COMMENT LETTER

March 12, 2009

ICI Letter Requesting SEC No-Action on Liquidity Protected Preferred Shares

Via Email

March 12, 2009

Douglas Scheidt, Esq.
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Liquidity Protected Preferred Shares

Dear Mr. Scheidt:

The Investment Company Institute[1] is writing with respect to liquidity protected preferred shares ("LPP") issued by closed-end investment companies. LPP was the subject of a no-action letter last year from the Staff to Eaton Vance Management.[2] We are writing with respect to an issue not addressed in the EV Letter – whether a firm serving as liquidity provider for the LPP or its affiliate (a "Liquidity Provider") would be deemed to control, or otherwise to be an affiliated person of, a registered closed-end investment company (a "Fund") issuing LPP solely on the basis of (a) the Liquidity Provider's acquisition of LPP pursuant to the LPP's liquidity feature and (b) contractual arrangements between the Fund and the Liquidity Provider regarding LPP of the type described in the EV Letter, such as the right of the Liquidity Provider to require the Fund to repurchase its LPP in certain circumstances (taken together, the "Liquidity Facility").

For the reasons expressed below, we request your assurance that the Staff would not recommend enforcement action to the Securities and Exchange Commission ("Commission") against a Liquidity Provider or any Fund (with respect to the Liquidity Provider) under provisions of the Investment Company Act of 1940 (the "1940 Act") and the rules thereunder applicable to a Fund, an affiliated person of a Fund, or an affiliated person of an affiliated person of a Fund that would be triggered solely by the operation of the Liquidity Facility as described in this letter (the "Affiliate Restrictions").

I. Factual Background: ARP, LPP and the Need for Further Staff Assurances

As of the end of 2007, more than half of all Funds had auction rate preferred shares ("ARP") outstanding with a total liquidation preference of approximately $64 billion, accounting for nearly twenty percent of the $330 billion auction rate securities market.[3] ARP permits Funds to engage in leverage to the benefit of the Funds' common shareholders. Funds typically issue ARP that pay dividends at rates set through auctions (or in a few cases, remarketings) held every seven or 28 days. Bids are filled to the extent shares are available, and sell orders are filled to the extent there are bids.

ARP auctions had operated successfully for more than twenty years,[4] but have consistently failed since mid-February 2008.[5] The failed auctions were not caused by defaults under the ARP terms or credit quality concerns with Fund investments, but rather simply because there were more shares offered for sale than there were bids. The initial auction failures created a general loss of confidence in the auction rate securities markets, which then spread to the ARP market, causing ARP auction failures that have been virtually universal since mid-February 2008. It is unlikely, given all of this, that the existing auction markets will resume normal functioning.

ARP holders have continued receiving dividends from Funds at a "maximum rate" equal to a stated spread over a particular market benchmark rate provided in the ARP's governing documents. Because auctions are not providing liquidity and there is no established secondary market, however, ARP holders wanting to sell their shares have been unable to do so. This loss of liquidity has created significant hardship and uncertainty for many ARP holders who may have viewed ARP as akin to a liquid cash alternative.

In order to address the current ARP illiquidity 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 ARP in favor of using debt financing as a form of leverage. Other Funds are seeking to issue LPP by engaging a Liquidity Provider to provide a Liquidity Facility with terms substantially as described in the EV Letter.

LPP is a new type of preferred stock that will be issued by a Fund and eligible for purchase by open-end investment companies that hold themselves out as money market funds in reliance on Rule 2a-7 under the 1940 Act. Although there are a number of different versions of LPP being contemplated in the market, the main features are substantially similar to the LPP described in the EV Letter. Any differences are immaterial to the issue presented in this letter, which exists in all of the different structures by operation of the central feature of LPP – a Liquidity Facility pursuant to which, in the event of a remarketing failure, a Liquidity Provider would purchase LPP at its liquidation preference plus accumulated but unpaid dividends. It is possible that a Liquidity Provider could acquire all or a large portion of an LPP issue through the operation of the Liquidity Facility.[6]

While LPP holds great promise to resolve some of the current liquidity concerns with ARP, the willingness of a party to serve as a Liquidity Provider depends, in large part, on a high degree of certainty with respect to any potential legal issues with the LPP. The EV Letter goes a long way towards providing this certainty, but we have been advised that some Liquidity Providers are less willing to serve in this capacity unless the assurance sought in this letter is provided by the Staff. In particular, we are concerned that the Affiliate Restrictions could be triggered solely by the Liquidity Provider's acquisition of all or a large portion of the LPP issued by the Fund through the operation of the Liquidity Feature or a Fund Put provided to the Liquidity Provider by the terms of the LPP, which would prevent the Liquidity Provider from, for example, engaging in certain transactions with the Fund or any other registered investment company in its complex as principal or agent.[7] Under these facts and circumstances, the application of the Affiliate Restrictions to the Liquidity Provider would unnecessarily hamper the development of LPP as a solution to the ARP liquidity problem.

II. Effect of Ownership of LPP and the Right to Elect Directors

A. LPP Holders Will Always Hold Less than Five Percent of Outstanding Voting Securities

LPP will be an equity security that entitles the owner or holder to vote for the election of the Fund's directors and, accordingly, is a "voting security" as defined by Section 2(a)(42) of the 1940 Act.[8] As required by Section 18(a)(2)(C) of the 1940 Act, the holders of the LPP and any other preferred stock outstanding, voting as a class, are entitled to elect at least two directors at all times, and to elect a majority of the directors if at any time the dividends on the LPP are unpaid in an amount equal to two full years' dividends on the LPP, and to continue to be entitled to elect a majority of the directors until all dividends in arrears are paid or otherwise provided for. 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.

It would not be possible, however, for a Liquidity Provider to hold five percent or more of the total outstanding voting stock of a Fund in any of the existing ARP capital structures or contemplated LPP capital structures such that it may become an affiliate of the Fund within the meaning of Section 2(a)(3)(A) of the 1940 Act.[9] Funds typically offer common stock at a price per share of between $15 and $25. ARP typically is, and LPP is expected to be, offered at a liquidation preference of at least $25,000 per share. In nearly every instance, ARP have one vote per share. We expect that LPP also will have one vote per share. Given the requirement for 200% asset coverage on preferred stock,[10] a Fund will always have more common stock than preferred stock outstanding, measured by the value of the outstanding shares. There also will be significantly more shares of common stock than preferred stock.

Two provisions of the 1940 Act bear directly on the calculation of ownership of a Fund's total outstanding voting securities. First, Section 18(i) of the 1940 Act requires that, except as set forth in Section 18(a) (or as otherwise required by law), every share of stock issued by a Fund "shall be a voting stock and have equal voting rights with every other outstanding voting stock . . . ." Second, Section 2(a)(42) of the 1940 Act provides that "a specified percentage of the outstanding voting securities of a company means such amount of its outstanding voting securities as entitles the holder or holders thereof to cast said specified percentage of the aggregate votes which the holders of all the outstanding voting securities of such company are entitled to cast."

Applying these sections to a Fund's capital structure, it is clear that a Liquidity Provider will never be an affiliated person of a Fund within the meaning of Section 2(a)(3)(A) of the 1940 Act as a result of its ownership of LPP because ARP and LPP will constitute a tiny fraction, typically less than 0.1%, of a Fund's total outstanding voting securities. The following example illustrates this point:

This example presents an extreme case, where the preferred stock's value at issuance is the same as the common stock's value. The actual percentage ownership of total outstanding voting securities represented by preferred stock would typically be much less than 0.1% because, in practice, Funds often have common stock initially priced at less than $25 and maintain a coverage ratio somewhat higher than 200%. Both of these facts would translate into an even lower percentage ownership of voting securities attributable to the preferred stock.

B. Analysis of Sections 2(a)(3)(C) and (D) of the 1940 Act and Related Affiliated Person Provisions

A Liquidity Provider that acquires a substantial amount of LPP will have both the ability to elect directors and a substantial economic interest in the Fund, which raises the question of whether the Liquidity Provider is an "affiliated person" of the Fund within the meaning of Section 2(a)(3)(C) or (D) of the 1940 Act.[11] These provisions define an "affiliated person" as: "(C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person…." Section 2(a)(9) defines "control" as "the power to exercise a controlling influence over the management or policies of the company, unless such power is solely the result of an official position with such company." Section 2(a)(9) of the 1940 Act includes a presumption, rebuttable only by a Commission determination or a judicial finding to the contrary, that a person does not control a company if the person owns 25% or less of the company's outstanding voting securities.[12]

Even with 100% ownership of the LPP, the hypothetical Liquidity Provider in the example would own far less than 5% of the total outstanding voting securities of the Fund, and thus, as discussed above, the Fund and Liquidity Provider would not be affiliated by virtue of share ownership under sections 2(a)(3)(A) or (B) of the 1940 Act. The Liquidity Provider would also have a presumption of non-control under section 2(a)(9) of the 1940 Act by virtue of owning much less than 25% of the total outstanding voting securities of the Fund.[13] Of course, our analysis would not apply to any Fund where, as a result of a different class structure, preferred shares exceeded 5% of its total outstanding voting securities.

Whether a person has "the power to exercise a controlling influence over the management or policies" of a company necessarily depends on the facts and circumstances of the relationship. In the typical case of a Liquidity Provider acting in its capacity as such, however, we do not believe such power would be present.

The Liquidity Provider is not a typical preferred shareholder. We do not anticipate that it will seek to acquire shares as an investment or to influence management; rather, it would typically only acquire shares when and to the extent that it is contractually required to do so. If the Liquidity Provider becomes a shareholder, it will be contractually required to make good faith efforts to dispose of its shares as soon as possible. As noted above, if those efforts fail, certain structures contemplate a Fund Put – either a mandatory repurchase of the LPP by the Fund or a conditional right for the Liquidity Provider to put the LPP to the Fund or another party.[14]

Theoretically, a Liquidity Provider could seek to exert influence over a Fund by threatening a large redemption. The nature of the repurchase provisions, however, significantly reduces or eliminates this risk. The mandatory repurchase provisions operate mechanically upon the occurrence of specified events, giving the Liquidity Provider no ability to dictate the timing of the redemption. Structures that include a Fund Put place a number of conditions on that put right, such that it is only exercisable upon the occurrence of specified events, after the expiration of a period of time, and upon written notice to the Fund.[15] In each case, a Fund will have previously negotiated the terms of any repurchase rights associated with the LPP. As a result, the Fund will have sufficient advance warning of the possibility of a large redemption of the LPP and, as such, should be able to plan for its eventuality.[16]

Moreover, the Liquidity Provider is a service provider to the Fund and its rights as such are limited by contract. As a service provider, it would not have any contractual right to participate in or influence a Fund's day-to-day management activities (e.g., how the Fund invests, or the selection of parties with which the Fund does business). Importantly, it cannot cause the Fund to deal, or increase its dealings, with the Liquidity Provider for the Liquidity Provider's own financial benefit, which will be subject to the Fund Board's fiduciary oversight and management's monitoring.

As a preferred shareholder, the Liquidity Provider would have the right to vote its shares, but the exercise of any such voting rights should not cause it to be deemed to control the Fund. With respect to any vote of all shareholders in the Fund, the Liquidity Provider will own, as discussed above, a tiny fraction (at most) of the total outstanding voting securities and would not be able to significantly influence the outcome of the vote.

The Liquidity Provider may be able to influence the outcome of matters requiring the approval of preferred shareholders voting as a class. Section 18(a)(2)(D) of the 1940 Act requires approval by a majority of a Fund's preferred shareholders, voting as a class, of any plan of reorganization adversely affecting the preferred shareholders or any action requiring a shareholder vote as provided in Section 13(a) of 1940 Act. Section 13(a) requires shareholders to approve matters such as changing from closed-end to open-end status, changing policies on leverage, or changing fundamental investment policies.

One of the purposes of Section 18(a)(2)(D) presumably is to protect the holders of preferred stock from action taken unilaterally by common shareholders (who, as a class, typically hold substantially all of a Fund's voting securities) that has an adverse effect on the preferred shareholders' investments. In order for a Liquidity Provider to adequately assess its risk in entering into an agreement with a Fund, it needs to evaluate the types of assets in which the Fund will invest and the policies the Fund will abide by in managing its portfolio. A Liquidity Provider would also be expected to seek a degree of certainty that such policies will not be changed. As a result, we do not expect that Liquidity Providers would be willing to cede their right to vote on these types of issues. Rather, we expect that Liquidity Providers would view their ability to vote on these types of actions—and indeed to prevent such actions if they hold a substantial amount of LPP—as an important mechanism to protect their interests.[17]

We believe that the ability of a Liquidity Provider to vote against, and effectively prevent, actions subject to Section 18(a)(2)(D) does not constitute control or a controlling influence over the Fund for several reasons. The power to vote—even the power to veto—does not mean that a Liquidity Provider can direct the Fund to take action. It is merely the power to prevent the Fund from taking action that it deems adverse to its status as a preferred shareholder and Liquidity Provider. The ability to prevent adverse actions does not necessarily place control of the issuer in the hands of the holders of the preferred stock. Thus, protective vetoes or consent rights more extensive than those provided by Section 13 and granted to minority shareholders have not generally been viewed as constituting a controlling influence, even when coupled with board representation. For example, in American Century Companies, Inc.,[18] the Staff found that a right to prevent a company from engaging in certain actions that altered the structure or business of the company did not result in a control relationship. We believe that the voting rights granted to preferred shareholders under Section 18(a)(2)(D) are similar in nature to the negative consent rights discussed in American Century. We also note that similar consent rights and restrictions are often included in credit agreements, and lenders to registered investment companies are not considered to control the investment company as a result of those agreements.

Moreover, as a practical matter, Fund management generally will remain in control of the Fund's policies and operations and hold the right to decide when changes in such matters will be brought to a vote of shareholders. Fund management is unlikely to present matters covered by section 18(a)(2)(D) for a shareholder vote if it believes that its proposal will fail to gain approval by preferred shareholders whether or not the Liquidity Provider is the primary holder of the LPP. It is more likely that management may choose to redeem the LPP (thereby eliminating the influence of LPP shareholders on the outcome) or, if the Liquidity Provider has been required to purchase all of the LPP, delay the vote for a few months until after a mandatory repurchase or Fund Put has occurred.

Liquidity Providers also may be able to influence the outcome of an election for the two directors attributable to the preferred shareholders, or as a majority preferred shareholder, to have the unilateral power to elect them. Those directors, however, should not be considered to be controlled by the Liquidity Provider. Directors have a fiduciary duty imposed by state law to act in the interest of all shareholders, and it would be inconsistent with this duty for directors to advance the interests of the Liquidity Provider at the expense of other shareholders and the Fund generally. In addition, the two directors generally would not constitute a majority of the Fund's directors or a majority of the Fund's directors who are not "interested persons," as defined in Section 2(a)(19), of the Fund (the "Independent Directors"). Absent such a majority, the two directors elected by the preferred shareholders would not be able to exert a controlling influence over the Fund or its adviser.[19] As a result, we believe that when a Liquidity Provider merely elects two directors and those directors do not represent a majority of the directors or the Independent Directors, that board representation is insufficient to control the Fund, absent other evidence of the power to influence management.

We acknowledge that the requisite element of control may be present if the two directors elected by the Liquidity Provider either 1) represent a majority of the entire Board or a majority of Independent Directors, or 2) are officers, directors, partners, copartners or employees of the Liquidity Provider. We also acknowledge that other relationships or arrangements between a Liquidity Provider and a Fund or its affiliates could lead to a different conclusion.[20]

Our position is consistent with prior Staff interpretations that appear to recognize that board representation, even coupled with an economic interest in a company, does not make a person an affiliate under the 1940 Act. In one set of facts, for example, the ability to appoint one out of six directors of a fund did not result in control of that fund.[21] In another situation, the right to elect two of the ten board members coupled with a significant economic interest and certain negative consent rights did not constitute control.[22]

The requested assurance is also consistent with the legislative intent of the 1940 Act. Congress included specific voting rights for preferred shareholders, including the right to elect two directors, to avoid the types of inequities committed upon holders of preferred stock prior to the enactment of the 1940 Act,23 but did not intend to give those holders "control" of a Fund.24 Rather, a Fund would have to fail to pay dividends for two years before a holder could gain control by electing a majority of the board. There would have been no need for the 1940 Act to specifically provide the ability to elect a majority of the board under such circumstances if Congress had viewed the preferred shareholders as controlling a Fund based on their ability to veto certain actions by voting as a class or elect two of the Fund's directors. Section 18(a)(2)(C) itself sets out a carefully designed framework for when preferred stock holders should and do have the right to exercise control over the Fund (i.e., in the event of two years of payment defaults).

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For all of the foregoing reasons, we request your assurance that the Staff would not recommend enforcement action to the Commission against a Liquidity Provider or Fund (with respect to the Liquidity Provider) under the Affiliate Restrictions that would be triggered solely by the circumstances described in this letter.

We look forward to discussing our request with you at your earliest convenience. Please feel free to contact me at (202) 326-5815, Bob Grohowski at (202) 371-5430, or Dorothy Donohue at (202) 218-3563 if you have any questions or would like additional information.

Sincerely,

Karrie McMillan
General Counsel

cc: Andrew J. Donohue, Director
James M. Curtis, Branch Chief
Lily C. Reid, Senior Counsel
Division of Investment Management

ENDNOTES

1 The Investment Company Institute ("ICI") 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 $10.14 trillion and serve over 93 million shareholders.

2 See Eaton Vance Management, SEC No-Action Letter (June 13, 2008), available at http://www.sec.gov/divisions/investment/noaction/2008/eatonvance061308.pdf (the "EV Letter").

3 See Thomas J. Herzfeld Advisors, "The Investors Guide to Closed-End Funds," at 16 (March 2009) (noting that there was $63.883 billion in closed-end ARP outstanding prior to February 2008, of which, as of February 25, 2009, $31.067 billion has been redeemed or is pending redemption pursuant to an announcement by the issuer). ICI data shows that these funds had a market value of $127 billion in common shares outstanding as of year-end 2007.

4 See, e.g., Thomas J. Herzfeld Advisors, The Investors Guide to Closed-End Funds, at 3 (April 2008).

5 See, e.g., “New Trouble in Auction Rate Securities,” The New York Times, p. C1 (February 15, 2008).

6 Funds and Liquidity Providers are evaluating various options to ensure that Liquidity Providers do not hold LPP indefinitely. Three of these features were described in the EV Letter: 1) an escalation of dividend rates following failed remarketings; 2) a mandatory repurchase of the LPP held by the Liquidity Provider after a stated period of time (e.g., six months) and/or upon the occurrence of predefined conditions (e.g., the Liquidity Provider owns more than a certain percentage of the outstanding LPP); and 3) a conditional contractual right, given to the Liquidity Provider, to sell (put) the LPP to an affiliate of the Fund (e.g., the Fund’s investment adviser or its parent) after a stated period of time and/or upon the occurrence of predefined conditions. For purposes of this letter, we define the second and third of these features, where the Liquidity Provider has the contractual right to sell acquired LPP to the Fund, or an affiliated person of the Fund, under specific circumstances, as the “Fund Put.” Some or all LPP will have a Fund Put. The versions of LPP being contemplated that have a Fund Put may have different holding periods before the Fund Put takes effect.

7 Section 17(a) of the 1940 Act, for example, generally makes it unlawful for any affiliated person of a registered fund, acting as principal, knowingly to sell any security or other property to such registered company or purchase from such registered company, any security or other property.

8 Section 2(a)(42) of the 1940 Act defines “voting security” as “any security presently entitling the owner or holder thereof to vote for the election of directors of a company.”

9 Section 2(a)(3)(A) of the 1940 Act defines an affiliated person as “any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person.”

10 Section 18(a) of the 1940 Act requires Funds to have asset coverage of at least 200 percent for preferred stock, both immediately after issuance of the stock and upon the declaration of any dividend or distribution.

11 See 1st Real Property Securities Fund, SEC No-Action Letter (January 18, 1973) (noting that the mere fact that a fund does not own more than 5% of the voting securities of a venture does not preclude the finding of an affiliation by the Commission through a control relationship) (notes omitted).

12 We understand that a Commission order rebutting a presumption of control can have retrospective as well as prospective effect. See Fundamental Investors, Inc., 41 SEC 285 (1962).

13 Based upon the same methodology, money market funds’ purchase of LPP will not violate the prohibition on owning more than 3% of the total outstanding voting stock of another investment company in section 12(d)(1)(A)(i). As a practical matter, money market funds’ ownership of LPP would be limited by the 5% and 10% thresholds in sections 12(d)(1)(A)(ii) and (iii), respectively, because those thresholds are calculated based upon the value of the money market fund’s assets, rather than the total outstanding voting stock of the Fund issuing LPP.

14 See note 6, supra.

15 See, e.g., the EV Letter.

16 Other instances where the LPP might be redeemed in large amounts will be at the option of the Fund, and not the Liquidity Provider, and so do not give rise to the same concerns. For example, the Fund may wish to accelerate redemption under the voluntary redemption provisions of the LPP for economic or business reasons.

17 In fact, liquidity agreements between Funds and their Liquidity Providers may provide similar consent rights, so that the Liquidity Provider will have the contractual power to prevent a Fund from engaging in these types of transactions regardless of whether it owns LPP.

18 American Century Companies, Inc., SEC No-Action Letter (Dec. 23, 1997) ("American Century").

19 An external investment adviser provides or supervises all the services necessary to operate and manage each Fund. The 1940 Act requires the vote of a majority of a Fund's directors, including a majority of the Independent Directors, to take critical actions regarding the Fund's investment adviser, such as approval, annual renewal or termination of the investment adviser's contract with the Fund.

20 For example, if the Liquidity Provider owned sufficient common stock of the Fund, such that when combined with its holdings of preferred stock, it would own 5% or more of the Fund's outstanding voting securities, the Liquidity Provider would not be able to rely upon this letter.

21 Nat'l. Liquid Reserves, Inc., SEC No-Action Letter (February 28, 1980). See also Investors Mutual, Inc., 42 SEC 1071, 1078-80, aff'd, Phillips v. SEC, 388 F.2d 964 (2d Cir 1968).

22 See American Century.

23 See, e.g., Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, Part 3, Chapter 5, H.R. Doc. No. 279, 76th Cong., 1st Sess. (1939), at pages 1790-96.

24 See Hearings Before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, 76th Cong. 3rd Sess. (1940), at pages 1046-47 (statement of Commissioner Robert E. Healy). In his statement, Commissioner Healy said:

I do not for a minute believe that we should have a statute here which permits anybody to turn the voting control of a corporation over to the preferred stock holders merely because the preferred stock happens at a particular moment to be under water, or merely because the dividends have been passed, let us say, for one period or for a year.... Yet, in some cases the preferred stock has not had a dividend for 5, 6, 7, or 8 years, and the preferred stock holder is completely helpless.... If this language in the bill is not satisfactory, then I should like to suggest that the committee consider a provision...that after dividends have been in arrears for a certain length of time, the preferred stock holders, voting as a class, can elect X percentage of the board of directors.... You might put an additional safeguard by providing that the control of the board of directors should not be turned over while the common stock can demonstrate that there is a fair chance...that the dividends can be resumed...