



# BRIEF EXPLANATION OF AUCTION RATE SECURITY REFINANCING ACTIVITY AND THE IMPACT OF PARTIAL CALLS

## FIXED INCOME

### **Recent Events Lead to Increase in Volume of Issuer Redemptions of ARS**

Continued dislocation in the Auction Rate Securities (ARS) market has resulted in elevated interest costs for many issuers, especially those with auctions that fail to produce a clearing rate. A “failed auction” often results in the establishment of a maximum rate for the rate period as described in each issue’s offering documents.

As issuers seek to reduce the interest rate paid for ARS, there has been an increase in the volume of early redemptions of ARS.

### **Issuers May Elect Full or Partial Calls**

Issuer options may be exercised as “full calls” that result in the complete redemption of the entire par value of the specific security. In such cases, all investors receive the full face value of their respective ARS position.

In addition, issuers can elect to exercise “partial calls” in which only a portion of the outstanding par value of the affected security is redeemed. In the event of a partial call, some investors may have all or a portion of their ARS position redeemed while other investors may not have any ARS redeemed.

### **Brief Description of ARS Partial Call Allocation Process**

When an ARS issuer initiates a partial call, it notifies the appropriate securities depository institution of the specific security and the amount to be redeemed. Most

commonly this is the Depository Trust Corporation (DTC). DTC then conducts an impartial lottery to determine the allocation of redemptions among broker-dealers for which it holds securities. After receiving notice of the number of securities to be called, DTC’s process assigns an identification number to each tradable unit held by each firm holding bonds with DTC. DTC’s lottery then randomly allocates the call across the units as designated by the unit’s identification number. Because this process is random, it is possible that some DTC participants may not receive an allocation from a partial call.

Once Wachovia Securities receives notice of any allocation from a partial call of an ARS issue, it conducts a computer-generated lottery to allocate the partial call in a fair and impartial manner among customers who hold ARS in “street name.”

After allocations are made, the firm notifies clients if a partial call results in a redemption of some portion of an ARS position.

### **How ARS Units are Entered in a Partial Redemption Lottery**

NYSE Rule 402.30, concerns the responsibilities of member firms when bonds or preferreds securities are subject to a partial call. Among the rule’s provisions, is a requirement that when a partial call is offered on terms favorable to owners of the security, that the member firm take measures to prohibit allocation of the call to its “proprietary accounts, or those of an affiliate or an employee, before all of its customers’ shares have been

redeemed. Likewise, if a redemption or call is made on unfavorable terms, a firm may not exclude its positions from of those that may be called or put itself ‘last in line.’” Wachovia Securities uses a form of the lottery system described in the rule so the probability of any unit held by customer being allocated in the partial call is proportional to the holdings of all customers holding the specific security by or for the firm.

The lottery performed by Wachovia Securities starts by identifying the number of units held by each customer of the affected ARS. Each unit is then assigned into the lottery process.

Units per customer are determined by dividing the total par value of the customer’s position in the affected ARS by the unit of trade for the redemption. For example, if a customer owns \$50,000 in the affected ARS and the unit of trade for the partial call is \$25,000, that customer will have two units entered into the lottery while a customer with a \$250,000 position in the affected ARS will have 10 units entered into the lottery. Each unit has equal odds of redemption in a random lottery. However, the odds of a client receiving a partial redemption is dependent on the number of units a client has in the lottery.

#### **PARTIAL CALL LOTTERY ENTRY SCENARIOS**

<b>Customer Position</b>	<b>Unit of Trade for Call</b>	<b>Units Entered in Lottery</b>
\$1,000,000	\$25,000	40
\$250,000	\$25,000	10
\$100,000	\$25,000	4
\$50,000	\$25,000	2
\$25,000	\$25,000	1

#### **ARS Partial Redemption Process Designed to Assure Impartiality**

The firm has designed this process to assure that lotteries are conducted in a fair and impartial fashion. The probability of a customer having units redeemed through the lottery process is proportional to the holdings of all clients holding the security in street name at the firm.

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