Liquidity and Auction Market Securities

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The auction rate securities market has recently experienced an unprecedented number of failed auctions since February 13, 2008, meaning that investors wanting or needing to liquidate their auction rate securities through the auction process were not able do so.

Auction rate securities are municipal securities with a variable interest rate that is set periodically through a Dutch auction process. An auction program employs one or more dealers that solicit offers from investors who wish to own the securities. Interest rates are reset during periods that are either 7, 28, or 35 days. Auction rate securities historically have been sold to investors seeking short-term, liquid investments, and consequently are often insured as to the payment of interest and principal by bond insurers.

However, 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.

The MSRB [Municipal Securities Rulemaking Board] has long had investor protection rules which apply for the protection of customers affecting transactions in auction rate securities. The two most important investor protection rules, Rule G-17, Disclosure and Fair Dealing, and Rule G-19, Suitability, require the suitability of recommendations, and require that municipal dealers deal fairly with all persons, and prohibits deceptive, dishonest, or unfair practices. This means that a dealer must ensure that the customer is informed of all material facts concerning the transaction. In general, a fact is considered material if there is a likelihood that its disclosure would have been significant by a reasonable investor.

In addition to the customer disclosure obligations, the seller must have reasonable grounds for believing that recommendation of the auction rate securities product is suitable based upon information available about the security, and the facts disclosed or otherwise known about the customer. Therefore, if a customer has expressed a desire to only purchase AAA securities, or has concerns about the short-term liquidity of the auction rate securities product, there will be some question as to whether the recommendation is suitable given those customer's concerns.

Recent class actions that have been filed against Deutsche Bank and UBS have raised questions as to whether auction rate securities that were recommended were properly marketed to customers of these brokerage firms. While class actions require that class members be similarly situated, the amounts invested in these auction rate securities are sufficiently large so the individual actions should be considered by customers who have suffered losses or were unable to liquidate their positions.

Listen to Howard Rosenfield with Anita Finley on Saturday, April 12 from 8:00-8:30 PM on WWNN 1470AM and on the Internet at www.wwnnradio.com.

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