



MSRB NOTICE 2008-09 (FEBRUARY 19, 2008)

APPLICATION OF MSRB RULES TO TRANSACTIONS IN AUCTION RATE SECURITIES

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Recent downgrades of municipal bond insurers and other short-term liquidity concerns have created extreme volatility in the market for municipal Auction Rate Securities. There also have been an unprecedented number of “failed auctions,” meaning that investors who chose to liquidate their positions through the auction process were not able to do so. This situation may result in existing investors selling Auction Rate Securities and investors unfamiliar with the product buying the securities. The MSRB is publishing this notice to remind brokers, dealers and municipal securities dealers (“dealers”) of the application of MSRB disclosure and suitability requirements that apply to all customer transactions in municipal Auction Rate Securities whether in primary offerings, at subsequent auctions, or in non-auction transactions.

AUCTION RATE SECURITIES

Auction Rate Securities are municipal securities with a variable interest rate that is set periodically through a “Dutch Auction” process.[1] An auction program employs one or more dealers (“Program Dealers”)[2] that solicit orders from investors who wish to own the securities over the next interest rate reset period. Interest rate reset periods normally are either 7, 28, or 35 days. The programs require one “Auction Agent” – typically a bank – that receives orders from the Program Dealer(s) and conducts auctions in accordance with the procedure described in program documents. This procedure is used to determine the lowest interest rate at which all of the securities that have been offered for sale by current holders of the securities will clear the market (the “clearing rate”). The clearing rate then becomes the interest rate for all of the securities in the issue for the next interest rate reset period. The Auction Agent provides the results of the auction to the Program Dealer(s), and these dealers inform their bidders of the auction results and the securities, if any, that have been allocated to them as a result of the auction.

The official documents for Auction Rate Securities contain specific procedures to set interest rates for the upcoming interest period. The documents typically set an “all hold” rate that will apply when all existing holders are willing to hold at any rate.[3] The documents also define situations under which a “maximum rate” is used for the next interest rate period. A maximum rate is used when the Auction Agent does not receive enough bids to cover the aggregate amount of securities that are put up for auction, or if the clearing rate of the auction would be above the maximum rate defined in program documents. This situation is commonly called a “failed auction.” As defined in the program documents, the maximum rate may be a multiple of a specified index or a fixed rate. The maximum rate set in a specific situation also may be dependent on other factors, such as the rating of the securities at the time of the auction.[4]

Auction Rate Securities historically have been sold to investors seeking short-term, liquid investments and consequently are often insured as to payment of interest and principal by bond insurers. Recent downgrades of several major bond insurers have created concerns about insured municipal bonds and have spurred liquidity concerns that have seriously affected the market for Auction Rate Securities.

APPLICATION OF MSRB RULES ON DISCLOSURE AND SUITABILITY

The MSRB is aware that Auction Rate Securities are often sold to individual investors, who may not have the same sophistication as institutional customers in understanding the features of complex securities. It is therefore particularly important for dealers to focus

attention on the application of MSRB investor protection rules when effecting transactions in Auction Rate Securities. The application of two important investor protection rules – Rule G-17 on fair practice and Rule G-19 on suitability of recommendations – is summarized below as a reminder of existing requirements.^[5]

MSRB Rule G-17 requires dealers to deal fairly with all persons and prohibits deceptive, dishonest, or unfair practices. A longstanding interpretation of Rule G-17 is that a dealer transacting with a customer^[6] must ensure that the customer is informed of all material facts concerning the transaction, including a complete description of the security.^[7] Disclosure of material facts to a customer under Rule G-17 may be made orally or in writing, but must be made at or prior to the time of trade. In general, a fact is considered “material” if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor.^[8]

The duty to disclose material facts to a customer in an Auction Rate Securities transaction includes the duty to give a complete description of the security, including features of the auction process that likely would be considered significant by a reasonable investor. Given the variety and complexity of Auction Rate Securities, there are a number of facts that may fall within this duty to disclose, including the duration of the interest rate reset period, information on how the “all hold” and maximum rates are determined, and other features of the security found in the official documents of the issue.^[9] In light of recent events, it may be a material fact for an investor that an Auction Rate Security recently was subject to a failed auction.^[10] Of course, this does not represent an exhaustive list of facts that a dealer must consider as potentially material, since this may vary with individual securities and transactions.

Dealers also should carefully focus on the application of MSRB Rule G-19 on the suitability of recommendations when making recommendations to customers in Auction Rate Securities. Rule G-19 provides that a dealer must consider the nature of the security as well as the customer’s financial status, tax status and investment objectives, based upon the facts disclosed by or otherwise known about the customer when making recommendations to customers. The dealer then must have reasonable grounds for believing that the recommendation is suitable for that customer.^[11] Thus, among other factors, a dealer must consider both the liquidity characteristics of an Auction Rate Security and the customer’s need for a liquid investment when making a suitability determination involving Auction Rate Securities.

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^[1] Unlike other short-term municipal securities with long-term maturity dates and short-term interest rate reset periods, such as Variable Rate Demand Obligations (VRDOs), Auction Rate Securities generally do not have “put” features or liquidity facilities that allow holders to tender their securities back to an issuer-appointed representative on a periodic basis.

^[2] The Program Dealer(s) is so designated through an agreement with an auction agent and the Issuer of the Auction Rate Security.

^[3] The “all hold” rate typically is set by reference to a short-term market index.

^[4] In recent auctions, maximum rates have ranged from as low as 3% to as high as 20%. It should be noted that a failed auction is not an event of default by the issuer, it only relates to the auction process not being able to determine a clearing rate and not permitting investors attempting to sell their securities from being able to do so in the auction process.

^[5] A dealer’s specific requirements under Rules G-17 and G-19 may be affected by the status of a customer as a Sophisticated Municipal Market Professional (“SMMP”). See *Bond Insurance Ratings – Application of MSRB Rules*, [MSRB Notice 2008-04 \(January 22, 2008\)](#). See also *Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals* (April 30, 2002). This current notice (MSRB Notice 2008-08) focuses on a dealer’s duty when transacting with a customer that is not a SMMP.

^[6] The word “customer,” as used in this notice, follows the definition in MSRB Rule D-9, which states that a “customer” is any person other than a broker, dealer or municipal securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the

issuer of a new issue of its securities.

[7] See, e.g., Notice Concerning Disclosure of Call Information to Customers of Municipal Securities (March 4, 1986), MSRB Manual (CCH) ¶ 3591.

[8] See, e.g., Basic v. Levinson, 485 U.S. 224 (1988).

[9] If the maximum rate is a formula linked to a particular securities market indicator, such as the London Interbank Offered Rate (LIBOR), the dealer's disclosure obligations may extend to a description of the material facts concerning the market indicator, as they relate to the Auction Rate Security.

[10] In a recent notice, the MSRB also reminded dealers that information about bond insurance and underlying credit ratings may constitute material facts about a transaction that must be disclosed under Rule G-17. See Bond Insurance Ratings – Application of MSRB Rules, [MSRB Notice 2008-04 \(January 22, 2008\)](#).

[11] In the case when a low maximum rate is set for failed auctions, there may be a high likelihood for continued failed auctions. In this case, dealers should consider the non-auction secondary market prices when recommending to a customer whether to purchase the Auction Rate Security through an auction or in the non-auction secondary market.

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