

**MEMO# 22910**

September 24, 2008

# House Financial Services Committee Hearing On Auction Rate Securities Market

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 40-08  
SEC RULES MEMBERS No. 99-08  
TAX MEMBERS No. 36-08  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 28-08  
FIXED-INCOME ADVISORY COMMITTEE No. 28-08 RE: HOUSE FINANCIAL SERVICES  
COMMITTEE HEARING ON AUCTION RATE SECURITIES MARKET

The House Financial Services Committee recently held a hearing to review problems and potential resolutions with respect to the auction rate securities (“ARS”) market. Linda Thomsen, Director, Division of Enforcement, SEC; Susan Merrill, Executive Vice President and Chief of Enforcement, FINRA; William Galvin, Secretary of the State of Massachusetts; Martha Coakley, Massachusetts Attorney General; and William Adams IV, Executive Vice President, Nuveen Investments, testified, as did several other witnesses. [\[1\]](#) The testimony of the regulators and Nuveen is summarized below.

## SEC Testimony

Ms. Thomsen primarily discussed the Commission’s enforcement-related efforts with respect to sales of ARS. She highlighted the settlements-in-principle reached with several firms that sold ARS to their customers and how the settlement terms reflected the Commission’s goal to restore liquidity to the holders of ARS as quickly as possible. She

noted that the Commission staff is now finalizing the settlement terms with the firms, which it intends to recommend to the Commission for approval.

Ms. Thomsen also noted that some closed-end investment companies have applied to the Commission for temporary exemptive relief from the Investment Company Act of 1940 to allow them to issue debt, the proceeds of which would be used to repurchase their outstanding ARS. She noted that the relief, if granted, would apply for a period of two years and that the Commission is currently considering that request for exemptive relief and anticipates taking action on it soon. Finally, she noted that the staff already has issued a no-action letter regarding closed-end fund ARS [\[2\]](#) and that it is considering additional actions to assist funds in the process of restoring liquidity.

## FINRA Testimony

Ms. Merrill discussed FINRA's use of its surveillance, enforcement, and regulatory tools to detect and deter abusive sales practices in the ARS market. In particular, she noted that FINRA sent out two sweep letters to broker-dealer firms seeking information about their ARS sales practices, their supervision of the activities of firm employees in the ARS market, and the firms' overall supervisory systems and controls as they relate to these issues. As a result of the sweeps, FINRA has opened nearly 50 enforcement inquiries. The focus of FINRA's inquiries relates to, among other things, ARS marketing materials; supervisory issues surrounding the purchases and sales of such securities; and possible conflicts of interest where a firm may have been in possession of knowledge about ARS market failures and liquidated their proprietary positions by selling those positions to customers or ahead of customer liquidations. Finally, Ms. Merrill noted that FINRA is expanding its regular examination procedures to include a more detailed analysis of ARS.

## Massachusetts Testimony

Secretary Galvin described the findings of two Massachusetts investigations of firms that sold ARS, lessons learned from those, and another, Massachusetts investigation, and proposals for preventing such problems in the future. In particular, Secretary Galvin recommended: (1) more aggressively monitoring and, when appropriate, disclosing to investors conflicts of interest between a firm and its clients; (2) disclosing more comprehensively financial adviser incentives with respect to products sold; (3) enhancing training of financial advisers with respect to products sold; (4) enhancing the regulation of research reports; (5) not pursuing the replacement of existing detailed, enforceable rules with principle based regulation; and (6) not diluting state enforcement authority in any contemplated regulatory reform package.

General Coakley explained the distinct roles carried out by her and Secretary Galvin's

offices in their ARS related investigations. She also described the results of her office's investigations and provided three recommendations to the Committee: (1) pursuing solutions that provide full par value payment to all investors in ARS; (2) returning monies promptly to these investors; and (3) reviewing ways to lower financing costs for non-profit and governmental issuers of ARS.

## Nuveen Testimony

Mr. Adams discussed Nuveen's use of ARS; the auction market and process generally; auction failures; Nuveen's disclosure regarding potential auction failures; and its refinancing of ARS, including its development of a new preferred stock, Variable Rate Demand Preferred ("VRDP").

Mr. Adams also highlighted several areas where regulatory relief or guidance could significantly accelerate the closed-end fund industry's ability to provide liquidity for preferred shareholders while facilitating new forms of financing for closed-end funds in the future. He recommended, among other things: (1) clarifying the ability of banks to own VRDP pursuant to their purchase obligations as a liquidity provider for VRDP; (2) allowing banks to pledge VRDP as collateral for extensions of credit; (3) the Commission expediting its consideration of exemptive relief requests to temporarily permit closed-end funds to use debt financing to a greater extent than currently permitted; (4) making the requested relief available to all closed-end funds seeking substantially the same relief in the form of a temporary rule; (5) considering permanently changing the Investment Company Act's asset coverage requirements for debt from 300% to 200% in the case of privately arranged borrowings from banks or other financial institutions; (6) permitting money market funds to own a greater amount of the new VRDP; (7) further clarifying the treatment of closed-end fund preferred that includes liquidity backstops as an equity security for tax law purposes; (8) making existing Treasury Department guidance applicable to all funds issuing preferred stock in the future, (not just to those refinancing existing ARS) and to equity funds; [\[3\]](#) and (9) clarifying that funds need not allocate alternative minimum tax income to holders of VRDP.

Dorothy M. Donohue  
Senior Associate Counsel

## endnotes

[\[1\]](#) Also testifying at the hearing were Leslie Norwood, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association; Roger Scherr, Vice President, Scherr Development Corporation; Tara Payne, Vice President for Corporate Communications, New Hampshire Higher Education Loan Corporation; and James Preston,

President and Chief Executive Officer, Pennsylvania Higher Education Assistance Agency. The written testimony of all of the witnesses is available on the House Financial Services Committee's website at

[http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/hr091808.shtml](http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr091808.shtml).

[2] See Institute [Memorandum](#) No. 22615, dated June 17, 2008 (summarizing the Commission staff's no-action relief).

[3] See Institute [Memorandum](#) No. 22644, dated June 25, 2008 (summarizing Treasury's guidance).

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