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By Electronic Delivery

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John J. Cross, III
Associate Tax Legislative Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

RE: Auction Rate Preferred Stock –
Extension of Notice 2008-55

Dear John:

We appreciate the time that you and your colleagues spent with us recently discussing the industry's request that Notice 2008-55 ("the Notice") regarding auction rate preferred stock ("ARPS") be extended. This letter follows up on several points discussed during the meeting.

First, the letter reviews the factors that closed-end fund boards must consider in determining whether to redeem ARPS that have been outstanding since the auction markets froze in February 2008. The competing considerations involving a fund's common and preferred shareholders, as you know, provided a compelling impetus for the Notice. These considerations remain paramount and support the Notice's extension.

Second, the letter describes in additional detail the efforts undertaken by industry participants to secure financing – such as through a new form of preferred stock supported by third-party liquidity arrangements (known as variable rate demand preferred ("VRDP")) – to generate cash to redeem the outstanding ARPS.[1] For the reasons we discussed, that also are summarized in this letter, industry participants do not anticipate being able to secure from liquidity providers sufficient financing for VRDP (or similarly structured preferred stock offerings) by the Notice's December 31, 2009 deadline. Thus, unless the Notice is extended, the relief it intended to provide will not be utilized effectively.

Third, the letter describes why a fund's board may be reluctant to replace ARPS with temporary financing without the authority to later replace the temporary financing with the

[1] These efforts were summarized in the memorandum attached to the ICI's September 4 letter to Josh Odintz.

permanent financing anticipated by the Notice. Consequently, as we discussed, it is important that the term "indirectly" be interpreted to permit a fund – within the limited confines of the Notice – always to secure permanent financing through VRDP that gives liquidity providers eventual recourse back to the issuing fund.

Finally, the letter explains the industry's rationale for requesting a multiple-year extension of the Notice. We believe that strong tax policy reasons support this request.

<u>Factors that boards consider in determining whether to redeem outstanding ARPS</u>

The Notice was received with particular enthusiasm by those closed-end funds investing in municipal bonds (for which financing providing investors with a tax-exempt yield is paramount). The industry sought this guidance, as you know, because the auction market's collapse in February 2008 prevented preferred shareholders who wanted to cash out their positions from doing so at "par" through the auction process.

The Notice's key feature, from our perspective, is the mechanism it provides for addressing a closed-end fund board's duty to protect the fund (including both its common and preferred shareholders). Specifically, the concerns of preferred shareholders can be addressed by the Notice without harming the common shareholders. Under the Notice, a fund could replace the permanent equity financing created by ARPS sold in the retail market with short-term (generally 7 to 28 day) dividend rates, with equity financing (also designed to be permanent) created by VRDP sold to money market funds with short-term (generally 7 day) dividend rates.

In determining whether to redeem outstanding ARPS, a fund's board will consider several factors relevant to protecting the interests of the fund (including both the common and preferred shareholders). These factors include the durability and permanence of the outstanding ARPS and any replacement security and the relative costs and risks (including marketability) of any replacement security. In addition, fund boards would have to consider the harm to the common shareholders of paying the "maximum rate" to any preferred shareholder whose shares could not be sold after being offered at auction. The maximum rate, which is set forth in the contractual rights for the preferred shares, typically is set at a multiple of a taxable market rate (such as 110 percent of the "AA" Composite Commercial Paper Rate) or at a spread over a relevant municipal index.

The current interest rate environment, as we discussed, creates an unprecedented situation, particularly for municipal bond funds, where taxable maximum rates are significantly lower than interest on the longer-term municipal bonds in which the fund invests. The maximum rates were designed provide sufficient "headroom" to enable auctions to restart or, if auctions continued to fail, to align common and preferred shareholder interests by making financial leverage through ARPS not economically viable for a fund in the long run. In the current interest rate environment, the maximum rate is far too low to cause the preferred shares to be redeemed. It may be quite some time before interest rates move closer to their historic norm (and the maximum rates begin to impact the economics to the common shareholders of the ARPS-financed leverage).

The cumulative effect of these factors and the current interest rate environment makes it likely that a substantial portion of the outstanding ARPS for closed-end municipal bond funds will not be redeemed soon. If interest rates increase to historic levels that make it uneconomic for funds to pay maximum rates to preferred shareholders, the ARPS will be redeemed (because the interests of the preferred and common shareholders will be aligned). Alternatively, the ARPS will be redeemed (because of aligned interests) if the Notice is extended and funds are able to secure economically-viable recourse financing to issue replacement securities such as VRDP.

Industry efforts to secure financing to redeem ARPS

Notwithstanding the industry's concerted effort to find economic replacements for ARPS,[2] approximately 70 percent ($21.13 billion) of the $30.55 billion of ARPS issued by closed-end municipal bond funds that were outstanding in February 2008 remain outstanding.[3]

The option that was used first by funds to replace ARPS – tender option bonds ("TOBs") – has more or less been utilized fully. The markets, as we discussed, effectively place certain restrictions (such as credit quality) on the types of municipal bonds that can be placed into a TOB structure. Most of the closed-end fund industry's securities that could be placed in TOBs already have been so placed. Thus, little of the remaining $21 billion of outstanding ARPS can be replaced by TOBs.

Four closed-end funds managed by one firm, as we discussed, were able in August 2008 to issue a form of non-recourse VRDP – in which the liquidity providers could not put the VRDP back to the funds (in contrast to the recourse VRDP envisioned by the Notice). Shortly after the deal closed, however, Lehman Brothers collapsed suddenly and the credit markets suffered severe stress. The firm that had secured non-recourse financing for its VRDP then was told by the bank providing liquidity for these securities that it would not consider any further non-recourse deals.

Another financing option being pursued involves preferred shares with a fixed term (such as five years). These short-intermediate-term securities, because of the current interest rate environment, are expected to be a viable option for replacing a portion of outstanding ARPS. Because of potential

[2] We understand that firms have sought financing from several dozen institutions (banks, insurance companies and public pension funds) after the auction markets froze in February 2008.

[3] As noted in our previous letter, approximately 80% of ARPS issued by non-municipal bond funds have been redeemed, mostly through debt refinancings. A significant portion of the debt used to replace taxable ARPS was issued pursuant to SEC exemptive orders enabling funds to temporarily issue debt in excess of the 300% asset coverage requirements imposed by the 1940 Act. While the ARPS crisis is more acute for municipal bonds funds, we believe that extension of the Notice also will provide an opportunity for taxable funds to issue VRDP as a more permanent method of financial leverage.

limits on the demand of five-year securities, the uncertainties regarding the cost in five years of replacing this temporary financing, and the impact of the reissuance costs of term securities that replace permanent financing, there may be limits on the ability of this option to replace outstanding ARPS.

The option that appears to carry the greatest promise for replacing ARPS is the option envisioned by the Notice: VRDP backed by a liquidity facility with recourse (after six months) to the fund. Unfortunately, as we discussed, the balance sheets of the banks most likely to provide the liquidity facilities for VRDP still have not recovered sufficiently from the recent credit market turmoil.[4] While closed-end fund firms actively are pursuing recourse financing that would be covered by the Notice, to date no deals have been finalized (although some may be finalized soon).[5]

<u>Enhancing likelihood that ARPS will be replaced with temporary financing</u>

One factor that may enhance significantly the viability of the fixed-term preferred shares alternative would be clarification that the Notice permits a fund that issued fixed-term preferred shares to issue VRDP to replace those preferred shares on or before the end of such shares' term (*e.g.,* five years). The Notice, as you know, applies:

> if such stock was outstanding on February 12, 2008, or issued after that date to refinance, *directly or indirectly,* any ARPS that was outstanding on that date, provided that the total par amount of the liquidation preferences on all such stock issued for refinancing purposes is no greater than the total par amount of the liquidation preferences on such outstanding refinanced stock. (emphasis added).

We submit that the Notice was intended to cover the situation in which ARPS are redeemed through some alternative financing and the fund later seeks to issue VRDP backed by a liquidity facility with recourse after six months to the fund. This interpretation, which we believe is the most compelling of the various alternative interpretations, also is most consistent with maximizing the options available to fund boards for redeeming preferred shareholders who cannot sell their shares in an auction. Clarification of this interpretation of "indirectly" would be appreciated greatly.

We recognize that this interpretation could be viewed as providing a permanent competitive advantage to funds with ARPS outstanding in February 2008. The provision, however, was needed to ensure that fund boards would utilize the relief provided by the Notice. The sound policy reasons for last year's decision remain compelling today. To the extent that any advantage is provided by this interpretation, one solution would be to permit all closed-end funds to utilize the guidance. As the

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[4] The lack of available liquidity support for a new preferred stock is evidenced by the declining volume of municipal variable rate demand obligations ("VRDOs"), which the Bond Buyer reports are down over 80% year-to-date.

[5] The institutions that are considering financing proposals are seeking confirmation, from at least one firm with which they are negotiating, that Notice 2008-55 may be extended or made permanent.

debt/equity analysis relied upon in the Notice is correct, we would support such an extension. Our paramount interest, however, is in securing additional time to provide relief for those preferred shareholders who cannot sell their ARPS due to the continued difficulties in the market.

<u>A multiple-year extension would increase significantly the Notice's utility</u>

We are requesting a multiple-year extension of the Notice because industry participants do not believe that another year will provide enough time to replace over $21 billion of ARPS. Even if the credit markets experienced a full recovery today, it likely would take at least a year to close all of the deals needed to redeem the outstanding ARPS. Because of the uncertainties regarding how quickly the credit markets will recover, extending the guidance for only one year virtually guarantees that the industry will request another extension next year.

Importantly, and unlike other guidance issued by Treasury in response to the recent market developments, the Notice was issued with the expectation that it would have some "permanence." Specifically, the Notice contemplated that any financing put into place by December 31, 2009 could remain outstanding indefinitely. Moreover, the Notice contemplated that financing put in place by that time could be replaced by new liquidity facility arrangements entered into thereafter. The Notice provides temporary guidance only in the sense that there is a cut-off date by which a liquidity facility must be entered into for the first time.

Given the "permanence" contemplated by the Notice when it was issued in June 2008, we also would welcome an extension of the Notice that does not include a date by which an initial liquidity facility arrangement must be finalized. If the Treasury Department believes that a shorter extension is necessary, we would prefer an extension that reflects current market conditions. While a two-year extension is preferable to a one-year extension, a longer extension (*e.g.,* five years) would be more likely than a shorter one to address the needs of the preferred shareholders whose shares have not yet been redeemed.

Moreover, it is critical that the guidance not be restricted, such as by preventing liquidity facility arrangements from rolling over after a specified period. Any "shut-off date" for the Notice would make it far more difficult for fund boards to enter into any arrangement that replaces the permanent financing provided by the existing outstanding ARPS.

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We appreciate the careful consideration that the Treasury Department already has given to this request. Please let me know if we can provide you with any additional information. We look forward to continuing our discussions with you and your colleagues.

Sincerely,

/s/ Keith Lawson

Keith Lawson
Senior Counsel – Tax Law

cc: Josh Odintz
Jeff Van Hove
Mike Novey