TESTIMONY
OF

ERIK R. SIRRI
DIRECTOR, DIVISION OF TRADING AND MARKETS
U.S. SECURITIES AND EXCHANGE COMMISSION

MUNICIPAL BOND TURMOIL:
IMPACT ON CITIES, TOWNS AND STATES

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 12, 2008

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Testimony Concerning
Municipal Bond Turmoil: Impact on Cities, Towns and States

by Erik R. Sirri
Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

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Chairman Frank, Ranking Member Bachus and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about the current turmoil in the municipal bond market, its impact on cities, towns and states, and the Commission's responses.

There is no question that the recent dislocations in the municipal bond markets have created unanticipated hardships for municipal issuers and in some cases dramatically increased their borrowing costs. Today I'd like to discuss some of the current problems in the municipal bond markets, with particular attention to problems that have developed in the market for certain short-term municipal securities known as auction-rate securities and variable rate demand notes.

The municipal markets have become much larger, more diverse, and more complex in recent years. There are over $2.4 trillion of municipal securities outstanding. More than $487 billion of new bonds and notes were issued last year. Despite its reputation as a "buy and hold" market, trading volume is also substantial, with over $6 trillion of long and short-term municipal securities traded in 2007. There are more than 50,000 state and local issuers of municipal securities, and two million separate bonds outstanding.

Individual investors are now significant investors in municipal securities, accounting for over one-third of the direct holdings of municipal securities, and that's not counting their indirect holdings through mutual funds, money market funds, and closed-end funds, which account for about another third of the market. And many non-traditional buyers, such as hedge funds, have become active participants in the market.

In addition, issuers of municipal securities have in recent years greatly increased their use of sophisticated financing arrangements, interest rate swap agreements and other derivative financial products in connection with municipal securities offerings. The widespread use of complex products by municipal issuers raises concerns about risks to investors, markets, and taxpayers.

However, at this time I would like to turn my attention to the latest serious problem in the municipal securities markets, auction-rate bond failures. Auction-rate securities are municipal bonds, preferred stocks and other instruments with interest rates or dividend yields that are

periodically re-set through auctions, typically every 7, 14, 28, or 35 days. Auction-rate bonds are usually issued with maturities of 30 years, but the maturities can range from 5 years to perpetuity. Auction-rate securities were first developed in 1984, and the market has grown to $325 to $360 billion of securities, with state and local governments accounting for about $166 billion of the outstanding auction-rate debt.

As you know, hundreds of auctions for auction-rate securities issued by municipal issuers recently have failed to obtain sufficient bids to establish a clearing rate. Consequently, issuers who decided to use this type of financing to obtain favorable short-term interest rates are instead paying what are known as "penalty" interest rates as high as 20 percent, at least until the next auction. In addition, investors cannot sell their holdings through the auction process until the next successful auction. The Commission has received many requests to address this market dislocation, from municipal issuers, conduit borrowers, dealers and investors.

Dealers often market auction-rate securities to issuers as an alternative variable rate financing vehicle. Generally, investors buy auction-rate securities as a higher-yielding alternative to money market mutual funds or certificates of deposit. Some smaller investors also have begun participating in the market. Typically, the minimum investment is $25,000.

Auction-rate securities are auctioned at par so the return on the investment to the investor and the cost of financing to the issuer between auction dates is determined by the interest rate set through the auctions. The interest rate is set through a process in which bids with successively higher rates are accepted until all of the securities in the auction are sold. The final rate at which all of the securities are sold is the "clearing rate" that applies to all of the securities of an offering until the next auction occurs. Bids with the lowest rate and then successively higher rates are accepted until all of the sell orders are filled. The clearing rate is the lowest rate bid sufficient to cover all of the securities for sale in the auction.[1] If there are not enough bids to cover the securities for sale, then the auction is said to "fail," the issuer pays a predetermined penalty or default rate that is generally well above-market rates, and all of the current holders continue to hold the securities (except that, in some cases, sellers are allowed to sell on a *pro rata* basis in the event of a "failed" auction). If all of the current holders of the security elect to hold their positions without bidding a particular rate, then the clearing rate is the "all-hold rate," a below-market rate described in the disclosure documents.[2]

The issuer of each security selects one or more broker-dealers to solicit bids for auctions of particular offerings. Investors can only submit orders through the selected broker-dealers, commonly referred to as participating dealers. The issuer also selects an auction agent to collect the orders and determine the clearing rate for the auction.

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[1] For example, suppose $100,000 of securities were for sale and the auction received four buy bids. Bid A was for $50,000 at 1.10%, Bid B was for $50,000 at 1.15%, Bid C was for $50,000 at 1.15%, and Bid D was for $25,000 at 1.20%. Under these circumstances, the "clearing rate" would be 1.15%, meaning all of the securities in the auction would pay interest at a rate of 1.15% until the next auction. Bid A would be allocated $50,000, Bids B and C would receive pro-rata allocations ($25,000 each), and Bid D would receive no allocation.

[2] All hold rates are typically set by formulas, but may sometimes be fixed rates.

For a variety of reasons, including the current lack of dealer support for auctions and frequent auction failures, many holders of auction-rate securities now want to sell them. Recent downgrades of bond insurers have caused many holders to desire to sell bonds insured by companies who have recently been downgraded or who may soon be. In addition, many holders of bonds insured or supported by the credit of insurers whose ratings have *not* been threatened now wish to sell – which may be due to a general loss in confidence in the municipal auction-rate market. As a result of these factors, among others, we understand that sellers of municipal auction-rate securities have often far exceeded buyers in auctions, resulting in auction failures.

Estimates of the value of the recent failures of auctions for municipal auction-rate securities exceed $80 billion. Prior to the current disruption in the municipal auction-rate market, participating dealers retained to solicit bids for the auctions generally supported the liquidity of the municipal auction-rate securities market by placing proprietary bids, as necessary in order that auctions not "fail," and disclosed the fact that they might do so. However, in recent weeks, for a variety of reasons, including liquidity concerns and uncertainty surrounding the monoline insurers, participating dealers have ceased to intervene proprietarily in auctions, with the result that hundreds of auctions have failed.

The current lack of price transparency for auction-rate securities may be exacerbating this situation. Currently, trades of auction-rate securities are reported at par and do not include the "clearing rates" or resulting yields to investors. Reporting of trades at par is not helpful in terms of furthering the availability of pricing information to investors and for issuers. The Municipal Securities Rulemaking Board has been considering rule changes to increase price transparency for this segment of the market, and has been considering requiring dealers to report the resulting yields to investors. The Commission staff now plans to ask the MSRB to consider expanding the scope of this proposal, and consider rule proposals to require dealers in auction-rate securities to report much of the same type of information that is reported in Treasury auctions.

The Commission has an obligation to protect investors in the municipal markets from fraud. Unlike corporate securities, municipal securities are expressly exempted from registration and reporting under the Securities Act of 1933 and the Securities Exchange Act of 1934. Municipal issuers generally do not file any documents with the Commission. There is no mandated line-item disclosure for municipal securities. However, the antifraud provisions of the federal securities laws do apply.

As previously noted in Chairman Cox's letter to the bipartisan leadership of the House Financial Services Committee and Senate Banking Committee last summer, disclosure in the municipal securities market, particularly in the secondary market, is substantially less comprehensive and less readily available than disclosure by public reporting companies. Despite the size and importance of this market, it lacks a variety of the systemic protections found in many other sectors of the U.S. capital markets.

Due to the recent auction failures and resulting higher borrowing costs, we understand that some municipal issuers and conduit borrowers[3] would like to, and in many cases have begun the process to, convert their auction-rate bonds into variable-rate bonds backed by letters of credit or other types of credit enhancement or fixed rate bonds. However, the ability to convert municipal auction-rate securities may be slowed due to heavy demand for such substitute instruments[4] and further overall concerns about the credit markets.

We understand that certain participating dealers may be unwilling to accept bids from issuers in an auction because of questions about the scope of the settlement in a past enforcement action. In May 2006, the Commission instituted proceedings against 15 broker-dealer firms for engaging in violative practices in the auction-rate securities market.[5] The firms consented to the entry of a cease-and-desist order providing for censures, undertakings, and more than $13 million in penalties. The Commission found in that order that, between January 2003 and June 2004, each firm engaged in one or more practices that violated the securities laws. Without adequate disclosure certain respondents bid to prevent auctions from failing. The order does not prohibit broker-dealers from bidding for their proprietary accounts when properly disclosed.

The Commission has received several requests to consider ways to assist issuers with an orderly exit from current market conditions. On February 28, the leadership of this Committee asked the Commission to clarify for the market as quickly as possible that issuers can – within the bounds of applicable laws and regulation – participate in auctions for their own securities. The staff is developing approaches to providing further guidance in this area in light of market developments and the settlement.

Due to the severity and immediacy of the auction-rate market decline and implications for investors, Commission staff is developing appropriate guidance to facilitate orderly markets and continue to protect investors. The guidance would be designed to clarify that, with appropriate disclosures, and compliance with certain other conditions, municipal issuers can provide liquidity to investors that want to sell their auction-rate securities without triggering market manipulation concerns. This may also have the secondary effect of easing the substantial financial burden on municipal issuers and conduit borrowers from unusually high interest rates. It also should facilitate an orderly exit from this market by municipal issuers and conduit borrowers who seek to do so.

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[3] Often, states and local governments issue municipal securities to finance a project to be used primarily by a third party, usually a for-profit entity engaged in private enterprise or a 501(c)(3) organization (referred to as the "conduit borrower"). The security for this type of issue is the credit of the conduit borrower or pledged revenues from the project financed, rather than the credit of the issuer. Many conduit borrowers are non-profit hospitals and private colleges and universities.

[4] According to the Bond Buyer, market sources have said that some banks have already reached their entire yearly capacity for writing letter of credit policies, after just a month and a half; the use of letters of credit increased 244.4% in January over the same month last year, on 66 deals for total volume of $1.55 billion, according to data from Thompson Financial. Dakin Campell, *Interest Rate Swaps Under Scrutiny*," The Bond Buyer, February 20, 2008.

[5] SEC Rel. No. 33-8684, 34-53888 (May 31, 2006).

Enhanced transparency would be a key component of the guidance, as it is to the auction process. For example, if municipal issuers or conduit borrowers want to bid in auctions, they must disclose, among other things, certain facts related to price and quantity. Of course, issuers must comply with their disclosure obligations under the Securities Act of 1933 and the Securities Exchange Act of 1934, as applicable. Staff anticipates that the guidance should remove any hesitancy on the part of broker-dealers and auction agents to allow municipal issuers to bid.

Of course, this guidance cannot modify terms of contracts between buyers and sellers, or contracts between issuers and bondholders, and so municipal issuer bidding could only take place if consistent with the terms of any auction-rate securities as reflected in their respective indentures and governing instruments. The guidance does not address the amendment of the terms of any auction-rate securities in accordance with their governing instruments.

The Commission staff is closely monitoring the potential effects of the developments in the municipal auction-rate securities markets on mutual funds, including money market funds, and closed-end funds. The Commission regulates these investment companies under the Investment Company Act of 1940 and other federal securities laws.

Tax-exempt money market funds, with $465 billion under management, are key investors in municipal securities and part of the $3.3 trillion money market fund industry. Money market funds typically have as their investment objective the generation of income and the preservation of capital. To help meet this objective, they are required by rule 2a-7 under the Investment Company Act to limit the securities in which they invest to high-quality, short-term instruments that the funds' advisers determine involve "minimal credit risks." As a part of this, rule 2a-7 employs NRSRO ratings to determine whether funds may purchase a security.

As much as 30% of the municipal securities currently held by tax-exempt money market funds is supported by bond insurance issued by monoline insurance companies. Some of the securities may be eligible for investment by money market funds because of the insurance that monoline insurers provide. Given the importance of money market funds as investors in municipal securities, some have raised questions regarding the effects of the credit rating conditions in rule 2a-7 on the funds' ability to purchase and hold municipal securities affected by downgrades of monoline insurers.

The Commission staff recognizes that a significant downgrade in a monoline insurer's rating could result in the securities becoming ineligible under rule 2a-7 for investment by money market funds. Also, in the long term, the inability of bond insurers to maintain high credit ratings may restrict the supply of high-quality paper for tax-exempt money market funds.

The credit ratings only create a "floor" below which funds may not invest, however, and constitute one among several risk-limiting conditions of rule 2a-7. Since its adoption in 1982, rule 2a-7 has continued to serve the purposes that the Commission intended. It is notable that, despite the current liquidity crisis, money market funds and their sponsors have not asked the Commission for any changes to the risk-limiting conditions of rule 2a-7, including the credit rating floor.

There are other possible effects that a significant downgrade in a monoline insurer's rating could have on money market funds. The municipal securities they hold include variable rate demand notes ("VRDNs") and tender option bonds ("TOBs") that typically have liquidity backstops, or "puts," that are provided by a financial institution. These liquidity features serve to provide a source of cash to satisfy redemptions by fund shareholders, and also to shorten the municipal bonds' maturities and make them eligible investments for a money market fund.

A significant downgrade could terminate the put, and thus result in money market funds holding long-term securities that would be inappropriate for funds maintaining a stable net asset value. The Commission staff has been in regular contact with fund management companies, which are aware of these risks and have taken steps intended to protect funds and thus fund investors from the loss of these puts.

In addition to money market funds, there are other funds that invest in municipal securities. Most of these are so-called municipal or tax-exempt funds, which are funds that seek to derive most or all of their income from municipal bonds that pay interest that is exempt from federal income tax. The Commission requires funds that call themselves tax-exempt to invest at least 80% of their assets in, or derive 80% of their income from, municipal bonds.

Some tax-exempt funds principally invest their assets in municipal bonds that carry insurance issued by the monolines. These funds generally have the word "insured" in their name and have an investment policy that requires at least 80% of their assets be invested in municipal bonds the payment of interest and principal on which is guaranteed by a AAA-rated insurance company.

Although it is difficult to predict the effect on municipal bond funds of additional rating downgrades of bond insurers, some projections can be made:

- Any overall decline in the value of municipal bonds or insured municipal bonds would be reflected in comparable declines in the value of municipal bond fund shares.

- A more severe downgrade (e.g., from AAA to A) is likely to have a greater effect on the value of municipal bonds and funds than a less severe downgrade (e.g., from AAA to AA).

- A downgrade may present more price risk to an owner of a single municipal bond than to an owner of shares of a diversified municipal bond fund.

- A downgrade may require many insured funds to change their investment policy with respect to the ratings quality of portfolio holdings if those holdings are no longer guaranteed by an AAA-rated insurance company.

Now that I have discussed mutual funds and other investment companies as investors in municipal auction-rate securities, it is important to understand that closed-end funds are also issuers of a particular type of auction-rate securities, called auction-rate preferred securities. The general loss of confidence in the auction-rate markets has spilled over into this market and many of these auctions have failed.

There are important differences in how auction failures have affected municipal and closed-end fund issuers. Although closed-end funds also issue auction-rate securities to obtain financing, they use the financing to leverage their investments in portfolio companies in order to seek higher dividends for the funds' common shareholders. Also, although the funds have been paying penalty rates to their preferred shareholders to compensate them for the illiquidity, the rates are generally much lower than those paid by municipal issuers. In fact, the penalty rates paid by closed-end funds are only slightly higher than the market rates for these securities before the auctions began to fail.

One effect of the relatively lower penalty rates is that the rates are generally not as detrimental to the fund issuers. As long the amount they pay to their preferred shareholders through penalty rates is less than the returns generated from converting the proceeds of the financing, the underlying mechanics continue to work as intended.

That does not necessarily mean that the current status of auction-rate preferred securities will continue, however. Although the closed-end funds pay their preferred shareholders the penalty rate, failed auctions mean that those shareholders may have to continue to hold the securities, which are perpetual, or attempt to sell them on a secondary market at what may be a heavy discount. Preferred shareholders have pressured closed-end fund companies to find solutions to the failed auctions, and the companies have recently begun to contact the Division of Investment Management for guidance.

Due to the special issues raised by the auction failures in the auction-rate preferred securities market, such as those raised by the fiduciary duties owed by funds to both preferred and common shareholders, the staff guidance in the municipal auction-rate securities market may not extend to closed-end fund issuers. The Division of Investment Management continues to assess requests for guidance, however, and to monitor the developments in this area closely.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you might have.