The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 22471

April 30, 2008

Institute Submits Draft No-Action Letter on Liquidity Protected Preferred Stock

[22471]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 20-08
SEC RULES COMMITTEE No. 32-08 RE: INSTITUTE SUBMITS DRAFT NO-ACTION LETTER ON LIQUIDITY PROTECTED PREFERRED STOCK

Earlier today we submitted a letter, in draft, to the Staff of the Securities and Exchange Commission asking for their views and various no-action assurances related to liquidity protected preferred stock ("LPPS"). A copy of the letter, which is briefly described below, is attached.

Please note that the letter remains in draft so that we can have the opportunity to fully address any of the Staff's comments and concerns. As such, the letter should be used by Committee members for Institute discussion purposes only and not widely distributed at this time.

Background

As of the end of the first quarter of 2008, more than half of all closed-end management investment companies ("Funds") had auction market preferred stock ("AMPS") outstanding with a total liquidation preference of approximately $64 billion. Auctions for AMPS had operated successfully for more than twenty years, but have consistently failed since mid-February. Holders of AMPS have continued receiving dividends from Funds at a "maximum rate," but because auctions are not providing liquidity and there is no

established secondary market, AMPS holders wanting to sell their shares have been unable to do so.

In order to address the current illiquidity of AMPS and seek to reduce the current cost of leverage, many Funds and their investment advisers are evaluating various alternatives. Some Funds may seek to redeem their existing AMPS in favor of using debt financing as a form of leverage. [1] Other Funds are seeking to engage a counterparty (the "Liquidity Provider") to provide a liquidity feature (the "Liquidity Feature") with terms substantially as described in the letter.

The idea of liquidity protection for preferred stock is not new. In 2002, the Staff issued a no-action letter to Merrill Lynch Investment Managers stating that it would not recommend enforcement action to the Commission if money market funds purchased AMPS having a demand feature that gives the holder the right to sell its AMPS to a counterparty for its liquidation preference plus any accumulated dividends upon the occurrence of certain triggering events. [2] To our knowledge, no Fund has relied on the MLIM Letter. Given the current situation, however, Funds are seriously considering ways to create LPPS, not all of which precisely the facts presented in the MLIM Letter.

Requests for No-Action Assurances and Other Staff Views

After providing a general description of the current situation, AMPS, remarketed preferred stock (which is similar to AMPS), and LPPS, the letter asks the Staff for a reaction to four main issues under the Investment Company Act of 1940 (the "1940 Act"):

1. LPPS as "eligible securities" under Rule 2a-7. The letter seeks no-action assurances from the Staff that the removal of two of the triggering events described in the MLIM letter would not affect the status of LPPS as eligible securities under Rule 2a-7. The two triggering events were a failure by a Fund to make a scheduled payment of dividends or redemption proceeds of the LPPS and a failure by a Fund to make scheduled payments of the required liquidation amounts. A failed auction or remarketing would continue to be a triggering event for LPPS.

2. The status of the Liquidity Provider as a Non-Affiliate. The letter notes that it is possible that a Liquidity Provider may become the holder of a majority of the outstanding shares of the Fund's preferred stock, such that it would have the unilateral power to elect two of a Fund's directors. We seek confirmation that, so long as the Liquidity Provider is not able to elect a majority of a Fund's board of directors or a majority of its independent directors, the Liquidity Provider would not be deemed to control, or otherwise to be an affiliated person of, the Fund solely on the basis of the Liquidity Provider's: (a) ownership of up to 100% of the Fund's LPPS; and/or (b) contractual arrangements with the Fund regarding the LPPS (such as the right to require a mandatory redemption of the LPPS in certain circumstances).

3. The Application of Sections 18(c) and 18(g) of the 1940 Act to LPPS. The letter addresses two questions involving LPPS and the prohibitions against issuing multiple classes of stock (Section 18(c)) or senior securities (Section 18(g)). The first question is whether Section 18(c) might be implicated if a Fund has both AMPS and LPPS outstanding at the same time. The second question is whether a Liquidity Feature with a mandatory repurchase component implicates either Section 18(c) or 18(g). In both cases, the letter concludes that LPPS would not violate the provisions of the 1940 Act, and requests the Staff's concurrence in those views.

4. Application of Rule 2a-7 to a Liquidity Provider Employing a Parent Guarantee. The letter seeks the Staff's concurrence with our conclusion that a Liquidity Feature provided by a Liquidity Provider without the requisite rating can be treated as an "eligible security" under Rule 2a-7 if the obligations of the Liquidity Provider are unconditionally guaranteed by a parent company that has received the rating required by Rule 2a-7.

The letter also addresses potential issues raised by the tender offer rules. It expresses the view that the operation of the liquidity features should not be deemed tender offers for LPPS and seeks assurances from the Staff of the Division of Corporation Finance that it will not recommend any enforcement action to the Commission under Sections 13(e) and 14(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 13e-4 and Regulations 14D and 14E thereunder in respect of the operation of those liquidity features and any transactions contemplated by their terms.

Robert C. Grohowski
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Attachment

endnotes

[1] We have asked the Staff to consider a request for temporary relaxation of the asset coverage requirements in Section 18 of the 1940 Act to permit Funds to refinance AMPS with debt. See Memorandum No. 22441, dated April 18, 2008.

[2] Merrill Lynch Investment Managers, SEC No-Action Letter (May 10, 2002) (the "MLIM Letter").