

Important Information about Auction-Rate Securities

What are Auction-Rate Securities?

Auction-rate securities are floating rate debt or preferred securities with long-term maturities issued by municipalities or corporations. The interest or dividend rate is reset periodically (normally 7, 28 or 35 days) through a “Dutch Auction” process. The auction agent receives orders to sell and orders to buy from various broker-dealers (acting for their clients) and determines the lowest interest rate at which all of the securities that have been offered for sale will clear (the “clearing rate”). Because the interest rate is reset frequently, it is typically expected to move in relation to money market rates with a maturity of the relevant reset period and similar credit quality. Most auction-rate securities trade at par and there is no established secondary market for them. They usually are sold in minimum denominations of \$25,000 or more. Most holders of auction-rate securities are institutional investors and high net worth individuals.

Typically in connection with an upcoming auction, investors advise their broker-dealers of (1) the amount of securities they wish to continue to hold, regardless of the clearing rate; (2) the amount of securities they will hold or buy as long as the clearing rate is no lower than their specified rate (and if the clearing rate is lower than their specified rate they are required to sell the securities they hold); and (3) the amount of securities they wish to sell regardless of the clearing rate. If a holder fails to place an order, most auction procedures provided that the holder is deemed to have elected to continue to hold its auction rate securities regardless of the clearing rate. However, not all auction procedures and other terms of auction-rate securities are the same. Investors should review the official or offering documents for auction-rate securities with their financial advisors before investing in them.

Downgrades of municipal bond insurers and other credit and liquidity issues affecting the financial sector beginning in 2008 created extreme volatility in the market for auction-rate securities, particularly those issued by municipalities. Such volatility caused a number of “failed auctions,” meaning that there were an insufficient number of buyers willing to purchase all of the bonds on terms that holders wanted to sell. Prior to their recent concerns about making capital commitments, banks and other financial services firms would often bid on their own behalf to prevent auctions from failing, but neither broker-dealers nor auction agents have any obligation to facilitate a successful auction process.

What happens if there is a “failed auction”?

When an auction fails, the holders of the bonds are unable to sell their bonds and cannot obtain the liquidity they may desire. However, following a failed auction, the interest rate until the next interest reset period is typically set at a stated maximum or penalty rate. The maximum rate can be a multiple of a referenced rate such as LIBOR or an index of Treasury securities, or a fixed percentage, and is normally above a market rate. If the maximum rate is much higher than market, most borrowers will opt to



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restructure their debt and repay the auction-rate securities. Also, as more investors seek to buy auction-rate securities because of the potential to earn high penalty interest rates, the less likely the next auction will fail and they will receive those rates.

With certain auction-rate securities, the maximum interest rate in the event of a failed auction may be lower than the current market rate (and may even be zero) because the rate, when averaged with the interest rates previously paid by the issuer over the past 12 months or other period, cannot exceed a certain threshold.

Investment Considerations

The following is a brief description of some of the risks associated with auction-rate securities:

1. Payment of interest and repayment of principal on auction-rate securities are not secured by collateral provided by the borrower, a letter of credit provided by a bank or other credit enhancement. Some auction-rate securities issued by municipalities may be insured but municipal bond insurers have experienced significant losses and may have difficulty honoring claims. Auction-rate securities are therefore subject to risk of default by the borrower.
2. The interest rate on auction-rate securities is not fixed; it is determined through a “Dutch auction” process, which takes place frequently on scheduled dates. The Dutch auction process, if successful, will cause the interest rate to be set at the lowest rate necessary to fill all of the sell orders.
3. There is no established secondary trading market for auction-rate securities, and Baird is not obligated to buy auction-rate securities from its clients who want to sell them. Holders needing to sell auction-rate securities in between auction dates may receive less than the price they paid for them. Holders who sell auction-rate securities in the secondary market may forego the possibility of earning the maximum or penalty rate applicable to failed auctions.
4. Holders interested in selling auction-rate securities may attempt to do so by asking Baird to submit a sell order on their behalf on a scheduled auction date; however, holders will only be able to successfully sell auction-rate securities if there are a sufficient number of buyers on that date willing to fill all of the sell orders. As a result, holders should understand that auction-rate securities may at times be illiquid.
5. Even though a failed auction may trigger an attractive penalty rate, that rate will only last until the next successful auction or repayment of the auction-rate securities. Investors who purchase auction-rate securities to take advantage of a penalty rate should understand that they may enjoy that rate for only a short period of time.
6. Not all interest rates determined as a result of a failed auction will be attractive; some have significant limitations on the amount of interest that can be paid.



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7. If the maximum or penalty rate is not significantly above market rates, continued failed auctions may be likely.
8. Auction-rate securities are subject to prepayment risk. Borrowers, especially during periods in which they are required to pay a maximum or penalty rate, may be able to refinance their debt at more attractive rates and prepay the auction-rate securities.
9. Borrowers may be able to change the auction dates and extent the period of time during which holders may be required to hold auction-rate securities.
10. Auction-rate securities are complex investments. It is important that investors discuss them in detail and understand their terms (including the relevant auction procedures) before buying them.