, but Broker-Dealers may require Bidders to comply with an earlier internal deadline.

The Auction Agent ranks the Orders by Rate. Hold Orders are allocated first. If there are any sell Orders, the Auction Agent then accepts Bids with the lowest Rate and then successively higher Rates, until all sell Orders are filled. If there are multiple Bids at the final Rate, the Auction Agent will allocate securities among the Bidders at such Rate on a pro-rata basis. All accepted Bids receive the same interest rate (the Clearing Rate). If all Existing Holders determine to hold their Auction Rate Securities without specifying a minimum coupon rate, the Auction is called an "All Hold" Auction and the new Rate will be equal to the All Hold Rate. Under existing program documents, the All Hold Rate typically is based on a percentage of a reference rate, usually LIBOR or an index of Treasury securities, which percentage usually produces a Rate that is materially below a market Rate. If the Auction Agent does not receive Bids lower than the Maximum Rate for the total par amount of Auction Rate Securities being auctioned, the Auction is said to be a "Failed Auction," and the Auction Procedures generally provide that the coupon rate is set at the Maximum Rate, which is usually a multiple of a reference rate, such as LIBOR or an index of Treasury securities, or a fixed number, such as 15%. The multiple may depend on the credit rating of the issuer or the securities. This Rate is designed to compensate the Holder for the loss of liquidity resulting from a failed Auction and to encourage the issuer to consider redeeming or restructuring the securities, if future Auctions also fail. Although the Maximum Rate is generally above a market Rate, Holders may be disadvantaged if there is a Failed Auction because they are not able to exit their positions by means of the Auction.

Once the Clearing Rate has been determined, the Auction Agent notifies the issuer's paying agent of the Clearing Rate, which will be effective the business day following the Auction or, in the case of daily Auctions, the same day, and notifies the participating Broker-Dealers whose customers are net sellers of the name of one or more Broker-Dealers whose customers are the buyers of such securities. Settlement of such purchase and sale transactions

occurs on the business day following the Auction unless the Auction is occurring daily in which case the settlement is the same day.

### 3. Definitions.

The following terms are used in these Best Practices and, with limited exception, in Auctions of Auction Rate Securities.

*All Hold Rate.* The Rate that will apply to a new Rate Period if all existing Holders determine to hold their Auction Rate Securities without specifying a minimum Rate or a Broker-Dealer for an issue with only one Broker-Dealer fails to submit Orders to the Auction Agent prior to the Submission Deadline.

*Auction.* A process in which Holders and Prospective Holders for an issue of Auction Rate Securities indicate their interest in continuing to hold or purchase such securities. The Auction Agent reviews all Orders and determines the lowest Rate that will result in the sale of all securities being auctioned in accordance with the applicable Auction Procedures.

*Auction Agent.* An agent of the issuer or the trustee for the Auction Rate Securities, usually a bank, which, under the Auction Procedures, receives Orders and determines the Clearing Rate and the allocation of Auction Rate Securities among Auction participants.

*Auction Desk.* The business unit of a Broker Dealer that fulfills the responsibilities of the Broker-Dealer under a Broker-Dealer Agreement, including soliciting Bids for Auction Rate Securities. The Auction Desk may also make a secondary market in Auction Rate Securities.

*Auction Procedures.* The procedures governing the conduct of an Auction, usually set forth in the indenture or resolution covering the securities and summarized in the prospectus or offering statement for the issue or in supplemental disclosure documents.

*Auction Rate Securities.* Securities whose Rate is reset periodically based on an Auction.

*Bid.* A direction by a Holder or Prospective Holder specifying the principal amount of Auction Rate Securities which (i) a Holder commits to continue to hold for the next succeeding Rate Period if the Clearing Rate for such Rate Period is not less than the Rate per annum specified in such Bid or (ii) a Holder or Prospective Holder offers to purchase if the Clearing Rate for the next succeeding Rate Period is not less than the Rate per annum specified in such Bid. Note that in clause (i) above, if the Clearing Rate is less than the Rate specified by a Holder, such Holder is obligated to sell such Auction Rate Securities.

*Bidder.* Each Holder and Prospective Holder who places a Bid.

*Broker-Dealer.* A Broker-Dealer designated in a Broker-Dealer Agreement to solicit Orders for Auction Rate Securities. Where the context so indicates, these Best Practices may apply only to the Auction Desk and any other business units of a Broker-Dealer firm that are not separated from the Auction Desk by an appropriate information barrier. See, e.g. the discussion of information barriers in Section 4.4.7.



*Broker-Dealer Agreement.* The agreement between a Broker-Dealer, the Auction Agent and the issuer under which a Broker-Dealer agrees to solicit Orders for Auction Rate Securities.

*Clearing Rate.* In an Auction, the Rate for the next Rate Period determined by the Auction Agent to be the lowest Rate at which there are purchasers willing to buy all Auction Rate Securities offered for sale in such Auction.

*Cover Bid.* A Bid placed by a Broker-Dealer for all or part of the Auction Rate Securities.

*Estimated Market Bid.* A bona fide Bid at the Broker-Dealer's Estimated Market Rate.

*Estimated Market Rate.* A Rate or range of Rates which, in the Broker-Dealer's good faith judgment, reflects a fair and reasonable Rate, taking into consideration such circumstances as it believes are relevant, including prevailing market conditions with respect to such security at the time of the determination, general economic conditions and trends, current Rates for comparable securities, and the issuer's financial condition and prospects. In determining the Estimated Market Rate, a Broker-Dealer should not take into consideration the interest of the issuer in paying a low Rate or the interest of investors in receiving a high Rate. In addition, in determining the Estimated Market Rate for purposes of submitting a Bid for its own account, the Broker-Dealer may also consider such factors as the expense involved, the size of the Broker-Dealer's inventory position, its capital requirements and its risk management needs.

The Association believes that no one Auction determines what is a market Rate. Consequently, an Estimated Market Rate is not necessarily the Rate Bid on the preponderance of securities in a particular Auction but rather a rate indicative of the broader market for similar securities.

*Failed Auction.* An Auction at which the Auction Agent does not receive sufficient Orders at or below the specified Maximum Rate to purchase all the securities being sold. In the case of a Failed Auction, the Rate is set at the Maximum Rate.

*Holder.* The persons who are then the beneficial owners of the Auction Rate Securities.

*Maximum Rate.* The Rate applied by the Auction Procedures to a Failed Auction, which is often a multiple of a reference Rate, such as LIBOR or an index of Treasury securities, not to exceed a fixed cap. The multiple may depend on the credit rating of the issuer of the securities. The Maximum Rate may also be an absolute number such as 15%.

*Order.* (i) A Bid, (ii) a Hold Order, i.e. a direction by a Holder specifying the principal amount of Auction Rate Securities which it will continue to hold regardless of the Clearing Rate in the ensuing Auction or (iii) a Sell Order, i.e. a direction by a Holder specifying the principal amount of Auction Rate Securities which it will sell regardless of the Clearing Rate in the ensuing Auction.

*Price Talk.* A range of Rates that represents the good faith judgment of a Broker-Dealer, based on market and other information at a given time, of the range within which the Auction is likely to clear. Price Talk serves only as a guideline for investors as to where a Broker-Dealer

believes that the Auction is likely, but not guaranteed, to clear. It may be based, among other things, on prevailing market conditions with respect to a security at the time of the determination, general economic conditions and trends, the Clearing Rate in recent Auctions for those securities and comparable securities and the issuer's financial condition and prospects.

*Prospective Holders.* Those persons who place a Bid in an Auction to become owners of the Auction Rate Securities.

*Rate.* An interest rate, in the case of auction rate bonds, or dividend rate, in the case of auction rate preferred stock.

*Rate Period.* The period of time for which the Auction will determine the Rate.

*Submission Deadline.* The time by which all Orders must be submitted to the Auction Agent by the Broker-Dealer.

#### 4. Best Practices.

##### 4.1 Purpose of the Auction.

##### 4.1.1 **The objective of the Auction is to establish a Rate for the next Rate Period.**

The objective of the Auction is to establish a Rate for the next Rate Period.

##### 4.2 The Broker-Dealer's Obligations.

##### 4.2.1 **The Broker-Dealer's obligation to the issuer is to solicit Bids.**

The Broker-Dealer is designated in a Broker-Dealer Agreement as a Broker-Dealer to contact Holders and Prospective Holders and solicit Bids for the securities. Some program documents, especially the Broker-Dealer Agreement, may currently state that solicitation of Bids to implement the Auction will result in the "lowest possible Rate" for the securities. This language is consistent with the notion that goods sold at auction are normally sold to the bidder bidding the highest price (which, in the case of Auction Rate Securities, would be the lowest Rate). The Association believes that such language is confusing in the context of an Auction for Auction Rate Securities, where the Clearing Rate often will be higher than the lowest Rate bid. Therefore, we recommend that this language not be used in the future.

The Association does not believe that existing program documents require the Broker-Dealer to make an orderly market in the Auction Rate Securities. The Association believes, however, that a Broker-Dealer may, in its discretion, take action to promote an orderly market consistent with these Best Practices.

**4.2.2 The Broker-Dealer’s obligation to Holders and Prospective Holders is a normal dealer obligation to persons purchasing securities from a Broker-Dealer.**

The obligation of the Broker-Dealer to Holders and Prospective Holders who Bid for and sell Auction Rate Securities is no more extensive than normal dealer obligations governed by existing securities law. Broker-Dealers must comply with applicable securities laws and regulations and the rules of self-regulatory organizations applicable to transactions in Auction Rate Securities.

**4.2.3 A Broker-Dealer should have policies and procedures, and a system for applying them, designed to assure that its Auction Rate Securities business complies with applicable laws and regulations.**

The Broker-Dealer’s policies and procedures may be specific to Auction Rate Securities or may be more generally applicable.

**4.2.4 A Broker-Dealer should educate issuers and investors as to the material features of Auction Rate Securities.**

Broker-Dealers should educate both issuers and investors as to the material features of Auction Rate Securities. Educational material should include a general discussion of the Auction Procedures. Broker-Dealers should consider including in such discussion the following information:

- (a) the role of a Broker-Dealer in an Auction including, but not necessarily limited to, the information set forth in Section 4.3.5 of these Best Practices;
- (b) how an All Hold Rate occurs and its consequences;
- (c) how a Maximum Rate occurs and its consequences;
- (d) whether the Auction Procedures permit accepting all-or-none Bids and the Broker-Dealer’s policy regarding whether it will, following the Auction, enter into agreements to buy or sell an amount of Auction Rate Securities necessary to fill an Order that has been pro-rated under the Auction Procedures;
- (e) whether the Broker-Dealer has a deadline for the submission of Bids to it by its customers that differs from the Submission Deadline in the Auction Procedures;
- (f) the ability of an investor to buy or sell Auction Rate Securities in the secondary market other than through an Auction; and
- (g) any conflicts of interest that the Broker-Dealer may have, including those that arise from its multiple roles as principal for its own account, agent for customers and agent for the issuer.

#### 4.3 Bidding by the Broker-Dealer.

##### **4.3.1 A Broker-Dealer should submit an Order to sell in an Auction all Auction Rate Securities for that Auction of which it is the beneficial owner.**

When a Broker-Dealer's Auction Desk holds Auction Rate Securities for its own account on the date of an Auction of such securities, the Auction Desk should submit an Order into the Auction to sell all such securities.

##### **4.3.2 A Broker-Dealer may place a Bid for its own account in an Auction at any time until the Submission Deadline, as long as any Bid it places is at its Estimated Market Rate.**

Notwithstanding Section 4.3.1, a Broker-Dealer may place a Bid for its own account in an Auction, whether before or after it has seen the Orders of others, as long as any Bid it places is at an Estimated Market Rate. It may, among other reasons, submit such a Bid to avoid having a Failed Auction or to avoid having an Auction clear at a Rate the Broker-Dealer in good faith believes is above its Estimated Market Rate. Because of the large number of individual Auction Rate Securities programs, there are often imbalances in bidding interest in a particular Auction. Consequently, any particular Auction may be subject to failing because there are not enough Bids and hold Orders, or it may be subject to clearing at a Rate that the Broker-Dealer in good faith believes is above an Estimated Market Rate. In a single-dealer Auction, the Broker-Dealer is privy to all the Orders and is able to anticipate the outcome of the Auction. In a multi-dealer Auction, any Broker-Dealer is privy only to the Orders placed through it. The Association believes that, although a Broker-Dealer is not obligated to Bid, a Broker-Dealer may place a Bid that has an effect on the outcome of the Auction as long as it is an Estimated Market Bid. In placing its Bid, the Broker-Dealer's Bid may step in front of another Bidder whose Bid the Broker-Dealer believes in good faith is not an Estimated Market Bid at the time the Broker-Dealer places its Bid.

Whether the Broker-Dealer's Bid is appropriate depends upon whether the Auction Desk believes in good faith that the Bid is at an Estimated Market Rate and that any Bids the Broker-Dealer knowingly steps in front of are above an Estimated Market Rate. There is not a single Rate that constitutes a market Rate. Indeed, Auctions for similar securities on the same date at the same time may produce a range of different Rates. The Association does not believe that a Bid of a Holder or Prospective Holder must be egregiously outside the range of what the Broker-Dealer reasonably believes is a market Rate before the Broker-Dealer may step in front of the Bid. A Broker-Dealer should have procedures regarding how to determine that Broker-Dealer Bids are Estimated Market Bids; however, given the number of Auctions and the number of Bids by Broker-Dealers, the Association does not recommend any particular procedures.

The Broker-Dealer should disclose to Holders and Prospective Holders that it may place a Bid in an Auction with knowledge of other Orders. See Section 4.3.5.

**4.3.3 A Broker-Dealer may place one or more Cover Bids for all or part of the Auction as long as any Bid it places is an Estimated Market Bid.**

Dealers typically place Cover Bids to avoid a Failed Auction, including a fail that may occur if there are unexpected sell Orders. A Cover Bid may be a single Bid or a series of Bids at staggered Rate levels. A Cover Bid may be placed by the Broker-Dealer at any time, but it should be at a Rate or Rates the Broker-Dealer believes in good faith to be an Estimated Market Rate. A Broker-Dealer may withdraw or modify a Cover Bid prior to the Submission Deadline if the Auction Procedures so allow; but may not withdraw or modify a Cover Bid if the Auction Procedures provide that all Bids are irrevocable when made.

**4.3.4 A Broker-Dealer may submit its own Bid in an Auction at any time until the Submission Deadline.**

Even if the Broker-Dealer has established an earlier time by which the Bids of other Bidders must be received, the Broker-Dealer may submit its own Bid at any time until the Submission Deadline. The fact that the Broker-Dealer may do this should be disclosed to Holders and other Bidders.

**4.3.5 A Broker-Dealer should disclose to Holders and other Bidders that it may place one or more Bids in an Auction, and, if true, that it routinely places Bids in Auctions generally, with knowledge of other Orders.**

The Association understands that Broker-Dealers routinely place Bids in Auctions generally, although a Bid for any particular Auction Rate Securities may be placed only occasionally. A Broker-Dealer should disclose, if true, that it routinely places Bids in Auctions generally, and the circumstances in which it may submit Orders in a particular Auction and the possible effect of such Orders. For example, a Broker-Dealer should disclose, if true, that:

(a) it routinely places one or more Orders in Auctions generally for its own account, even after obtaining knowledge of some or all of the other Orders, and it may do so in any particular Auction;

(b) it routinely places one or more Bids in Auctions generally to prevent a Failed Auction or a Clearing Rate the Broker-Dealer believes is not a market Rate at the time it makes its Bid, even after obtaining knowledge of some or all of the other Orders, but is not obligated to continue to place such Bids or to bid in any particular Auction;

(c) it routinely encourages bidding by others in Auctions generally, including to prevent a Failed Auction or a Clearing Rate it believes is not a market Rate, even after obtaining knowledge of some or all of the other Orders, and it may do so in any particular Auction; and

(d) its Bids or those of others it may encourage to place Bids are likely to affect the Clearing Rate (including preventing the Clearing Rate from becoming the Maximum Rate) and the allocation of securities being auctioned (including displacing other Prospective Holders).

**4.3.6. Except for the aggregation of each of (i) Bids at the same Rate by Holders and (ii) Bids at the same Rate by Prospective Holders, in each case into a single Bid at that Rate for the aggregate amount, a Broker-Dealer must separately submit all Orders to the Auction Agent.**

A Broker-Dealer may not net sell Orders against Bids. If a Broker-Dealer that has submitted an aggregated Order is awarded securities with respect to a type of Order and Rate level in the Auction, it must allocate any such award among its customers who placed Orders of such type at that level in accordance with the allocation procedures in the Auction Procedures.

#### 4.4 Bidding by Investors.

**4.4.1 A Broker-Dealer may provide oral or written Price Talk to Holders and Prospective Holders. Price Talk generally should be established before the start of the Auction.**

Price Talk represents the Broker-Dealer's good faith judgment, at a given time, of the range of likely Clearing Rates for an Auction, based on market and other information. Such information may include among other things, the Clearing Rates for prior Auctions for those securities as well as similar securities, the credit quality of the issuer, market factors and general economic conditions. It is not a guaranty and Holders and Prospective Holders are free to use it or ignore it. It generally is established early in the day of the Auction. If Price Talk is communicated to any Holder or Prospective Holder, it should be made available through a means reasonably designed to make it available to all in time to act upon it, such as by posting on a website of the Broker-Dealer or by having sales representatives communicate with Holders and Bidders. Some Broker-Dealers determine their Price Talk on a sector-by-sector basis; for example, AA New York tax exempt. Others determine their Price Talk for a particular issue. The Broker-Dealer may advise a Holder and Prospective Holder that there is a greater likelihood of having an order filled in full if the Holder or Prospective Holder places its Bid at the lower end of the range than at the higher end.

A Broker-Dealer may occasionally change the Price Talk if the prior Price Talk becomes superceded by changes in issuer credit quality or macroeconomic factors that are likely to result in a change in interest rate levels, such as an announcement by the Federal Reserve Board of a change in the Federal Funds rate or an announcement by the Bureau of Labor Statistics of unemployment numbers, provided that a notice of the changed opinion is given in a manner reasonably designed to make it available to all Holders and Prospective Holders that were given the original Price Talk.

A Broker-Dealer must not give Holders or Prospective Holders information about actual bidding (e.g. the Broker-Dealer may never tell one Holder or Prospective Holder where other Bidders have placed their Bids, tell a Holder or Prospective Holder where the Clearing Rate is or whether there are sufficient Bids to avoid a Failed Auction.)

**4.4.2 A Broker-Dealer should not provide Price Talk to other Broker-Dealers in the program, but may provide Price Talk to brokers, other than such Broker-Dealers, who are acting on behalf of Holders and Prospective Holders.**

Broker-Dealers in a multi-dealer program must act independently. They should never share estimates of their Price Talk with the other Broker-Dealers. This should not apply to a broker that is not a program Broker-Dealer who is acting for a Holder or Prospective Holder. A program Broker-Dealer should be as free to provide Price Talk to such a broker as it would with any other Bidder.

In all cases, the Broker-Dealer must not discuss the status of Orders during the Auction process.

**4.4.3 A Broker-Dealer should not inform Bidders that there are no Bids at a Rate in order to avoid an All Hold Rate.**

All Hold Rates occur most often with issues held primarily by retail Holders. A Broker-Dealer should not inform a Holder that there are no Bids at a Rate and that the resulting Rate will be an All Hold Rate. However, the Broker-Dealer should take steps to ensure that Holders are aware of the consequences of there being no Bids at a Rate. If the Broker-Dealer were to tell a single Holder of an impending “All Hold” situation, then that Holder could place a Bid at a Rate other than a market Rate that would become the Clearing Rate. The best course of action for the Broker-Dealer is to educate Holders before the start of the auction regarding the effects of an All Hold Rate and to do nothing to encourage an Existing Holder to Bid at a Rate once the Auction begins. Alternatively, if the Broker-Dealer elected to do so, it could inform all Holders that an “All Hold” situation is likely, giving them sufficient time to act before the Submission Deadline or the internal deadline, if any, established by the Broker-Dealer.

**4.4.4 If the program documents do not provide for all-or-none Bids, a Bidder should not be able to place an all-or-none Bid or any other type of Bid that allows the Bidder to avoid pro-ration.**

Many Bidders do not wish to receive pro rated Orders. However, the program documents for Auction Rate Securities do not currently provide for all-or-none Bids and most Auction Procedures currently provide for a pro rata allocation if a Bid is placed at the Clearing Rate and there are not sufficient sell Orders to fill all Bids at the Clearing Rate. Accordingly, the only way for such a Prospective Holder to ensure that it is not pro rated is to submit a Bid below the Clearing Rate, or to sell its pro rated amount in the market after the Auction. All Bidders in the Auction should be treated equally in this respect. So long as the Auction Procedures require pro rata allocation, the Auction must operate on a pro rata allocation basis.

The Broker-Dealer may advise a Bidder that it will attempt in the secondary market to fill an Order in full or take a Bidder out of a partial position, but it should not agree, explicitly or implicitly, to do so.

**4.4.5 A Broker-Dealer should not accept “market order” Bids.**

In Treasury auctions, “non-competitive” Bidders place firm Bids to receive securities at the Clearing Rate. However, current program documents for Auction Rate

Securities do not provide for such Bids. If Prospective Holders could place “market order” Bids, and all Bids in an Auction were either “Hold Orders” or “market order” Bids, then the Clearing Rate would not be set through the Auction process. Accordingly, the only way for a Prospective Holder to ensure that it receives securities is to submit a Bid that is likely to be accepted or to ask the Broker-Dealer to sell it securities after the Auction. All Bidders in the Auction should be treated equally in this respect. Consequently, a Broker-Dealer should not agree before the conclusion of the Auction to sell the securities that are subject to the Auction to a customer at par.

**4.4.6 A Bidder may give a Broker-Dealer investment discretion to place all aspects of a Bid consistent with applicable rules regarding investment discretion. The individual authorized to exercise such discretion should not have access to information about Orders in a given Auction (other than Orders placed through such individual) or to the Broker-Dealer’s placed or planned Bids for its own account.**

Many Bidders are indifferent to particular securities within the same sector. They therefore may wish to give investment discretion to their dealer as to the Auction or Auctions in which, and the terms on which, to place an Order. The Association believes that, if a Bidder wishes to bestow such discretion, it should use the Broker-Dealer’s procedures for authorizing discretionary trades. The individual authorized to exercise such discretion should be separated from access to information about Orders in a given Auction (other than Orders placed through such individual) or to the Broker-Dealer’s placed or planned Orders for its own account by an appropriate information barrier. See, e.g. the discussion of information barriers in Section 4.4.7. Broker-Dealers should ensure that the exercise of such discretion complies with the Investment Advisers Act. A Broker-Dealer may not change a customer Bid without authorization from the customer or appropriate investment discretion, as provided in Section 4.4.6, and only if not prohibited by the Auction Procedures. Any change in a customer Bid should not be based on knowledge of other customers’ bids. See Section 4.4.7.

**4.4.7 A Broker-Dealer should prohibit the flow of information about Order flow from the Auction Desk to the sales desk and should prohibit disclosure of the Order of any Bidder to any other Bidder.**

Broker-Dealers should have in place information controls appropriate to their own business activities to control, limit and monitor the inappropriate dissemination and use of information about Auction Bids. Such information controls may include physical separation or policies and procedures to limit the inappropriate dissemination of bidding information. Such controls may separate different units within the Broker-Dealer, such as the Auction Desk and the Sales Desk, or may control the flow of information within a single unit. Such controls should be designed to ensure that a Broker-Dealer does not give Bidders or prospective Bidders information about actual bidding (e.g. that the Broker-Dealer does not tell one Holder or Prospective Holder where other Bidders, including the Broker-Dealer, have placed their Bids or the likelihood of success of a bid at a particular rate. This is equally true of the Broker-Dealer’s sales desk as it is of the Auction Desk. Thus, although the sales desk may be privy to all Bids placed by its customers, the sales people must not share one customer’s information with another.



**4.4.8 A Broker-Dealer should maintain adequate documentation with respect to each Order for Auction Rate Securities.**

A Broker-Dealer must comply with the SEC's Rules 17a-3 and 17a-4. For example, rule 17a-3 requires that a broker-dealer make a memorandum, containing certain specified information, including the timing, of each brokerage order for the purchase or sale of securities, whether or not executed, as well as each purchase and sale for the account of the broker-dealer.

**4.5 Relationship Between Broker-Dealers and the Auction Agent.**

**4.5.1. A Broker-Dealer may be the bank designated as the Auction Agent or an affiliate of such bank.**

A Broker-Dealer may be the bank designated as the Auction Agent or an affiliate of such bank. In such a case, the Auction Agent should take steps to ensure that, in a multi-Broker-Dealer Auction Rate Securities program, it does not treat its Auction Desk or affiliated Broker-Dealer more favorably than the other Broker-Dealers for the program.

**4.5.2. Prior to the Submission Deadline, an Auction Agent should be permitted, but not required, to inform each Broker-Dealer that there are insufficient Bids to prevent a Failed Auction.**

If the Auction Agent informs one Broker-Dealer that there are insufficient Bids to prevent a Failed Auction for an issue, it should inform all Broker-Dealers for that issue. Any Bids made to prevent such a Failed Auction must be submitted prior to the Submission Deadline.

**4.5.3. A Broker-Dealer should be able to correct clerical errors made by the Broker-Dealer between the time an Order is submitted to the Auction Agent and one hour after the time the Auction results are first posted. Auction Agents and Broker-Dealers should verbally or electronically confirm receipt of Orders between the Auction Agent and the Broker-Dealer.**

As in any process where many different Bidders are placing Orders using telephones, fax machines and other communications media, there occasionally are clerical errors in submitting the Orders. Some such errors are not discovered until after the Auction results are first posted, i.e. released by the Auction Agent.

The Bond Market Association believes it is best practice for market participants to check their Orders before they submit them. In addition, Broker-Dealers and Auction Agents should be able to correct clerical errors in Orders submitted to the Auction Agent any time up to one hour after the time the Auction results are first posted. The Auction Agent may rely on the submission by a Broker-Dealer of a change as a representation by the Broker-Dealer as to the existence of a clerical error. The Auction Agent should be permitted, but not obligated, to advise a Broker-Dealer, prior to posting the final Auction results, if it believes there has been a clerical error. If an Auction Agent offers such error correction service to any Broker-Dealer, it should offer it to all Broker-Dealers.

Determining whether an error was a clerical error is within the reasonable judgment of the Broker-Dealer. The Association believes that clerical errors may include, among others, transmission errors (e.g. the fax transmission does not fax all of the pages properly or omits pages), circumstances where the Broker-Dealer has received valid time stamped Orders which were not transmitted to the Auction Agent, typographical errors or technological errors.

The Auction Agent should be encouraged, but not required, to verify the Orders of a Broker-Dealer either orally or electronically. The Association understands that some Auction Agents will verify Bids orally. If, however, an Auction Agent verifies the Orders of some Broker-Dealers, it should do it for all Broker-Dealers who request it.

**4.5.4. There should be a grace period after the Auction results have been first posted in order to correct clerical errors by the Auction Agent.**

Some errors in calculation made by the Auction Agent are not identified until after the results of the Auction are first posted. The Association believes there should be a grace period after the posting of the Auction results in which a Broker-Dealer may notify the Auction Agent, or the Auction Agent may notify the Broker-Dealers, of a suspected clerical error by the Auction Agent. If the Auction Agent confirms the existence of such an error prior to the final settlement of transfers with respect to such Auction at The Depository Trust Company, the Auction Agent should correct the error and notify the Broker-Dealers of the corrected results. If a clerical error by the Auction Agent is discovered after such final settlement, the Auction Agent may make the change and post new results if the Auction Agent receives consent from all Broker-Dealers that participated in the Auction.

**4.6 Post-Auction Sales of Auction Rate Securities by a Broker-Dealer.**

**4.6.1 A Broker-Dealer may buy or sell Auction Rate Securities outside the Auction at, above or below par as long as the purchase or sale price is at a then current yield.**

A Broker-Dealer may place Bids in an Auction. If the Broker-Dealer is awarded securities in the Auction, the Broker-Dealer is not required to hold such securities for investment, but may re-sell them in the market at any time. The program documents for Auction Rate Securities allow Broker-Dealers to buy and sell Auction Rate Securities between Auctions. Whether or not the Broker-Dealer had knowledge of other Orders at the time it made any Bid, its bids and offers in the secondary market should be at a price reflecting the Broker-Dealer's good faith judgment of current market yields. Re-sales of securities bought at Auction ordinarily should not be at a price above or below par if market yields have not moved and the credit quality of the issuer has not changed since the Auction. The Association recognizes that it is a generally accepted practice that a Broker-Dealer with an inventory position may sell the position at a discount in order to reduce its portfolio risk and manage its regulatory capital. A Broker-Dealer should not agree in advance with a customer to guaranty an effective yield to the customer.

Settlement of secondary market trades in Auction Rate Securities may vary. When entering into a secondary market trade, a Broker-Dealer should agree with the counterparty on the settlement period.

#### 4.7 Program Documents.

**4.7.1 Disclosure documents describing the Auction Procedures and Broker-Dealer Agreements for Auction Rate Securities programs should reflect current auction practices.**

An initial offering of Auction Rate Securities is effected by means of a prospectus or offering statement. Most subsequent auctions of such securities are secondary market transactions that do not involve a requirement to deliver a prospectus or official statement. Broker-Dealers, however, often use marketing materials and other disclosure documents to identify the issuer and inform investors of the salient features of the program, including the Auction Procedures. Such disclosure document should reflect current auction practices. Broker-Dealers should consider using website postings, educational brochures and/or disclosure in confirmations to help Holders and Prospective Holders understand the market for Auction Rate Securities.

**4.7.2 Each Broker-Dealer should establish its own deadline for Bid submissions to help ensure that it can comply with the applicable Submission Deadline.**

Some current program documents provide that investors can submit Bids to the Broker-Dealer at any time prior to the Submission Deadline, and also provide that the Broker-Dealer must submit its Bids to the Auction Agent no later than the Submission Deadline. Submission Deadlines vary from program to program. To ensure that the Broker-Dealer can comply with any applicable Submission Deadline, the Broker-Dealer should establish its own deadline for Bid submissions. Such deadline should apply to all Bidders and should only be changed in a manner that gives sufficient notice to all Bidders. A Broker-Dealer should notify Bidders if it has an internal deadline for the submission of Orders, and whether such internal deadline is subject to change (e.g. by a website posting or communication from a sales representative).

**4.7.3 Holders and Prospective Holders should be able to change their Orders after they have been submitted to the Broker-Dealer and before the Broker-Dealer's internal submission deadline.**

The Association believes that customers should be able to change their Orders after they have been submitted to the Broker-Dealer but before the Broker-Dealer's internal submission deadline. Consequently, we recommend that future Auction Procedures explicitly permit such changes until the Broker-Dealer's internal submission deadline. Many Broker-Dealers have internal deadlines that are prior to the Submission Deadline in the applicable program documents. A Broker-Dealer should clearly communicate its internal deadlines to prospective Auction participants. This will also facilitate the process for Bidders and Broker-Dealers to correct errors before the Submission Deadline.

**4.7.4 The All Hold Rate should continue to be a below market Rate, to encourage Bidders to place Bids at a specified Rate, but a Broker-Dealer should advise an issuer client to consider whether the current discount is in the best interest of its program.**

The Association believes that, going forward, the All Hold Rate should continue to include a discount under market Rates, in order to encourage Bidders to place Bids at a specified Rate, but that investors, particularly retail investors, will be more willing to participate in the market for Auction Rate Securities if they can “roll” the securities they have purchased without a significant market penalty should all other Holders of those securities also choose to hold the securities without specifying a Rate. The Association is developing several indices of Auction Rate Securities which may be appropriate for such purpose.

**4.7.5. Broker-Dealers should not be required to submit Holder information with their Bids. The Broker-Dealer should be considered the Holder for this purpose.**

Generally, Broker-Dealers should not be required to submit the name of each Bidder. For purposes of conducting an Auction, the Auction Agent should be able to deem a Broker-Dealer submitting a Bid on behalf of a customer as the Holder. This would allow for the aggregating of Bids, which permits all Bids of the same type (e.g. bids by Holders and Bids by Prospective Holders) that are placed at the same Rate to be considered together.