SIFMA

Securities Industry and Financial Markets Association

Written Testimony

of

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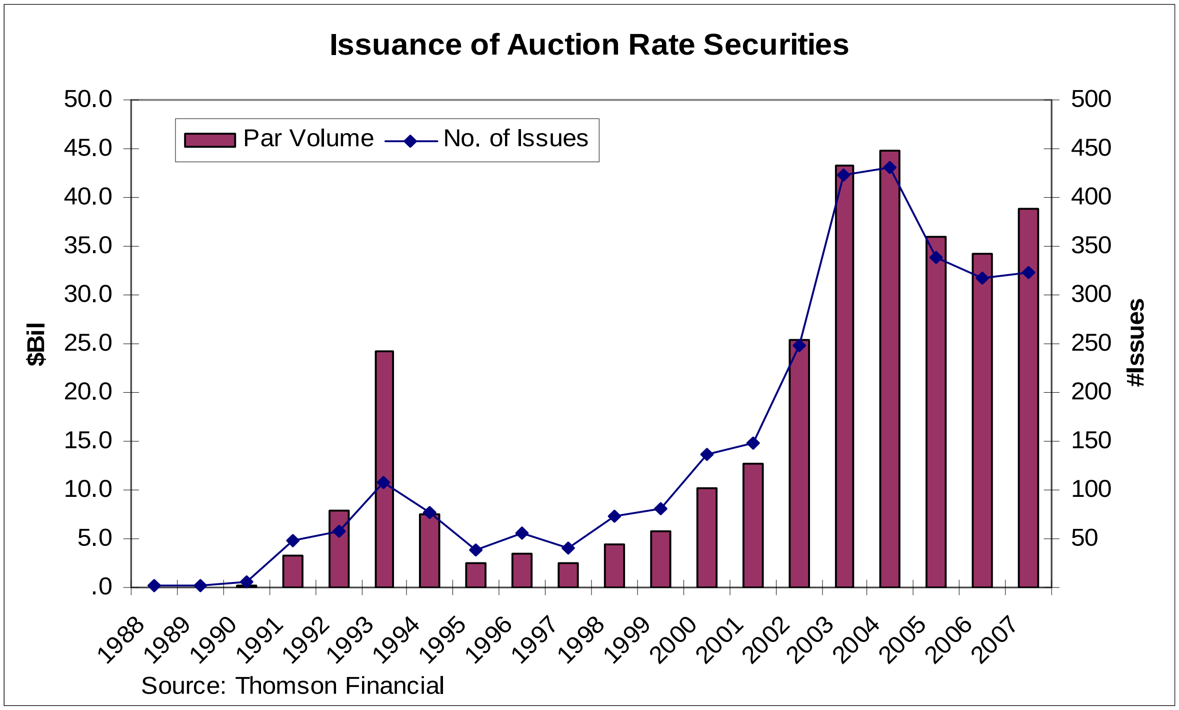
Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. My name is Leslie Norwood and I am Managing Director and Associate General Counsel of the Securities Industry and Financial Markets Association[1]. I serve as the staff advisor to SIFMA's Municipal Securities Division. Thank you for the opportunity to testify before you on the Auction Rate Securities (ARS) market.

I. Background: Auction Rate Securities Market

Auction rate securities are investment vehicles, typically with a 20-30 year maturity, with interest rates or dividend rates that reset through bidding at predetermined intervals. There are two types of auction rate securities—debt and preferred stock. The Auction Rate Securities (ARS) market is made up of auction rate bonds (ARBs), including municipal ARBs and student loan ARBs; auction rate preferred securities (ARPS) issued by closed-end mutual funds; and collateralized loan obligations (CLOs) and collateralized mortgage obligations (CMOs). ARS were first used in 1984 and historically, state and local governments, student loan financing authorities and closed-end mutual funds routinely opted to issue ARS, because they provided the lowest cost of financing with the most flexibility. Nearly $307.2 billion in municipal ARS have been issued since 1988[2]. Auction rate bonds offered issuers an attractive cost of financing, as low as 3.66 percent in October 2007, a maturity of thirty-years or longer, and the flexibility to call the bond at any time. ARPS offered closed-end funds the ability to leverage their assets and reinvest proceeds in the funds' long-term portfolios.

[1] SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information may be found on our website: http://www.sifma.org.

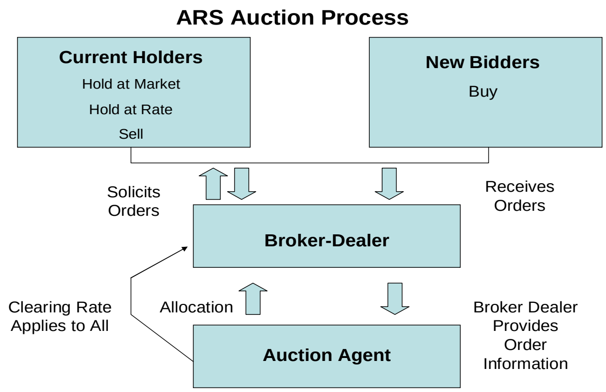
[2] Source: Thomson Financial



ARS investors included institutional investors and retail investors. ARS were issued and remain highly-rated investments because they are backed by state and local governments' taxing authority, revenues from student loan financing authorities, 501c3s and the assets of closed-end mutual funds. Closed-end funds are required by the Investment Company Act of 1940 to have at least $2 of assets for each $1 of preferred stock issued.

The Auction Process

The auction process was designed to offer investors the opportunity to sell ARS as frequently as daily, weekly or monthly. The frequency of the periodic auctions varies, with common interest rate reset periods being daily, 7 days, 28 days, 35 days, 49 days and six months. Under some auction rate securities programs, the issuer may change the interest rate reset period to a multi-year period. The auction is a competitive bidding process in which investors submit orders through a broker-dealer. An ARS auction is different from other types of auctions in that the bid that clears the auction is the price for everyone who owns the security. Clearing an auction means that there are now enough bids, at some level, to provide buyers for all sellers. In other types of auctions, such as auctions for Treasury securities, customers will receive an average of the auction's accepted competitive bids.



Some Auction Rate Securities programs have a single broker-dealer and some have multiple broker-dealers. The total number of bonds or shares available to auction at any given period is determined by the number of investors who wish to sell or hold ARS. During the auction, at each interest rate reset date, ARS holders may submit orders to the broker-dealer to hold their securities no matter what the rate is; to hold them only if the clearing rate is at or above a specific number; or to sell or buy them. A "hold at any" bid indicates the ARS holder will hold the existing position regardless of the new interest rate. These securities are not included in the auction. A "hold at rate" bid signals the ARS holder will hold his/her securities at a specified minimum rate. If the clearing rate is lower than the specified rate, the holder is obligated to sell the securities they hold. If the ARS holder wishes to "sell" his securities, he/she requests to sell the existing position regardless of the interest rate set at the auction. Investors wishing to "buy" ARS specify to their broker-dealer the number of shares, typically in denominations of $25,000, they wish to purchase at the bid rate, or the interest rate payable on the securities which they are willing to accept.

The broker-dealer then conveys the bids to the auction agent. The auction agent, typically a third-party bank selected by the ARS issuer, collects all bids and ranks them from the lowest to the highest minimum bid rate. If there are any sell orders, the auction agent then matches bids to purchase with the minimum bid rate and successively higher rates until all sell orders are filled.

The lowest bid rate at which all shares can be sold at par establishes the interest rate, or the clearing rate. The clearing rate is the interest rate or dividend rate paid on the entire ARS issue until the next auction date. If there are more offers to buy than securities to be purchased existing holders receive preference over new bidders at the same rate. Once the clearing rate has been determined, the auction agent notifies the issuer's paying agent of the rate, which will be effective the business day following the auction. The transactions are then settled by the broker-dealers representing the buyers and sellers the next day. In the case of an auction occurring daily, the clearing rate becomes effective the same day and the transactions are settled that day. Investors who bid a minimum rate above the clearing rate receive no securities while those whose minimum bid rates were at or below the clearing rate receive the clearing rate for the next period.

An auction fails if there are more sellers than buyers for the securities. In a failed auction, all of those looking to sell cannot sell and must hold the securities until the next successful auction. The interest or dividend rate resets at the maximum rate as established in the ARS program documents. For ARPS, the general guidelines for the maximum rates are established in the prospectus. General guidelines often include a rate around 150 percent of the AA rated comparable commercial paper, 125 percent of comparable LIBOR rate, or approximately 4.1 to 4.4 percent. For other ARS, the maximum rate is often determined by a certain percentage of LIBOR, an index of comparable Treasury securities, or a specified fixed percentage rate.

It is important to remember that a failed auction is not a default. It is a result of a supply and demand imbalance. Security holders continue to receive interest and dividend payments. However, they are forced to hold their securities until the next successful auction. The maximum rate is designed to compensate the investor for this loss of liquidity and to encourage the issuer to redeem or restructure the securities.

A secondary market for some auction rate bonds develops between auction dates. In the secondary market, securities can be traded between interested clients at a discount from par value with accrued interest.

2006 SEC Settlement

Beginning in 2004, the Securities and Exchange Commission (SEC) conducted an investigation of ARS underwriting practices and bidding processes. In 2006, the SEC settled with fifteen broker-dealer firms for auction practices that were not adequately disclosed to investors. Examples of the types of auction practices the SEC found include broker-dealers failing to disclose that they were intervening in auctions by bidding for a firm's proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a market rate or to prevent all-hold auctions and submitting or changing orders or allowing customers to submit or change orders, after auction deadlines.

SIFMA Best Practices for Broker-Dealers of Auction Rate Securities

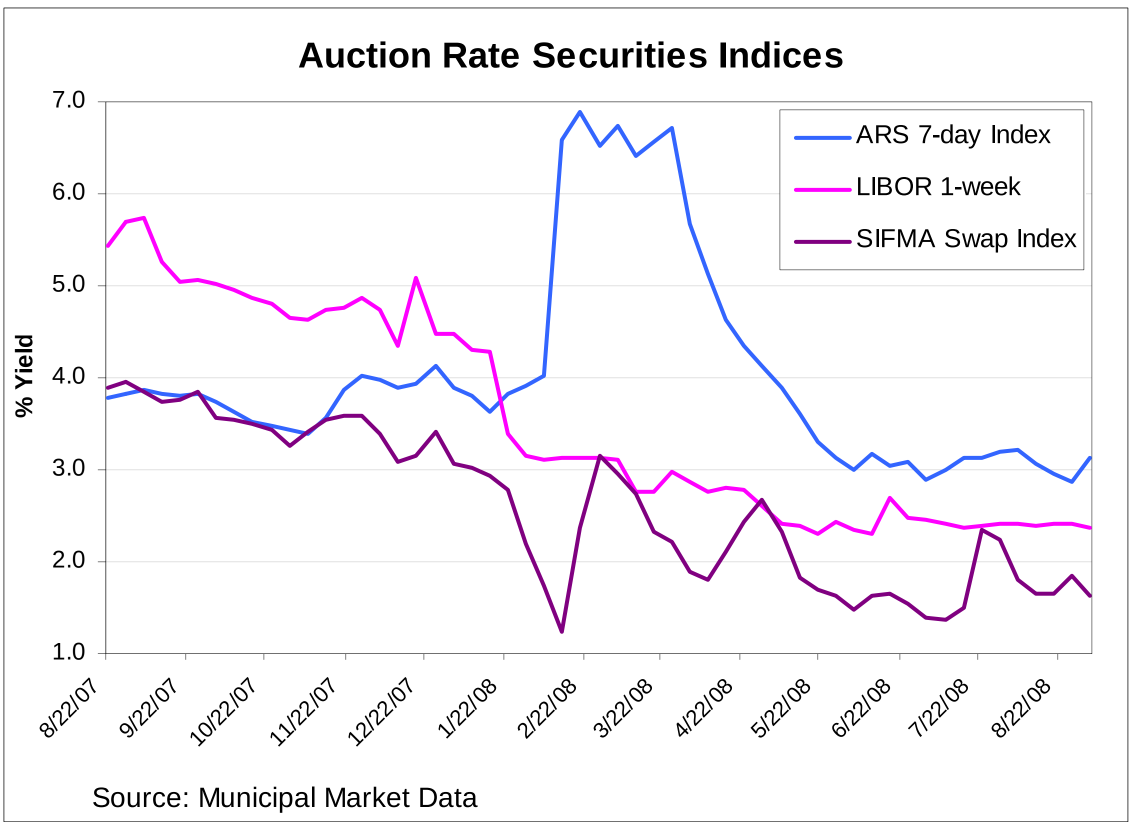
In light of the settlement, SIFMA developed the Best Practices for Broker-Dealers of Auction Rate Securities[3]. The Best Practices for Broker-Dealers of Auction Rate Securities are voluntary, they are not regulations; they were developed by a task force composed of traders, lawyers and compliance officers from SIFMA member firms who acted as broker-dealers in connection with auction rate securities programs. The Best Practices describe the way the auction rate market works, the role of the broker-dealer, and how clearing rates are determined. SIFMA also prepared model auction procedures that may be used by issuers, broker-dealers and auction agents. The model auction procedures are designed to be consistent with the Best Practices and may be used as an exhibit to standard deal documents for auction rate securities. SIFMA also created sample disclosure language regarding the role of the broker-dealer in auctions and a note to bond counsel regarding certain other auction procedures for auction rate securities. SIFMA's model auction procedures, the final version of the Best Practices, the

[3] SIFMA's Best Practices for Broker-Dealers of Auction Rate Securities.
http://www.sifma.org/services/pdf/AuctionRateSecurities_FinalBestPractices.pdf

standard disclosure language and the accompanying note to bond counsel are available on our website www.sifma.org.

SIFMA Auction Rate Securities Indices

SIFMA also created the SIFMA Auction Rate Securities Indices to serve as a benchmark for issuers and investors. The SIFMA ARS Indices were constructed and are maintained through a partnership between SIFMA and Thomson Municipal Market Data (MMD), a division of Thomson Financial. MMD works with auction agents and broker dealers to collect the relevant data, maintain the data and make the index calculations. SIFMA and MMD provide tax-exempt indices—including a 7-day index, a one month index, a state index, preferred issues 7-day, preferred issues one month and a preferred issues state—and taxable indices—including a one-month index and a 7-day index. A weekly report is available to market participants and the SIFMA ARS Indices values are available on SIFMA's website. www.sifma.org



II. Deteriorating Credit Markets, the Resulting Failed Auctions, and the Increased Cost of Capital

The credit crisis over the last eighteen months is like none we have experienced before. Conditions have changed dramatically since the middle of 2007. According to the President's Working Group on Financial Markets (PWG) Policy Statement on Financial Market Developments,

> "Since mid-2007, financial markets have been in turmoil. Soaring delinquencies on U.S. subprime mortgages were the primary trigger of recent events. However that initial shock both uncovered and exacerbated other weaknesses in the global financial system. Because financial markets are interconnected, both across asset classes and countries, the impact has been widespread."[4]

As problems in the mortgage market spread into the mortgage securitization market in 2007, faith in the monoline insurers who insured mortgage bonds and collateralized debt obligations began to waiver. Investors became wary of being exposed to anything with the potential for downgrades, including any securities insured by the monoline insurers and third-party credit enhanced bonds in general. Because of the critical role the insurers and third party credit enhancers play in the auction rate securities market, demand for ARS began to decline sharply, ultimately resulting in failures across the auction rate securities market; in spite of the fact the underlying credit ratings of ARS issuers have remained high. As for the role of the broker-dealer, broker-dealers often supported the market by bidding themselves in auction to prevent a failed auction. Broker-dealers, however, were and are not obligated in any way to support an auction. In the 2006 settlement, the SEC required dealers to make disclosures about auction practices and procedures, which include information such as the fact that dealers are not required to put in a bid or order and that there is no assurance about the outcome of any auction. As the demand for ARS began to evaporate in 2007, many broker-dealers purchased ARS in order to support auctions and prevent failed auctions. As the credit crisis began to impact the liquidity

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[4] President's Working Group on Financial Markets, "Policy Statement on Financial Market Developments," March 2008.

and capital of firms and their inventory of supported auctions increased, many firms did not have the capacity to continue to support the ARS market.

In the second half of 2007 as the credit markets tightened, the demand for ARS and other variable rate securities began to show signs of decline and the number of failed auctions increased. While this is not the first time auctions have failed, this is the first time a significant portion of the auction rate securities market has failed. Between 1984 and 2006, thirteen failed auctions were recorded out of thousands of auctions. In the second half of 2007, estimates show there were 31 failed auctions[5]. On February 22, 2008, 258 of 386 auctions of publicly offered bonds failed, or 67 percent. About 87 percent of auctions on February 14 failed. By February 20, the fail rate declined to about 66 percent.[6] The issues in the auction rate securities market are unprecedented and unexpected and flow from overall issues in the financial markets. For the most part, ARS issuers are still, to this day, making the interest and principal payments as they come due.

For both issuer and investor, ARS were an attractive financing tool and investment vehicle respectively. While SIFMA cannot speak to the specifics of the sales and marketing practices of individual firms, it is fair to say there were some deficiencies in the market. While I am sure you will hear many anecdotes of sales and marketing practices, it is important to remember the liquidity issues in the ARS market are a result of the ongoing credit crunch and not sales and marketing practices. As the Committee is aware, several firms have settled, or are in the process of negotiating settlements to buy back ARS to provide liquidity to investors.

The failures of ARS have left investors to hold their auction rate securities. Many state and local issuers face steep increases in their cost of capital. For instance in February 2008, auction rate securities issued by a state student loan financing authority reset at 18 percent, up from the previous clearing rate of 5 percent in January 2008. Some state and local government issuers

[5]Frantz, Blaine and Fitzpatrick, Bill. "Prolonged Disruption of the Auction Rate Market Could Have Negative Impact on Some Ratings." Moody's Investors Service. February 20, 2008. p.2.
[6] Cooke, Jeremy, "Florida Schools, California Convert Auction-Rate Debt." Bloomberg.com. February 22, 2008.

found their securities resetting at a rate as high as 20 percent. The high maximum rates on these securities were an example of the product functioning as expected in failed auctions, and as agreed to by issuers in the ARS program documents. The high interest rates compensated the holders for their loss of liquidity as well as encouraged issuers to refund these securities into a more cost effective form of debt.

While there have been a number of failures in the student loan ARB market, it is important to note the primary cause of the unavailability of student loan credit has been the higher costs of financing loans in the secondary market and the reduced federal government payments enacted last fall. Over the past six months, turmoil in the debt capital markets and the reductions of federal guarantee rates and special allowance payments of Federal Financial Education Loan Program ("FFELP") loans caused significant concern regarding the availability of student loans. Unlike most other forms of consumer credit, the interest rates charged to students on FFELP loans are set by law, so lenders are not able to recoup any additional costs in the FFELP loans they originate. But for the few issuances of securities that have been put into the market this year and backed by FFELP Stafford and PLUS loans that are already at least 97% government guaranteed, the spreads on the AAA-rated tranches have widened by 150 basis points, or roughly 15 times the levels seen in the summer of 2007. Yet, the credit performance of the student loans with a government guarantee has not deteriorated at all, further evidencing the unprecedented and extraordinary liquidity crisis the U.S. faces.

III. What Have We Done?

Regulatory Action for Municipal ARS

In response to the increased failures in the auction rate securities market and the number of municipal issuers who were considering converting their auction rate securities into other debt instruments, SIFMA sent a letter on February 13, 2008 urging the Treasury Department to simplify the reissuance standards for state and local bonds. In response to SIFMA's request, the Treasury Department released Notice 2008-27 in March providing that the conversion of bonds from an ARS mode to a fixed rate at a maturity that occurs under the existing bond documents will not result in a reissuance. The Notice provides generally that auction rate securities will be treated as a form of qualified tender bonds, which are protected from reissuance treatment in their ordinary rate-setting procedures. This is important, because depending on the exact situation, a reissuance could have various tax consequences, from the need to file a new report with the IRS to technical changes in applicable requirements for tax exemption. The Notice also provided that the issuance of new bonds to retire existing ARS bonds would not constitute a reissuance if the transaction occurs in the context of an exchange of new bonds for the old bonds. On March 25, the IRS issued Notice 2008-41, which further clarifies Notice 2008-27. Notice 2008-41 allows an issuer of auction rate securities to purchase them and hold them for up to 180 days without causing the purchase to be treated as a retirement of the bonds and any subsequent remarketing to be treated as a reissuance. The 180-day rule is temporary and expires on September 30, 2008.

SIFMA received, in response to a February 21, 2008 request, a "no action" letter from the Securities and Exchange Commission (SEC) allowing municipal issuers and conduit obligors to bid into its own auctions or purchase their own ARS from dealer inventory. There had been, in light of the 2006 SEC settlement, concern that the participation of an issuer in an auction of their own securities would be construed by the SEC to constitute market manipulation or that a broker dealer's participation in an auction on behalf of an issuer would violate any consent order it may have with the SEC on ARS. SIFMA later met with SEC staff to get clarification on certain points in the no action letter and released a clarifying memo on April 8. This no-action letter, which we solicited, allowed issuers with capital reserves to bid for their own securities, and in many cases, those bids caused their auctions to clear again, reducing the high interest rate levels to average rates.

Regulatory Action for Auction Rate Preferred Securities

Auction rate preferred securities (ARPS) issued by closed-end funds are not marginable—broker-dealers must allocate 100 percent of net capital on amounts they lend against these securities. To address the liquidity needs of customers holding auction rate securities, SIFMA and its member firms asked FINRA to provide temporary relief to the net capital requirements. On April 11, FINRA released an interpretive letter authorizing firms to offer non-purpose loans collateralized by ARPS backed with a line of credit from a bank and subject to certain requirements and conditions. To address the pull back by banks in extending credit collateralized with auction rate preferred securities, SIFMA and its members asked for some relief from the large amounts of net capital needed to finance such loans. FINRA temporarily allowed broker-dealers to extend credit on ARPS in amounts up to 25 percent of a firm's excess net capital without having to apply a net capital charge for the credit extended, even though the firm had not obtained a bank loan for the aggregate amount of credit extended. This made available a small amount of money to redeem ARPS.

As closed-end funds sought to restructure their outstanding ARPS, they found themselves limited by legal restrictions. Closed-end funds are restricted in their ability to redeem securities under the Investment Advisers Act of 1940. Several closed-end funds sought relief from the SEC in order to be able to issue a new class of preferred securities. On June 13, the SEC granted no action relief to Eaton Vance Management in connection with the issuance by its closed-end funds of a new class of preferred stock. The no action letter allows closed-end funds to offer liquidity protected preferred shares (LPP) to finance the repurchase or redemption of their outstanding auction rate securities. The LPP also include a put feature that would allow money market funds to purchase them. Auction rate preferred securities are generally not eligible for purchase by money market funds, or 2a-7 funds, because of maturity and quality requirements imposed on money market investments.

On June 13, 2008, the IRS provided guidance regarding the tax treatment of variable rate demand securities like LPP. Notice 2008-55 provides that the IRS will not challenge the equity characterization of auction rate securities, such as LPP. This is important, because if the auction rate securities were treated as debt for U.S. federal income tax purposes, payments on these securities will be characterized as exempt-interest dividends and not taxable interest. The IRS issued revised Notice 2008-55, which eased some of the minimum criteria that closed-end funds and liquidating partnerships must satisfy in order to obtain the protection of the Notice.

Exemptive Relief for Individuals Invested in ARS in IRAs and Qualified Plans

SIFMA and its member companies have sought exemptive relief for individuals invested in ARS in an Individual Retirement Account (IRA). Many of SIFMA's member companies have applied for exemptive relief from the Department of Labor (DOL) and it appears the DOL has tentatively concluded it will propose relief for certain sales and exchanges at par value for certain loans bearing a reasonable rate of interest, not to exceed the interest rate paid, at each relevant point in time, on the ARS. While the DOL guidance would be helpful, it is likely that IRA investors will not take advantage of the exemption unless Treasury determines that there will not be negative tax consequences. In a July 25 letter, SIFMA respectfully requested guidance from the Treasury Department and it is currently under review by the Internal Revenue Service.

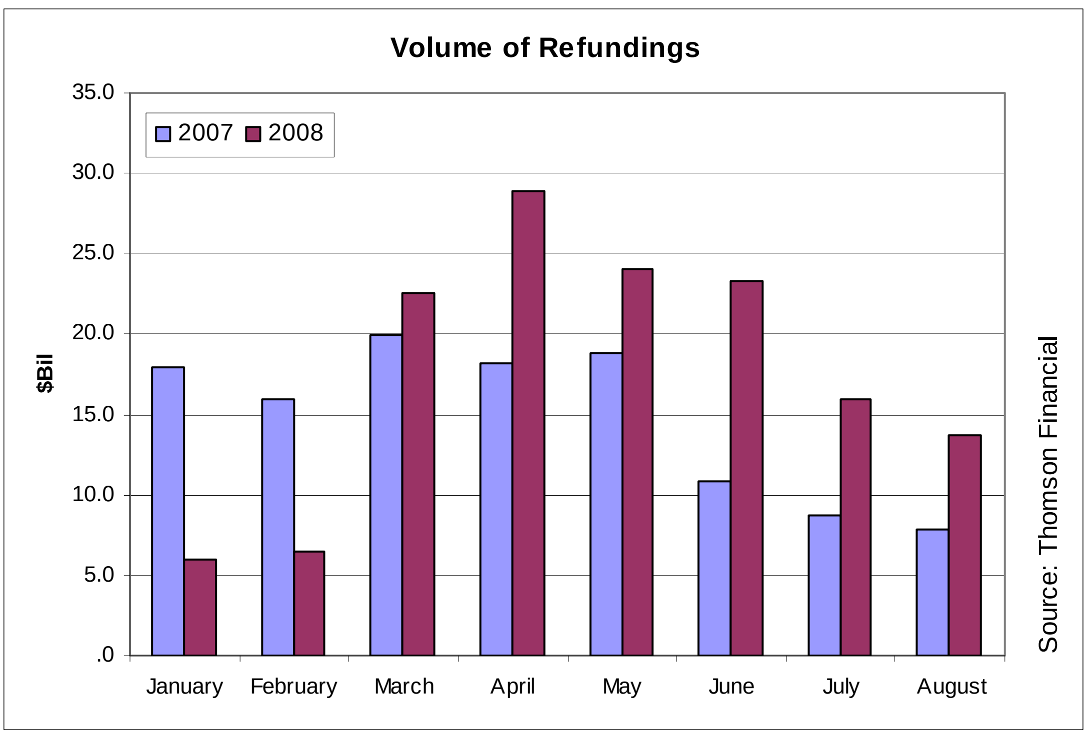
Additional Transparency in the ARS Market

SIFMA filed comment letters with the Municipal Securities Regulatory Board (MSRB) in April and June expressing its support for the MSRB's proposal to develop transparency in the auction rate securities and variable rate demand obligation (VRDO) markets. SIFMA expressed strong support for the MSRB's proposal to develop a website that would display information on the results of auctions of auction rate securities and VRDOs. We encouraged the MSRB to create and launch the website as soon as possible using information that is readily available. During its July 18 board meeting, the MSRB approved a plan to develop a system to collect and disseminate critical market information on auction rate securities and variable rate demand obligations. The MSRB will implement a phased-in system with the implementation of the first phase estimated for first quarter 2009. SIFMA strongly supports the MSRB's decision and its ongoing progress on efforts to increase transparency of certain data elements related to auction rate securities and variable rate demand obligations. The MSRB also recently released a notice clarifying the requirements of broker-dealers buying back auction-rate securities from their customers reporting the purchases to the Municipal Securities Rulemaking Board's Real-Time Transaction Reporting System.

IV. Current Market Conditions

Various regulatory initiatives provided by the SEC, Treasury, the IRS, FINRA and the MSRB have aided the efforts of market participants to provide liquidity in the auction rate securities market.

In the municipal ARS market, many issuers have restructured or refinanced their ARS securities. Depending on the terms of the original bond documents, municipal issuers may restructure their auction rate security into variable-rate demand notes (VRDN). A VRDN is a variable rate bond that includes a "hard put" or "tender option" to require either the issuer or a third party agent to purchase the bonds, typically at par at certain designated times. The volume of refundings in 2008 is up significantly from 2007. In August 2008, the volume of refundings was almost two times that of the same period in 2007.



The ongoing credit crunch continues to threaten the availability of student loan credit. The combined effect of last year's significant incentive reductions with the current high cost of credit in the capital markets has increased substantially the potential for severe disruption in the availability of student loans through the FFELP.

The SEC's "no action" letter and IRS Notice 2008-55 have aided efforts by closed-end funds to repurchase and redeem auction rate preferred securities. However, the market continues to be affected by the ongoing tightening in the credit markets. Closed-end funds must find financing sources and implement solutions to balance the interests of both common and preferred shareholders. Some refinancing alternatives used by closed-end funds include establishing committed borrowing facilities, the issuance of extendible money market-eligible notes backed by a Letter of Credit, and reverse repurchase transactions.

While some liquidity is returning to investors in the ARS market and a number of ARS programs are clearing at rates lower than the maximum rates, many challenges remain. Over the last few months, a number of firms and banks have offered to buy back auction rate securities at par value from customers including retail investors, charities and small to mid-sized businesses. Many firms are facing capital limitations as a result of the continuing credit crunch. They have limited funding available to buy back outstanding ARS. Many broker-dealers also face regulatory constraints. If a broker-dealer holds inventory of a particular ARS issuer, the affiliated bank is limited in how much credit assistance it can offer a distressed issuer because of Federal Reserve Regulation W (Reg. W) implications. The credit assistance is deemed to be direct assistance to the broker-dealer affiliate, which has capital cost implications. Under Reg W, which applies to all federal insured depository institutions, covered transactions with all affiliates cannot be more than 20 percent of the bank's capital. This severely limits the ability of broker-dealer with bank affiliates to take some of the ARBs out of the market. A safe harbor for these firms would allow more banks to buy back some of the outstanding ARS.

Auction rate securities were an attractive source of funding for state and local governments, student loan financing authorities, and closed-end funds for over two decades. They provided low cost financing with the most flexibility. Until 2007, failed auctions were uncommon. But the tightening of the credit markets and the desire of investors to avoid investment options connected to the monoline insurers and third-party credit enhancers, led to a sharp decline in demand for ARS in 2007, ultimately resulting in failures across the ARS market. The broker-

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dealer community is working to provide liquidity to the ARS market and to assist issuers in refinancing and restructuring their ARS into more attractive investment options as quickly as possible, but the continuing credit crisis makes it unlikely a full return of liquidity to the ARS market will happen in the near term.

Thank you for the opportunity to testify before you today.