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By Electronic Transmission

September 4, 2009

Joshua Odintz
Tax Legislative Counsel
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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

Dear Josh:

The Investment Company Institute¹ and several of its closed-end fund members would like to meet with you and your colleagues to discuss extending Notice 2008-55 by permitting initial liquidity facilities for auction rate preferred securities (“ARPS”) to be entered into after December 31, 2009. The continued need for the relief provided by the Notice to ARPS is discussed in detail in the attached memorandum. In particular, the current condition of the credit markets has made it difficult for those closed-end funds seeking to utilize the Notice to obtain the necessary liquidity at a cost-effective price. These funds do not anticipate being able to secure liquidity facilities before the December 31, 2009 deadline. Consequently, we would like to discuss with you the continued need for his guidance and the appropriate length of an extension. We also would like to raise one interpretive issue that is discussed in the attached memorandum.

If we can provide you with any additional information, please contact Karen Gibian (371-5432 or kgibian@ici.org) or me (326-5832 or lawson@ici.org).

Sincerely,

/s/ Keith Lawson

Keith Lawson
Senior Counsel – Tax Law

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.02 trillion and serve over 93 million shareholders.

ICI Letter Requesting Extension of ARPS Guidance

September 4, 2009

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Attachment

cc: Treasury Department

Jeffrey Van Hove

John Cross

Michael Novey

Internal Revenue Service

William Alexander

Alfred Bishop

Investment Company Institute
Auction Rate Preferred Stock – Extension of Notice 2008-55

Notice 2008-55, which clarified the tax treatment of certain auction rate preferred stock (“ARPS”) issued by closed-end funds, was requested, and strongly supported, by the Investment Company Institute and its members. We appreciate greatly the Notice’s attempt to address the difficulties created by the failed ARPS auctions for closed-end funds and their investors.

The most significant intended benefit of the Notice is its effective removal of a potential legal obstacle to those closed-end funds seeking to issue a new form of preferred stock known as variable rate demand preferred (“VRDP”). Specifically, the Notice provides that the Internal Revenue Service (“IRS”) will not challenge the equity characterization of certain ARPS that were outstanding on February 12, 2008 (or issued after that date to refinance, directly or indirectly, ARPS outstanding on that date). VRDP would be supported by a liquidity facility, the terms of which would permit a purchasing bank to require the issuer to redeem the securities after a continuous six-month hold period. VRDP was designed specifically to qualify under Rule 2a-7 of the Investment Company Act of 1940 (the “1940 Act”) to permit investment by money market funds.

One condition imposed by the Notice, which at the time was not expected to be problematic, is that it applies only to ARPS for which a liquidity facility is entered into on or before December 31, 2009. The continued state of the credit markets, however, is making it difficult for funds to find parties willing to supply such liquidity facilities. Because it is unlikely that funds seeking to utilize the Notice’s relief will be able to do so before the December 31 deadline, we request that the deadline be extended.

Continued ARPS Liquidity Challenges

Although eighteen months have passed since the ARPS market effectively froze, almost half of the \$64 billion of ARPS issued by closed-end funds prior to February 2008 remain outstanding (*see* Appendix A). Most of the refinancings and redemptions of ARPS over the past eighteen months have been by non-municipal closed-end funds. While over 80 percent of ARPS issued by non-municipal funds have been redeemed, the redemption percentage for ARPS issued by municipal funds is only 30 percent. The difference between the two sectors reflects the fact that non-municipal funds have more tools available to access the banking system and the capital markets for capital. Given the lapsed time, the liquidity challenges for municipal funds have become even more acute.

ARPS continue to be illiquid, with secondary market sales being completed at discounts to the full liquidation preference value, and with transaction fees and expenses, that vary widely from historic norms. While “buy-back” settlements with major broker dealers have effectively restored liquidity for a significant portion of the investing public, substantial ongoing commitments of capital and significant opportunity costs are impacting negatively the financial sector. Moreover, tens of thousands of individual investors, who held their ARPS through institutions that did not buy them back, continue to hold these illiquid securities.

Notice 2008-55 and VRDP

To date, approximately \$500 million of VRDP has been issued for four closed-end funds. VRDP currently outstanding have liquidity facilities in place, but the contractual agreements do not grant the liquidity provider the right to require the issuing fund to redeem purchased VRDP. As such, the outstanding VRDP do not rely on Notice 2008-55, though market acceptance may have benefited indirectly from the policy support demonstrated by Notice 2008-55.

It should be noted that these VRDP transactions closed in early August, 2008. Since then, no other VRDP transactions have been completed. It is unlikely that similar VRDP transactions (*i.e.*, that do not grant the liquidity provider the right to require the fund to redeem purchased VRDP) will be completed in the foreseeable future. The consensus of the banking institutions who may be considering furnishing liquidity for VRDP is that they will require a six-month put-back-to or mandatory redemption by the issuing fund, as contemplated by Notice 2008-55, as a precondition for further negotiation.

Although the experience of the closed-end fund industry in the use of VRDP has been limited, in general, VRDP has been a success. The original placements of VRDP required a significant yield premium to the principal benchmark for tax-exempt money market investing. The weekly remarketing process, however, has virtually eliminated the premium. There have been no remarketing failures or “puts” to the liquidity provider. Money market funds chose to retain their investments in VRDP shares through the crisis weeks of September and October of last year (a period of unprecedented stress in the short-term municipal market). This behavior reflected their evaluation of the security structure and the liquidity provider, and an acknowledgement of the investment quality of the VRDP, taking into account the short-term rating of the liquidity provider and the long-term credit and issuer ratings of Aaa and AAA assigned to each fund.

While additional issuances of VRDP have been planned, no additional transactions have been completed; market conditions have been extremely challenging and the costs for liquidity facilities are prohibitively expensive. Various closed-end fund sponsors are engaged in a continuing effort to arrange liquidity support agreements, with outreach to virtually all of the major domestic and global banks. Market conditions, however, have frustrated these efforts over the past year.

As the capital position and profitability of the banking sector recover, sponsors of closed-end funds see an improved outlook for the potential to negotiate liquidity facilities and undertake the issuance of substantial amounts of VRDP. Certain sponsors estimate the potential for VRDP, based on current negotiations, in the range of \$7.5 to \$10.0 billion over the next year. In all cases, these sponsors report (as indicated above) that the terms and provisions negotiated for new issuances of VRDP will need to include a put-back-to or mandatory redemption by the issuing fund, as contemplated by Notice 2008-55. Considerable time will be required to structure, negotiate and market VRDP. The current sunset provision in Notice 2008-55, requiring liquidity facilities in place by December 31, 2009, may substantially limit or even eliminate the opportunity to use VRDP to refinance frozen ARPS. An

extension of 2008-55 would signal policy support for VRDP, which in turn could further induce additional institutions to furnish liquidity support.

Resolving the ARPS Crisis

Sponsors are exploring a number of alternatives for refinancing ARPS, including (i) the expanded use of tender option bonds, (2) issuing fixed rate preferred shares with terms for redemption of three to six years (“MuniFund Term Preferred” or “MTP”) and (3) VRDP. Municipal closed-end funds in particular need to broaden the range of options for structuring issues of preferred stock, due to the tax inefficiencies of using bank loans and other forms of debt issuance. Non-municipal closed-end funds generally have redeemed ARPS through bank borrowings and debt, but possibly also could refinance ARPS through MTP or VRDP.

Industry sponsors believe that the ARPS crisis will be resolved through a number of alternatives. VRDP is envisioned as one among several, but very important, financing tools that closed-end funds may use. VRDP is particularly important as it is unlikely that other tools can themselves be issued in sufficient volume to refinance all of the outstanding ARPS, due to the structural limitations of such products and the relative size of the markets for them. Thus, a fund may seek to refinance a portion of its ARPS through tender option bonds, another portion through the issuance of MTP, and another portion through VRDP.

Proposal to Extend Notice 2008-55

The Investment Company Institute proposes that the December 31, 2009 deadline in Notice 2008-55 be extended. While the industry’s preferred approach would be to eliminate the deadline completely, as there is no certainty as to when the credit markets will recover completely, a shorter extension also would be beneficial to the industry. Regardless of the length of any extension, the relief provided in Notice 2008-55 still would be limited to refinancing ARPS outstanding as of February 12, 2008.

Elimination or extension of the December 31, 2009 deadline would accommodate the pace at which the banking and financial sector appear to be recovering. It would accommodate the practical considerations relating to analyzing and completing transactions. Because of the unique features associated with preferred stock issuance under the 1940 Act (particularly when compared with corporate or municipal debt issuance), banking institutions willing to consider providing liquidity to support VRDP must undertake comprehensive due diligence; this due diligence includes addressing numerous legal and regulatory questions, as well as confirming compliance with internal capital and risk management standards. Further, elimination or extension of the deadline would accommodate practical concerns regarding the number of funds seeking to arrange refinancing of existing ARPS.

Interpretative Issue – “Directly or Indirectly”

Notice 2008-55 applies to ARPS:

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).

A question has arisen as to the term “indirectly.” As discussed above, closed-end funds are considering, or already have used, a number of alternatives to refinance ARPS. One paramount lesson of the ARPS crisis is the need to diversify the tools for managing the financial operations and capital structure of the closed-end funds. Going forward, after the ARPS crisis, it would be extremely helpful for closed-end funds to have a number of viable alternative forms of financial leverage.

It is unclear from the Notice whether the guidance would apply to ARPS with a liquidity facility that was used to refinance such alternative securities, which in turn were used to refinance the original ARPS in place on February 12, 2008. Funds would like to be able to use a variety of alternatives to resolve the ARPS problem, but each has its limitations; permitting closed-end funds to use ARPS with liquidity facilities to refinance these other alternatives, should the need arise, would increase greatly the funds’ flexibility.

APPENDIX A

CEF Auction Rate Preferred Securites
Summary of Redemption Activity (as of 8/28/09)

Fund Sector	February 1, 2008		Redeemed		August 28, 2009	
	\$Bn	%	\$Bn	%	\$Bn	%
Municipal	\$30.55	100	\$9.42	30.9	\$21.13	69.1
Non-Municipal	\$33.33	100	\$27.13	81.4	\$6.20	18.6
Total	\$63.88	100%	\$36.55	57.2%	\$27.33	42.8%

Source: Thomas J. Herzfeld Advisors, Inc. www.herzfeld.com