November 10, 2008

Senator Jim Peterson, Chair
Senator Kim Gillan, Vice Chair
Revenue and Transportation Interim Committee
Room 110, State Capitol, PO Box 201706

Re: Axon and Orion Securities

Dear Senators Peterson and Gillan:

I am responding to your letter of October 20, 2008 in which you request information regarding the status of the Axon and Orion Structured Investment Vehicles held in the Short Term Investment Pool (STIP).

WHAT IS A STRUCTURED INVESTMENT VEHICLE?

Structured Investment Vehicles were first created in the mid-1980s sponsored by large banks or investment managers for the purpose of generating leveraged returns. Returns are achieved by the spread (differences in yields) between the long-term assets purchased in the vehicle and the short-term debt issued to fund them. While the structures and documents creating these vehicles may be complex, the concept behind them is as simple as the operations of a local bank that pays 2.0 percent on deposits and charges 6.0 percent to lend those deposits. The vehicles issue short-term debt in several tranches with varying degrees of risk and return, with the highest tranche receiving the highest investment grade rating.

WHAT WENT WRONG?

In a normal credit market the concept worked well. When short-term debt matured, it was simply rolled over, with other investors, or perhaps the same investor, purchasing the debt with a new maturity date and interest rate. However, when the debt markets froze, the mismatch of long-term assets purchased with short-term debt caused serious problems. Investors were unwilling to purchase the short-term debt and the “spread” that profited the vehicles in better times ended. And to make matters worse, the value of the longer-term securities plummeted as the debt markets froze. In order to pay off short-term debt at maturity, the vehicles either had to have sufficient cash on hand to meet the obligations or sell long-term assets at depressed prices to obtain the cash. Faced with this scenario, several of the major banks that had sponsored the vehicles “off” their balance sheets chose to bring the vehicles “on” their balance sheets to protect their reputations and ensure that short term debt was paid at maturity. Several of the vehicles held in STIP were paid at maturity by bank sponsors.

HISTORY OF AXON AND ORION

These investments were rated AAA when purchased in 2007 and are the only vehicles remaining in STIP. On November 20, 2007, Axon declared an insolvency event and Orion declared an insolvency event on January 14, 2008. The vehicles did not pay short-term debt when due and defaulted. Per the documents governing the vehicles, once a default occurred, all outstanding senior debt became due and payable regardless of the maturity date. The defaults occurred because there was insufficient cash in the vehicles to pay the short-term debt and it could not be rolled over because investors were unwilling to purchase it. In order to obtain cash to pay the short-term debt, long-term assets would have had to be sold in a severely depressed credit market resulting in a realized loss. The Trustee and the senior creditors determined that it was not in the best interest of the creditors to sell assets in the vehicles under these conditions to pay short-term obligations.

CURRENT STATUS OF AXON AND ORION

Both vehicles were structured similarly in three credit tranches with different degrees of risk and return. By segregating the debt into three tranches with sufficient collateralization to cover all three tranches, the rating agencies were able to provide an AAA rating to the senior debt. The Board is a senior creditor in both vehicles and is a member of the senior creditors' steering committee in the Orion vehicle.

Creditor Type	Axon	Orion
Secured Senior Creditors	8,555,300,000	719,679,781
Secured Junior Creditors	890,000,000	65,000,000
Unsecured Capital Notes	210,000,000	112,500,000
STIP	**90,000,000**	**50,000,000**
	1.05%	**6.95%**

The adjacent table shows the most recent information available on the vehicles and the percentage of the senior credit held by STIP. The unsecured capital notes were basically equity and are not involved in the current restructuring of the vehicles. The senior and junior creditors in both vehicles have hired legal counsel to protect their interests. The junior creditors, who will receive nothing unless the senior creditors are paid in full, are attempting to stay in the vehicles because they believe that if the debt markets improve, the value of the assets in the vehicles will be sufficient to fully pay the senior creditors with something left over for them.

The Bank of New York/Mellon, the Trustee responsible for holding assets in both vehicles is receiving conflicting messages from the seniors and juniors and is fearful of litigation if it follows the instructions of either party. The seniors asked that the Orion Trustee hold a foreclosure sale, at which the seniors would utilize their notes to purchase all assets in the vehicle. This action would have required the juniors to "buy out" the seniors at par or be removed from the vehicle. The juniors were against the sale and wanted the vehicles to continue to wind down until credit markets improved. The vehicles cannot be restructured until the Trustee makes a decision as to which set of instructions to follow.

Faced with the conflicting instructions, the Orion Trustee sought guidance from a United Kingdom court as to the proper course of action. The court ruled that, pursuant to the documents creating the vehicle, the seniors have the authority to request a foreclosure sale but cannot dictate the place or the time of the sale. The senior creditors in both vehicles continue to work with the

Trustees to implement a restructuring that would involve a new company and the issuance of new securities to the senior creditors. The junior creditors would not be paying a legal firm to keep them in the vehicle if they not believe the assets in the vehicles would have sufficient value to fully pay the senior creditors and provide some recovery for them.

In the meantime, there are approximately 79 securities in Orion and 251 securities in Axon that continue to generate cash. As of September 30, 2008, 18.7 percent of the Orion senior debt was held in cash, while Axon held 13.4 percent of senior debt in cash. The cash will be distributed solely to the senior creditors. The distribution of this cash to the senior creditors will over time reduce any potential recovery by junior creditors as it reduces the intrinsic value of the vehicles.

WHAT KIND OF INVESTMENT POOL IS THE STIP?

The STIP is an amortized cost pool that maintains all securities in the portfolio at either original cost or amortized cost. Original cost is used for securities purchased at par (the principal amount due at maturity). Amortized cost is used for discount securities that may or may not pay interest and are purchased for less than par. The difference between the discount purchase price and par at maturity is "amortized" from the date of purchase to maturity and is counted as income earned on the security.

Income is distributed to participants based on the "accrued" interest and "amortized" discount of the STIP securities. The daily numerical value of the combined interest and amortization is divided by the daily amortized cost value of the pool to determine the STIP yield for the day. The STIP yield will most likely change each business day as securities with different yields are purchased to replace maturing securities. At the end of the month, each participant is distributed income based on the number of shares held each day of the month times the daily yield factor.

The amortized cost methodology is standard practice for money market type funds and is the only way these funds can maintain a constant share value of $1.00. This methodology permits participants to purchase/sell shares on 24-hours notice at a constant value - $1.00 in - $1.00 out. If the share value was based on the "price" of the underlying securities, the share value would change whenever the securities were priced.

The underlying securities in the pool are not "priced" or "marked to market" because there is no intention of selling the securities and in some cases prices may not be readily available. While securities may be sold occasionally for strategic investment purposes, the assumption is made when a security is purchased that it will be held to maturity. This limits any potential principal loss to the issuer's failure to repay the principal rather than realizing a loss of principal on a security sale.

THE IMPACT OF AXON AND ORION ON STIP

These securities are currently held in the STIP portfolio at amortized cost and the Board has determined it is in the best of interest of participants to continue to hold them. While they are not accruing interest and are totally illiquid at this time, they do not pose a liquidity threat to the STIP operations. As of November 7, there was $2.2 billion in liquid securities in the pool and daily purchases and sales of STIP shares continue on a daily basis with no liquidity problems. There were 1,058 individual STIP transactions by local and state agencies during the month of September 2008. Because state agencies must invest in the STIP, they provide a significant degree of stability to the pool. As of November 10, 2008, state agencies held $1.96 billion, or 84.0 percent of pool assets.

WHAT IF THERE IS A REALIZED LOSS OF PRINCIPAL?

The Board has no definitive information at this time to indicate that there will be any realized loss of principal on these vehicles and will likely not have this information until they are restructured in a new company. If there is a realized principal loss, it will be amortized with STIP income over a period of time to ensure that the constant $1.00 share value is maintained.

The law creating STIP and permitting local governments to participate was one of 10 sections contained in legislation to implement the Unified Investment Program created by the new Constitution. The pertinent section of that law as it relates to local government's ability to withdraw funds from the pool is shown below:

> **"17-6-204(3) The principal and accrued income, and any part thereof, of each and every account maintained for a participant in the pooled investment fund shall be subject to payment at any time from the fund upon request. Accumulated income shall be remitted to each participant at least annually."**

After searching the history of this law and finding no record of legislative committee discussion or other written records addressing legislative intent of this language, the Board interprets this section literally – it is required to return local government principal when it is requested. In the absence of any legislative intent to the contrary, the Board must honor the strict language of the law and the only way to do so is by maintaining a $1.00 share value for all local government participants.

However, the Board also has a fiduciary and legal responsibility to treat all STIP participants equally as provided in 17-6-202 (3).

> **"If, within the list in 17-6-203 of separate investment funds, more than one investment fund is included which may be held jointly with others under the same separate listing, all investments purchased for that separate investment fund shall be held jointly for all the accounts participating therein, which shall share all capital gains and losses and income pro rata."**

The only method by which the Board can ensure that state and local STIP participants are treated equally is to maintain a $1.00 share value for all participants – state and local. If a realized loss of principal occurs, the loss would be offset against income over a period of time that would maintain a competitive yield for participants remaining in the pool.

Sincerely yours,

Carroll V. South, Executive Director
Montana Board of Investments