WHAT ARE AUCTION-RATE SECURITIES?

According to Wikipedia, an auction-rate security (ARS) typically refers to a debt instrument (corporate or municipal bonds) with a long-term nominal maturity for which the interest rate is reset through a Dutch auction (typically held every 7 to 35 days, with exceptions). An ARS could also refer to a preferred stock for which the dividend is reset through the same process.

In a Dutch auction, a broker-dealer submits bids, on behalf of current and prospective investors, to the auction agent (typically a third-party bank selected by the issuer). Based on the submitted bids, the auction agent will set the next interest rate by determining the lowest rate to clear the total outstanding amount of the ARS. For issuers, the attraction of the auction market has typically been the low cost and high flexibility of variable-rate debt.

WHAT HAPPENED?

Beginning in early February, these Dutch auctions began to fail as the securities were rejected by investors and the usual bidders of last resort – the investment banks – took passes as well. The largest market makers in this business were clearly focusing their efforts on conserving their own capital cushions in the wake of the widespread, subprime mortgage-fueled crisis that continues to plague financial institutions. (Standard & Poor’s said in March that write-downs by large financial institutions on subprime debt could hit $285 billion.)

On a single day in late February, 386 auctions of publicly offered bonds resulted in 258 failures, or 67%, according to data compiled by Bloomberg from four auction agents. Put another way, auctions covering as much as $26 billion per day have failed to attract enough buyers since February 13, according to Bank of America Corp.
The result of these failed auctions? Existing holders maintain their positions at the maximum rate set in the official statement until sufficient bids are entered to set a clearing bid at the next auction. The lingering question is: When will the next successful auction happen?

**WHY SO SUDDEN?**

The term auction-rate securities has been a misnomer for several years. The system as it has evolved does not *really* involve buyers and sellers meeting and setting the interest rate via a true bidding process. Instead, Wall Street brokerage firms dominate the process by bidding with their own capital rather than facilitating a marketplace of buyers and sellers. And so, when the brokerage firms’ capital dried up, the whole process screeched to a halt.

**AUCTION FAILURES = ILLIQUIDITY = MARKDOWNS**

As a result, some broker-dealers have decided to mark down the value of auction-rate securities in brokerage accounts from a few percentage points to, in some cases, more than 20%. The markdowns reflect the estimated drop in value of the securities. If you apply back-of-the-envelope math to a $330+ billion marketplace, it is easy to calculate potential losses in billions. More important than the size of the potential losses may be the suddenness of the changes in value of the securities and the subsequent shock for those investors who thought they had their assets in liquid, cash-equivalent investments.

**SEEKING REDRESS**

Investors and regulators will look to the deep pockets for relief and answers, with allegations of deception and lack of disclosure at the forefront. “Auction securities became a managed bidding system, not a true investor auction,” said Joseph S. Fichera, chief executive of Saber Partners, a financial advisory firm.4 “The investor never knew how many investors there were, how often the brokerage firms were stepping in to make the system work, nor that the broker’s support could stop all of a sudden.” This sums up several issues that are likely to form the basis of potential claims against some financial institutions and/or any funds that offered auction-rate securities as investments.

Already, several class action lawsuits have been filed against some of the larger banks as broker-dealers and/or issuers of the auction-rate securities. ARS investors have filed lawsuits in federal court in Manhattan against many FIs alleging that the brokerage houses deceptively marketed the auction-rate securities as cash alternatives and then took actions that made the market for these securities almost completely illiquid. The complaints allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The list of institutions that have been sued already is extensive. Add into the mix the fact that that this type of securities have morphed, particularly in recent times, from a product sold mainly to institutions to one marketed heavily to individual investors (the minimum investment decreased from $250,000 to $25,000 in recent years) and the scope of the matter grows larger and wider. At the end of 2006, institutional investors held about 80% of all auction-rate securities issues, according to Treasury Strategies, a consulting firm in Chicago.5 At the end of 2007, that portion had fallen to just 30%.

It should come as little surprise then that regulators – federal and state – are joining the party. The Securities & Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) are probing whether broker-dealers misrepresented the liquidity risks of the securities when they sold them. The regulators also are looking at whether broker-dealers favored certain clients by ensuring they would be able to sell their auction-rate securities when others couldn’t. It has been reported that more than 15 banks and broker-dealers received questionnaires and document requests relating to auction-rate securities. Not to be left out, Massachusetts’ top securities regulator announced on March 28 that his office issued subpoenas to three major firms to determine whether they adequately disclosed the potential risks of these investments to investors. New York’s attorney general followed suit in April, sending subpoenas to 18 banks and broker-dealers.

**THE INSURANCE QUESTIONS**

Analyzing the above in the context of Executive Risks insurance policies, it is important to understand what type of policies are potentially exposed for banks/broker-dealers/asset managers and/or any impacted investment funds.
While words like “securities class actions,” “violations of Sections 10(b) of the ’34 Act” and/or “false and misleading registration statements” are usually found in public-company Director and Officer (D&O) claims, in this case, Professional Liability or Errors & Omissions (E&O) claims are the more likely initial outcome.

The claimants against the FIs are likely to be customers (buyers of the investment products offered by the FIs) and not shareholders of the FIs themselves. In fact, the accusations against the banks essentially accuse the FIs of putting shareholders before clients by protecting their already-troubled balance sheets by shutting down the ARS market for its customers. For those financial institutions and fund complexes being probed by regulators, the initial insurance coverage analysis will likely ask: Has the definition of claim been triggered? (Think inquiries vs. subpoenas.)

For those financial institutions that have been sued, the initial analysis will likely ask: Is the potential loss – defense costs and damages – severe enough to pierce the deductible or retention, which are usually quite substantial? Related to that question is: How are damages and therefore loss (another defined term in a typical E&O policy) determined in the absence of any sale of the securities?

Other pertinent questions: While some institutions may definitively mark down the value of the assets in customer accounts, will all FIs? If the assets are marked down on the balance sheets of the banks themselves, are they compelled to do the same for customer accounts and impacted investment funds? What if, in the process of the litigation, which usually plays out over several years, the credit markets thaw, the auctions start to succeed again and/or the ARS’s get refinanced by the issuers and customers ultimately get their money back? Will there be any true financial loss to those that did not sell at marked down prices?

**FROM E&O TO D&O**

In the advent of many severe E&O claims and/or regulatory settlements, the share prices of some FIs themselves may continue to show extreme volatility and the possibility of shareholder suits (D&O claims) becomes a very real likelihood.

FI D&O policies usually contain broadly worded E&O exclusions, eliminating coverage for claims alleging a breach in professional services to customers. These exclusions usually include language along these lines: “This coverage does not apply to any Claim, or any Loss, based upon, arising, out of, related to, or in consequence of the performing of, or failure to perform, professional services.” This language alone may limit D&O coverage if the claim stems from the activities in the ARS market or related areas. Therefore, it is critical for FIs that any E&O exclusion in a D&O policy be carefully worded so that coverage for any follow-on or related claims is not limited.

**PRIOR NOTICE AND LIMITS OF (COVERAGE) LIABILITY**

While relatively less publicized at the time, in May 2006, the SEC brought a case against 14 big brokerage firms that sold auction-rate securities based on the fear of illiquidity in other investments. The commission accused certain banks of favoring some customers over others and manipulating the auctions by adding capital to smooth out the process. Regulators allege that these arrangements, while easing the bidding process, hid the potential for this market to freeze. In announcing a settlement, the SEC said that “investors may not have been aware of the liquidity and credit risks associated” with the securities. The firms paid $13 million to settle the matter, neither admitting nor denying the allegations.

For any of the impacted institutions looking for insurance to protect them from the 2008 ARS fallout, insurance carriers may raise the coverage defense that a “prior notice” or “pending and prior litigation” exclusion may limit or completely eliminate coverage. For others who may have provided warranty statements (stating that they were not aware of anything that might lead to a claim against the addition layers of coverage) in exchange for more insurance over the intervening years, insurance carriers may similarly raise the issue of “prior known acts” to deny access to the additional insurance.
Another potential concern for E&O-buying FIs: Are the limits of liability of the E&O policy blended or shared with the coverage or limits of liability of the D&O policy? Further, are either of these corporate coverages shared with coverage for the funds/trustees? If indeed blended, have excess D&O-only limits been secured to exclusively protect any exposed individuals?

**BEYOND FIS**

These risks posed by auction-rate securities are not exclusively a concern for FIs. For commercial companies, the impact of ARS investments on the balance sheet will rear its head in earnings reports. Few events drive stock price down as effectively as a shock to earnings. Already, one major company took an impairment charge of $275 million in connection with its ARS investments, and several others have made what may be significant adjustments to their balance sheets. There are likely to be more to come. Disclosure is all about accuracy and timing.

The auction-rate securities issue is a tangential issue in the overall credit crisis impacting global financial markets. For FIs, however, it is a reminder that, in our financial system, banks/broker-dealers supply the financial plumbing and in some cases the water (money and securities) that flows through the pipes. When the pipes freeze and/or burst, the damage can be widespread, impacting investor clients, the FIs themselves, shareholders, fund shareholders and ultimately any organization that relies on credit to manage its business – which includes most firms. Insurance can help mop up the mess for some, but those exposed must be sure that their coverage is as absorbent as they assumed at the time of purchase.

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3 Ibid.
5 Ibid.
6 Ibid.