



# Public Finance Alert

## Developments in public finance law

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### Municipal issuers and borrowers bidding on their own Auction Rate Securities

Many municipal issuers and 501(c)(3) and other conduit borrowers have sought to submit bids in auctions for their own Auction Rate Securities (ARSs). The following sets forth the guidelines under which such bidding may occur.

#### *Background on Auction Rate Securities and guidelines*

Auction Rate Securities are municipal bonds with interest rates that are periodically re-set through auctions, typically every seven, 14, 28, or 35 days. At each auction, the interest rate on ARSs is re-set at the lowest rate submitted in a qualifying bid in the auction that allows for the sale of all of the ARSs for which holders have submitted sell orders in that auction. If the bids for ARSs in an auction are insufficient to permit the sale of all ARSs for which an existing holder has submitted a sale order, then (a) the interest rate on the ARSs becomes a predetermined rate that is either a specific percentage, such as 12 percent or a percentage of a published interest rate index, and (b) any existing holders of the ARSs continue to hold their ARSs.

Since early February 2008, many auctions for ARSs have failed and the interest rate on several other ARSs has consistently remained very high. This dislocation in the market for ARSs has led many municipal issuers and borrowers to seek to submit bids in auctions for their own ARSs, in the hope of reducing the interest cost on their ARSs. Initially, this raised a number of concerns, in part from how the Securities Exchange Commission (SEC) would view such bidding in light of the cease-and-desist orders that the commission had issued against broker-dealers in May 2006. The commission issued a no-action letter (the No-Action Letter) on March 14, 2008, that generally permits municipal issuers and borrowers to submit bids in their own auctions as long as that bidding is appropriately disclosed.

The No-Action Letter set forth guidelines regarding municipal issuers and borrowers bidding for their own ARSs, but did not address several mechanical details. The broker-dealers had discussions among themselves and additional discussions with the commission to better develop these guidelines. Based on the No-Action Letter and these discussions, the broker-dealers each developed their own guidelines under which they would submit bids on behalf of municipal issuers and borrowers to purchase their own ARSs. Since the procedures under which the auctions for ARSs are conducted require that a broker-dealer submit bids on behalf of purchasers, a municipal issuer or borrower must work with a broker-dealer in the submission of a bid.

## *Summary of guidelines*

- *Method of bidding*

The No-Action Letter permits municipal issuers and borrowers to submit bids for less than all of the ARSs subject to an auction. However, to prevent an unfair result for existing holders, some broker-dealers have required municipal issuers and borrowers to submit a bid in the auction for up to all of the ARSs subject to the auction.

- *Substance of disclosure*

Municipal issuers and borrowers must disclose to the market three kinds of information in connection with bidding for ARSs. First, the municipal issuer or borrower must disclose which auction or auctions it will bid in, the amount of ARSs it will bid for, and interest rate that it will bid at. Second, the municipal issuer or borrower must disclose the results of the immediately preceding auction, including the number and aggregate dollar amount of bids, the clearing rate, and other related information. Third, the municipal issuer or borrower must disclose if it will offer to purchase any ARS that an existing holder seeks to tender for purchase in-between auctions. In some instances, some broker-dealers have required such an offer.

- *Timing of disclosure*

Based on the guidance of the No-Action Letter and other guidance by the commission, municipal issuers and borrowers must disseminate the disclosure as follows:

- At least two business days before the auction in which the municipal issuer and borrower will bid, the municipal issuer or borrower must disseminate the disclosure regarding its intent to bid in the auction and the other required disclosure as described above;
- Not more than two business days after an auction in which the municipal issuer or borrower bids, it must disclose the results of that auction as described above; and
- Even if a municipal issuer or borrower intends to bid in multiple auctions for the same ARSs, it must continue to make these disclosures before and after each such auction.

- *Method of disseminating the disclosure*

Municipal issuers and borrowers must disseminate the disclosure in the following manner:

- The municipal issuer or borrower must send the disclosure to the Nationally Recognized Municipal Securities Information Repositories;
- The municipal issuer or borrower must establish a link and post the disclosure on its website;
- The broker-dealer will post the disclosure on its website or provide a link to a website that disseminates the disclosure; and

- The municipal issuer or borrower must send the disclosure to the *Bond Buyer*.

- *Compliance with bond documents*

The terms and provisions of the bond documents for ARSs vary from issuance to issuance. Some bond documents prohibit the issuer or borrower from purchasing the ARS or require purchased ARSs to be cancelled. For example, in some cases, the bond insurers required these prohibitions to prevent refundings that would not extinguish their bond insurance policies.

Some broker-dealers have sought comfort from the municipal issuer or borrower, such as legal opinions and representations and warranties, that its bidding on its own ARS does not violate the terms of the related bond documents.

- *Compliance with state law*

The impact of state law on a municipal issuer or borrower bidding for its own ARS varies from state to state. In some states, governmental agencies may not have statutory authorization to invest in their own ARSs. In other states, these purchases of ARSs may cause the obligation under the ARSs to become extinguished. The laws of some states may even expressly prohibit municipal issuers or borrowers from purchasing their own ARSs.

Some broker-dealers have also sought assurance from the municipal issuer or borrower that its bidding on its own ARSs does not violate the laws of the state in which it is located.

- *Other requirements*

Some broker-dealers have also imposed other requirements on municipal issuers and borrowers who seek to bid on their own ARSs. These include various indemnifications, legal opinions, and other similar types of protection.

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If you have any questions or require further information regarding these or other matters, please call your regular Nixon Peabody contact or feel free to contact one of the attorneys listed below:

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