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Auction Rate Securities: SEC Releases Guidance on Issuer and Conduit Borrower Bidding in Auctions of Own Securities

As we noted in the previous issue of our National Public Finance Bulletin, several auctions for municipal auction rate securities have failed recently. Upon the failure of an auction, generally, an issuer is required to pay a predetermined rate of interest that can be well above market rates and the current owners are required to hold their auction rate securities. As a result, several issuers and conduit borrowers have considered bidding or having broker-dealers bid on their behalf on their auction rate securities. Many broker-dealers have been reluctant to bid on behalf of an issuer or conduit borrower because of the cease and desist orders issued by the Securities and Exchange Commission (SEC) beginning in May 2006 against several

broker-dealers and auction agents for participating in several practices in the auction rate securities markets that, according to the SEC, violated certain federal securities laws. These practices included bidding to prevent auction failures without making adequate disclosure that such bidding was going to take place.

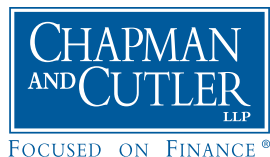
On March 14, 2008, the SEC issued guidance in an attempt to address the concerns of municipal issuers, conduit borrowers and broker-dealers, acting on behalf of such issuers and conduit borrowers, regarding bidding on auction rate securities issued

by such issuers. In light of the cease and desist orders, the SEC set forth its views on some of the circumstances under which, consistent with certain federal securities laws, parties may participate in bidding in a municipal auction as follows:

- an issuer of municipal auction rate securities may submit a bid in an auction for such securities;
- a conduit borrower may submit a bid in an auction for municipal auction rate securities that are payable from amounts due from such conduit borrower; and

“Many broker-dealers have been reluctant to bid on behalf of an issuer or conduit borrower because of the cease and desist orders issued by the Securities and Exchange Commission...”

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- a broker-dealer or auction agent may accept and process a bid from any such issuer or conduit borrower.

The SEC limited its guidance to only municipal securities exempt under Section 3(a)(2) of the Securities Act and stated that the guidance should not be relied upon with respect to any other securities. It went on to state that auction rate securities and separate securities that are not exempt securities under Section 3(a)(2), such as those issued by corporate entities, certain conduit borrowers and auction rate preferred securities issued by closed-end-funds, involve a variety of registration and other issues outside the scope of the guidance.

In its guidance, the SEC emphasized that the cease and desist orders do not prohibit broker-dealers from bidding for their proprietary accounts *when properly disclosed* and that appropriate disclosure regarding the submission, acceptance and processing of a bid in a municipal auction could consist of the following:

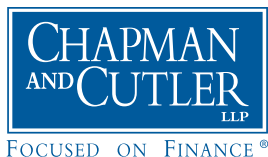
- Disclosure, at least two business days prior to an auction, of the municipal issuer's or conduit borrower's intention to bid in an auction for municipal securities, the intention of broker-dealers to bid on behalf of any municipal issuer or conduit borrower and the interest rate and the amount of securities that will be bid for.
- If a municipal issuer or conduit borrower intends to bid, directly or indirectly through a broker-dealer, for nearly all

(the SEC suggests 90% or more as constituting "all") of the outstanding principal amount of an issue of its municipal auction rate securities, disclosure of any steps the issuer or conduit borrower intends to take to allow remaining holders to sell their securities to the issuer or the conduit borrower following the auction, such as whether the securities will promptly be purchased at par plus accrued interest, if any, from any and all holders who request such a purchase following the auction.

- Disclosure of detailed information regarding bidding in the immediately preceding auction, such as (i) the amount of securities for sale in the auction, (ii) the number and aggregate dollar amount of bids made, (iii) the number of bidders other than the participating dealers, the issuer or conduit borrower, (iv) the number, interest rate or rates, and the amount of bids, if any, made by the participating dealers, the issuer or the conduit borrower, (v) the clearing rate and (vi) the high, low and median bids received.
- Disclosure of any steps to avoid an auction leading to a below market clearing interest rate, such as whether the rate or rates bid would not be less than an appropriate benchmark (for example, the relevant SIFMA municipal swap index).
- Prompt disclosure following the auction of detailed information concerning the bidding that occurred, such as that described in the third bullet point above.

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National Public Finance
Bulletin has been prepared by the Chapman and Cutler LLP National Public Finance Group for Firm clients to highlight recent developments affecting the public finance industry. Legal advice requires a detailed analysis of the particular facts of each situation and transaction. Accordingly, the items contained herein are not intended as legal advice and readers should contact an attorney with regard to any specific questions raised by the items in this issue.

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- Timely dissemination of the foregoing disclosures to the public, including provision of these disclosures to nationally recognized municipal securities information repositories and the financial press, coupled with posting on publicly accessible portions of the participating dealers' web sites and the municipal issuer's or the conduit borrower's web site.

The SEC noted that appropriate disclosure, in any particular case, would depend on all the relevant facts and circumstances. Also, the SEC indicated that when considering the relevant facts and circumstances, municipal issuers, conduit borrowers and participating dealers should consider whether bidding on one's own auction rate securities is permissible under the contractual arrangements governing the particular municipal auction rate securities, consistent with the issuer's or conduit borrower's disclosure documents and permissible under federal securities laws, state laws or the rules of any self-regulatory organization.

In the final section of its guidance, the SEC stated that "Consistent with [such cease and desist orders] and consistent with Section 17(a) of the Securities Act of 1933, Sections 10(b) and 14(e) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, the Staff would not recommend enforcement action to the Commission under the circumstances outlined in [the guidance] if Municipal Issuers, Conduit Borrowers, participating dealers and auction agents participate in bids for municipal auction rate securities." The

SEC was careful to note that its guidance is an expression of the position of the Staff of the Division of Trading and Markets and Corporation Finance on enforcement action only and does not represent a legal conclusion regarding the matters discussed therein or the applicability of any other federal or state law, or rules of any self regulatory organization.

Consistent with the cautionary statements by the SEC that its guidance does not override contractual prohibitions regarding participation in bidding on auction rate securities, issuer's and conduit borrowers should remain mindful of other considerations in bidding on and holding auction rate securities, including extinguishment of debt and tax

reissuance concerns. Furthermore, the SEC's guidance was narrowly scoped to provide assistance to municipal issuers, conduit borrowers and broker-dealers participating in municipal auctions. The guidance did not address other areas of concern for such participants such as purchases and

sales of auction rate securities outside the auctions, i.e., in the secondary market. While the guidance was helpful in understanding the SEC's views regarding the limitations on broker-dealers resulting from the cease and desist orders, further guidance would be useful to address other concerns of auction rate securities participants who face economic challenges in this time of market turmoil.

For additional information on the SEC guidance described in this issue of the NPF Bulletin, please contact your regular Chapman and Cutler attorney or the author of this article, Rich Hagen, at (312) 845-3765 or rhagen@chapman.com.

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