

**Testimony of William Adams IV**  
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**Before the Committee on Financial Services**  
**U.S. House of Representatives**  
**September 18, 2008**

Chairman Frank and members of the Financial Services Committee, thank you for inviting me to testify today about the continuing turmoil in the auction-rate securities marketplace and about our efforts, as a closed-end fund sponsor and investment adviser, to find ways to relieve the significant financial burdens being borne by the preferred and common shareholders of leveraged closed-end funds.

**Introduction**

My name is William Adams IV, Executive Vice President of Nuveen Investments. I have been employed at Nuveen for 27 years and currently head our Closed-end Fund Group. For the past seven months, my team's principal charge has been to find a resolution to the auction-rate crisis on behalf of our funds' shareholders. Nuveen, through its subsidiaries, is the largest sponsor and investment adviser of closed-end funds in the United States, managing a total of 120 closed-end funds with approximately \$50 billion in assets. One hundred of these funds (the "Funds") have issued auction-rate preferred stock ("ARPS") as a way to seek to capture the difference between generally lower short-term borrowing rates and generally higher long-term investment returns, thereby offering common shareholders the potential for enhanced distributions and total returns over time. Nuveen Funds together represent the largest issuer of ARPS with more than \$15 billion of ARPS outstanding at the time the auction rate securities market experienced sudden and widespread failures in February of this year. My testimony will provide some background on how the ARPS market developed and functioned, and the causes of that market's breakdown, but given the Committee's focus on helping resolve the current situation, I plan to focus primarily on potential solutions.

**Impact on Investors**

The failed auctions for our Funds have continued uninterrupted to the present time. This has resulted in decreased earnings for the over 1 million common shareholders of our Funds, and has prevented tens of thousands of ARPS shareholders from liquidating their shares at par at weekly auctions. This has created significant financial hardship for many preferred shareholders who have been unable to

sell their ARPS to meet a host of pressing financial needs. The ARPS turmoil has also introduced increased uncertainty and volatility in the market for the Funds' common shares, which trade on stock exchanges. The industry-wide scope of this problem is more far-reaching than many believe, as it affects preferred shareholders with over \$60 billion in closed-end fund ARPS holdings and common shareholders with over \$100 billion in common share holdings.

### **Nuveen's Response to ARPS Crisis**

Soon after the systemic breakdown of the auction-rate securities market, we concluded that it was the absence of market liquidity, rather than credit concerns related to our Funds, that caused the auction failures. It was also our view that the existing ARPS market was unlikely to return to normal in the foreseeable future and that continued failed auctions would be detrimental to our Funds and their shareholders. In March, Nuveen and the Funds announced they would seek to refinance all the Funds' outstanding ARPS. Nuveen and the Funds set a goal to refinance the outstanding ARPS using a range of alternative financing methods, and to do so in a way that would reduce the Funds' relative cost of leverage over time for the benefit of our Funds' common shareholders while providing liquidity at par for our Funds' preferred shareholders. We sought to do this as quickly as possible, cognizant that there would be significant challenges due to the extremely difficult financing environment and the need to obtain regulatory relief to enable certain potential refinancing solutions. We committed to keep common and preferred shareholders and other market participants fully informed of our progress towards our goal with ongoing press releases, conference calls, and website information.

Our primary approach for refinancing the ARPS issued by our non-municipal closed-end Funds was to use conventional debt financing in the form of bank loans, lines of credit, and other forms of secured lending. For our municipal Funds, we considered the use of tender option bonds, or TOBs<sup>1</sup>, which due to collateral requirements could be used only to a limited extent. More importantly, we undertook to develop a new form of preferred stock – Variable Rate Demand Preferred or VRDP – that included a liquidity backstop, or put, [furnished by a financial institution with a short-term debt rating in the highest tier](#) that would make the new preferred stock eligible for purchase by tax-exempt money market funds pursuant to Rule 2a-7 of the Investment Company Act of 1940 (the "Investment Company

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<sup>1</sup> TOBs involve a fund depositing portfolio securities into a trust and having the trust issue short-term floating rate interests (called "tender option bonds") secured by the deposited securities. The depositing fund gains the use of the proceeds of the sale of the TOBs, which the fund can use to invest in other portfolio securities or to redeem other leveraging instruments. TOBs are typically sold to tax-exempt money market funds, which are required to adhere to strict credit quality standards.

Act”). Our municipal Funds, which have issued a significant majority of our Funds’ ARPS, need to employ a financing vehicle that is characterized as equity for tax purposes and that enables the Funds to pass through the Funds’ tax-exempt income to preferred shareholders. VRDP would be the only means for the Funds to continue their financing at lower tax-exempt short-term rates of interest, as was the case with ARPS. VRDP also benefits from the lower 200% asset coverage threshold required by the Investment Company Act rather than the 300% asset coverage required by the Investment Company Act for debt financing. For this reason, we also identified VRDP as a potential financing alternative for our equity and corporate debt Funds.

### **Progress on Potential Solutions**

Significant progress has been made in the seven months since our Funds began their ARPS refinancing efforts. Still, we are not where we and our preferred and common shareholders would have wanted us to be at this point in time. Unprecedented turmoil in the financial markets, including the failure of major financial institutions and resulting market disruptions, has severely limited the availability of financing and liquidity backstops, even for highly creditworthy entities like the Funds. To date, Nuveen’s non-municipal Funds have redeemed or announced plans to redeem \$2.7 billion of their outstanding ARPS using traditional lending arrangements with a variety of major financial institutions. In addition, 32 of our municipal Funds have completed or announced a partial redemption of their outstanding ARPS totaling \$1 billion through the use of TOBs. Most significantly, we have recently achieved an important breakthrough in our efforts to develop VRDP. In August, four of our municipal Funds successfully refinanced all of their outstanding ARPS, totaling approximately \$600 million, using the proceeds from both TOBs and the issuance of a total of \$500 million of VRDP that was purchased by tax-exempt money market funds. The VRDP was developed in close consultation with major money market funds and a major commercial bank, and we believe there is significant additional demand for VRDP from money market funds that could enable the refinancing of all our Funds’ outstanding ARPS, and potentially much or all of the outstanding ARPS of closed-end funds industry-wide.

We greatly appreciate the timely guidance that we (along with others in the industry) have received from the Securities and Exchange Commission (“SEC”) and the Department of the Treasury (“Treasury”) in the development of VRDP. We also appreciate the sense of urgency this Committee has imparted on regulatory agencies and market participants to find creative solutions to this serious problem. That said, we believe there remain a number of regulatory impediments that hamper our Funds’ ability to significantly expand their issuance of VRDP as well as to pursue other approaches for refinancing

outstanding ARPS. With additional regulatory relief and/or guidance from the SEC, Treasury and the Federal Reserve, we believe that we and the entire closed-end fund industry will be able to significantly accelerate our ability to provide liquidity for preferred shareholders while facilitating new and viable forms of financing for closed-end funds moving forward.

### **Key Regulatory Actions That Could Accelerate Progress**

I would like to briefly highlight a few of the areas where regulatory relief or guidance would be most instrumental and which I discuss in greater detail later in my testimony.

First and foremost is clarification of the ability of banks to own VRDP pursuant to their purchase obligations as a liquidity provider for VRDP, and approval from the Federal Reserve to allow banks to pledge VRDP as collateral at the Fed discount window. Existing constraints regarding the ability of banks to own preferred stock, and the fact that VRDP is not eligible collateral for Fed discount window purposes, have significantly limited the ability of banks to provide liquidity backstops for VRDP despite VRDP's inherently high credit quality and despite significant potential demand from money market funds and other institutional investors.

Second, it would be quite helpful if the SEC would expedite its consideration of exemptive relief requests under Section 18 of the Investment Company Act to temporarily permit closed-end funds to use debt financing to a greater extent than currently permitted and enable funds that utilize debt leverage to fully refinance their ARPS. The SEC is currently considering these requests on a case-by-case basis. Ideally, it would be very helpful if the SEC made the requested relief available to all closed-end funds seeking substantially the same relief.

Third, it would be helpful if the Treasury Department provided further clarity regarding the equity treatment of closed-end fund preferred that includes liquidity backstops. The Treasury's recent guidance in this area, while helpful, is limiting in that it is applicable to a type of preferred stock with very specific features that may not be the most desirable set of features for closed-end fund preferred stock, including variations on VRDP, still in development. Ideally, we would appreciate it if Treasury would provide greater flexibility for closed-end funds to structure new forms of preferred stock as an equity security for tax purposes, and that would allow equity as well as debt-oriented funds to issue such preferred. It would also be helpful if the guidance was permanent rather than applicable only to funds refinancing existing ARPS within the next two years.

Finally, it would be helpful if the Treasury Department would clarify that federally tax-exempt municipal bond interest subject to the Alternative Minimum Tax (AMT) should not be subject to the provisions of Revenue Ruling 89-81 which requires different types of income earned by a closed-end fund be allocated to common and preferred shareholders on a pro-rata basis. The need to allocate AMT income earned by our funds to VRDP shareholders, even in small amounts, has precluded a meaningful number of major money market funds with non-AMT policies from becoming potential purchasers. We do not believe such a clarification, narrowly written, would undermine the general policy intent of the Revenue Ruling.

### **Background on Use of ARPS by Nuveen Closed-End Funds**

Before getting into more detail on needed regulatory actions, I would like to provide some background on the use of ARPS by our Funds. Many Nuveen Closed-End Funds employ financial leverage as a strategic element of their overall design in order to offer shareholders the potential for enhanced distributions and total returns over time. Nuveen believes that there are certain asset classes whose yields and long-term returns historically have consistently exceeded short-term financing rates. By judiciously using leverage that pays dividends or interest based on such short-term rates and investing the proceeds in these higher-yielding or higher returning asset classes, a fund can enhance its long-term performance potential. Keep in mind that the Investment Company Act limits the amount of leverage closed-end funds can employ to a relatively conservative maximum of 0.5 to 1 (e.g., \$1 of leverage for every \$2 of assets). Most Nuveen funds that employ leverage are leveraged at a ratio of between 0.33 and 0.4 to 1.

Leveraged municipal bond funds are one of the largest segments of the closed-end fund market and account for the substantial majority of Nuveen's leveraged closed-end fund assets under management. Leveraged municipal bond closed-end funds are designed to capture the persistent yield spread that has existed historically between long-term and short-term rates in the municipal bond market. This yield spread reflects the generally upward-sloping nature of the municipal yield curve created by the mismatch between municipalities' preference for issuing longer-term securities and municipal investors' preference for shorter-term securities.

Historically, this yield spread has offered closed-end fund investors an attractive opportunity to enhance both common share dividends and the total returns available from a portfolio of municipal bonds.

The accompanying chart shows that, for a hypothetical leveraged municipal closed-end fund investing its portfolio in a long-term municipal bond index and leveraging itself at the rates of a short-term municipal bond index, leverage generated positive incremental returns (often quite significant) to common shareholders over 100% of all 5-year rolling periods, over almost 100% of all 3-year rolling periods, and over the vast majority of all 1-year rolling periods, during the 19-year period covered by the chart. The actual experience of the common shares of Nuveen's leveraged closed-end municipal funds is very similar.

**Historical Incremental Returns from Leverage\***  
Rolling Investment Horizons, July 1989 – August 2008



\*For illustrative purposes only. Incremental returns based upon an assumed 35% leverage ratio. Long-term rates are represented by the Lehman Genreal Municipal Bond Index. Short-term rates are represented by the SIFMA Municipal Swap Index.

As mentioned earlier, closed-end funds investing in municipal bonds earning federally tax-exempt income cannot efficiently leverage themselves by borrowing or issuing debt securities, because such funds are not permitted by the Internal Revenue Code to pay interest that is federally tax-exempt. Absent something else, they would therefore need to pay financing rates at a federally taxable rate that would not be able to take advantage of the upward-sloping municipal yield curve previously mentioned. The Code, however, does authorize municipal bond funds to pay dividends that qualify as “exempt interest dividends,” effectively passing through to fund shareholders the tax-exempt quality of the income earned on a fund’s investment portfolio. Our municipal Funds thus elected to employ leverage by issuing ARPS, which pay dividends at rates determined at a weekly auction. Those auctions also served as the normal medium through which investors could buy ARPS and preferred shareholders could sell their ARPS. We describe this process in more detail later in my testimony. For almost 20 years, the ARPS

succeeded at both providing the closed-end funds with a low-cost financing vehicle for their leverage and preferred shareholders with an attractive and historically liquid investment paying short-term rates. The success and cost-efficiency of ARPS for municipal closed-end funds caused non-municipal closed-end funds to also use ARPS as their primary leverage financing vehicle.

While leverage offers a closed-end fund the opportunity for higher common share distributions and total returns over time, a leveraged fund also exposes common shareholders to increased risk from greater volatility in common share yield and net asset value (NAV) than an otherwise comparable non-leveraged fund. First, the spread between long-term fixed-income funds' earnings rates and short-term rates (i.e., the fund's borrowing rate) can vary widely over time, and this changing spread can increase the volatility of the leveraged fund's common share earnings and distributions. Moreover, because common shareholders of a leveraged fund bear the market risk on a fund's portfolio assets attributable to leverage, the NAV of a leveraged fund will fluctuate to a greater degree compared to an otherwise similar non-leveraged fund.

### **Background on the ARPS Market and the Auction Process**

Nuveen's leveraged closed-end Funds typically issued ARPS several months after the initial public offering of their common shares, to coincide with the completion of the investment of the proceeds raised in the funds' initial common share offering. The Funds engaged a major broker/dealer firm to serve as lead underwriter (the "lead manager"), and often additional underwriters ("co-managers") that would initially place the ARPS with investors. The ARPS issued by the Nuveen Funds have a "liquidation preference" (akin to a bond's "par amount") of \$25,000 per share. The aggregate liquidation preference of the ARPS issued by a Fund would correspond to the Fund's desired leverage ratio (e.g., a ratio of common share assets to ARPS of 2:1 would result in a leverage ratio of .33).

The lead manager, co-managers, and other broker/dealer firms that may not have participated in the initial ARPS offering (collectively "Auction Participants"), would enter into an auction participant agreement with the Funds that enabled them to participate in the weekly auctions for the Funds' ARPS. Auction Participants were permitted to participate in the Funds' ARPS auctions by submitting bids on behalf of their investor customers, or for their own account, to an independent third party (the "Auction Agent") pursuant to guidelines specifying the types of bids and the process for submitting such bids. Any investor wishing to buy or sell ARPS in the auctions needed to do so through the broker/dealer firms that were Auction Participants or broker/dealer firms that had clearing relationships with Auction Participants

who would bid on their behalf on an agency basis. On average, Nuveen Funds had approximately 25 Auction Participants bidding at weekly ARPS auctions, with 6 of them serving as lead managers. For their role in bidding at the auctions and all the attendant responsibilities involved, including recording and clearing ARPS trades, disseminating ARPS rates and relevant market information to investor customers, and submitting bids on their behalf, Auction Participants were paid a weekly fee at the annual rate of 0.25% based on the par amount of ARPS held by the broker/dealer and its customers.

The ARPS auctions were conducted in a manner commonly referred to as a “Dutch auction”. Existing ARPS shareholders could, with respect to their existing shares, place one of three types of orders: “hold”, “hold at (or above) a specified rate”, and “sell”. New investors (including existing shareholders wishing to buy additional shares in an auction) could place either a “buy” or a “buy at (or above) a specified rate” order. The dividend rate set in a particular auction would be the rate, as determined by an Auction Agent that conducted each auction, that would “clear” all the shares being sold – the lowest rate at which the number of shares being sold would exactly equal the number of shares being newly purchased (with a process for prorating any “ties”). The lead manager of the underwriting of a particular Fund’s series of ARPS would typically assume the responsibility of closely overseeing the conduct of that series’ weekly auctions, and would place “buy at a rate” bids in auctions with its own capital to help ensure that there would be a sufficient number of bids to “clear” the auction if there were a larger-than-expected number of “sell” orders (including “hold at/above a rate” orders with high specified rates).

Under the terms of the ARPS, a failed auction results in the dividend rate on the ARPS being determined based on an index-based formula designed to penalize the Fund and compensate the ARPS shareholder for their inability to liquidate their ARPS at the auction (the “Maximum Rate”), while at the same time offering some protection to the Fund’s common shareholders from a potentially egregious cost of leverage should the rate be set at whatever level the market might bear (this was the case for many municipal issuers who saw interest rates on their failed auction-rate bonds rise well into double digits). This higher Maximum Rate was also intended to draw potential buyers back into the auctions so that the subsequent auction might succeed.

The federal securities laws and the terms of each Fund’s ARPS preclude Nuveen’s closed-end Funds from participating at the auctions for their own or their affiliated Funds’ ARPS. Nuveen, as the Funds’ investment adviser, is similarly precluded from participating in the Funds’ ARPS auctions for its own account. Nuveen is allowed to, and did routinely, place “buy” or “sell” orders in the weekly auctions

solely on an agency basis on behalf of other broker/dealers and their investor customers. Nuveen did not have any direct relationships with ARPS investors and mainly provided the operational capabilities as a service to broker/dealer firms who did not have the necessary personnel and trading systems to bid at the ARPS auctions directly. Other Auction Participants served in a similar role for similarly situated broker/dealer firms. The principal goal behind Nuveen's role was to help expand the number of firms bidding at the Funds' ARPS auctions with the expectation of increasing competition among bidders, and potentially achieving a lower cost of leverage for the Funds that could enhance potential common shareholder net income and/or returns. Nuveen placed "buy" and "sell" orders on an agency basis only for Nuveen Fund-issued ARPS. Like other Auction Participants serving in a similar capacity, Nuveen receives the Auction Participant fee based on the holdings of Nuveen Fund ARPS beneficially owned by investor customers of the broker/dealers on whose behalf Nuveen placed orders. Nuveen shares approximately 50% of the amount it receives with the broker/dealers on whose behalf it placed bids. The balance retained by Nuveen is intended to cover the cost of its ARPS-related personnel and trading systems and is reviewed at least annually by the Funds' independent trustees. In addition to the above activities, Nuveen's and the Funds' principal role in the secondary market for the Funds' ARPS is primarily related to disseminating the clearing rates on Nuveen Fund ARPS through their website and responding to client service questions from financial advisors regarding the Funds' ARPS.

#### Risk Disclosures Regarding Potential Auction Failures

The Funds' ARPS offerings were made pursuant to a registration statement filed with the SEC including a prospectus that was provided to potential investors at the time of the initial offering. Beginning with the very first offering of ARPS by a Nuveen closed-end Fund in 1989, the prospectuses used in connection with offerings of ARPS by Nuveen Funds contained detailed disclosure regarding the auction process, including, among other things, disclosure of the risk of a "failed auction" – the risk that shareholders may be unable to sell their shares at times when they have placed sell orders. The first offering of ARPS by a Nuveen Fund was completed by the Nuveen Performance Plus Municipal Fund in October 1989, and the prospectus for that offering included the following statement:

*"If Sufficient Clearing Bids do not exist, . . . Existing Holders that have submitted Sell Orders may not be able to sell in such Auction all shares of [ARPS] subject to such Sell Orders."*

As the specific auction procedures evolved over time, so did the disclosure describing the auction process and the risks associated with that process. Even though auctions involving ARPS for a number of Nuveen Funds had been successfully completed for more than ten years and the perceived risk of failed auctions was considered remote, Nuveen Funds continued to disclose the inherent risks of the consequences of a failed auction. For example, in the May 16, 2001 prospectus for the ARPS offering by Nuveen Dividend Advantage Municipal Fund 2, the first risk disclosed was (Page 2 of the prospectus):

*“• if an auction fails you may not be able to sell some or all of your shares;”*

In that same prospectus, the following was the first sentence of the Risk Factor entitled “Auction Risk”:

*“You may not be able to sell your [ARPS] shares at an auction if the auction fails; that is, if there are more [ARPS] shares offered for sale than there are buyers for those shares.”*

Prospectus disclosure also made it clear that a Fund has no obligation to repurchase shares in the event a shareholder is unable to sell shares in the event of a failed auction or as a result of a failure to sell shares in the secondary market. The following sentence was included in the prospectus under the Risk Factor entitled “Secondary Market Risk”:

*“Broker-Dealers that maintain a secondary trading market for [ARPS] are not required to maintain this market, and the Fund is not required to redeem shares either if an auction or an attempted secondary market sale fails because of a lack of buyers.”*

As mentioned above, as the auction process evolved over time, so did the relevant disclosure. However, the offering materials consistently disclosed that shareholders were subject to the risk of failed auctions and a potential inability to sell shares when they desired to do so. While the disclosure among Funds varied from time to time, the above disclosure cited from the prospectus for the Dividend Advantage Fund 2 remained a representative example of the type of disclosure made on behalf of the Nuveen Funds that issued ARPS from 2001 through 2007.

## Background on the Auction Failures

As mentioned earlier, Nuveen closed-end funds first issued ARPS almost 20 years ago. The auction process described above worked smoothly with no Nuveen Fund ever experiencing a failed auction on their ARPS until late January of this year. Over those nearly 20 years, dividend rates on ARPS fluctuated in fairly close concert with relevant short-term money-market indexes, and over time, ARPS became an effective means of leveraging the Funds. The first failed ARPS auction experienced by one of our Funds in late January was unexpected and was viewed at the time as an isolated incident related to the inability of the lead manager of the original ARPS issuance to produce enough “buy” orders to clear the auction. Indeed, all auctions for Nuveen ARPS, including the ARPS whose auction initially failed and other auctions for which the same firm served as lead manager, succeeded in the ensuing days and weeks. Several weeks later, however, all auctions for all series of ARPS issued by Nuveen Funds and most other closed-end funds – irrespective of which firm was the lead manager – failed virtually in unison as credit and liquidity concerns began to spread through the financial markets, and Auction Participants, including the various lead managers, did not submit sufficient bids to cover ARPS sell orders. The failures caused all of the funds’ ARPS dividend rates to be set at the Maximum Rate, a condition that continues to this day. This, in turn, has increased the cost of leverage for our closed-end Funds and their common shareholders and illiquidity for ARPS holders, a condition that is expected to persist as long as auctions continue to fail.

Although auctions have continued to fail since mid-February, auctions continue to be held for all of our Funds’ ARPS. Auction Participants continue to place orders at the auctions on behalf of their investor customers, although the majority of orders are “sell” orders. From time to time, the Auction Agent receives small amounts of “buy” orders which are matched against “sell” orders and executed pursuant to an impartial lottery system administered by the Auction Agent. A number of entities have sought to create a secondary market for the ARPS. There have been reports, that we cannot confirm, of closed-end fund ARPS sales in these markets at prices below par. However, due in part to the successful efforts of a number of closed-end fund sponsors to refinance their funds’ ARPS at par, the significant majority of ARPS shareholders have opted to wait, albeit anxiously, for their ARPS to be redeemed through refinancings by the funds. Most major pricing services and major broker/dealer firms have continued to price closed-end fund ARPS at par or very close to par. More recently, announcements by major broker/dealer firms of their intent to repurchase ARPS and other auction-rate securities at par from certain classes of investors has provided the prospect of some liquidity to ARPS shareholders. Still, the broker/dealer purchases do not provide liquidity to all ARPS shareholders and are unlikely to result in the

resumption of successful auctions. Nuveen and our Funds thus remain committed to our original goal of reducing the relative cost of leverage for the Funds and providing liquidity at par for all ARPS shareholders.

### **Expanded Discussion of Regulatory Actions That Could Help Resolve the ARPS Crisis**

Since the substantial failure of the auction process, Nuveen and other sponsors of leveraged closed-end funds have sought to diligently and systematically develop marketable and economically feasible long-term or permanent refinancing solutions for ARPS. Our Funds' recently completed VRDP issuance is an important potential solution, as are similar preferred securities proposed by other closed-end funds that include liquidity support furnished by a financial institution with short-term debt ratings in the highest tier (collectively, "Demand Preferred").

Many of the possible solutions to replace ARPS have presented challenging issues for key regulators. As mentioned earlier, we would like to express our gratitude to the Committee for its continued interest in achieving the widest possible range of solutions to this difficult situation. Regulators such as the SEC and Treasury have worked with the industry to overcome regulatory hurdles, and we believe that the Committee's support has helped accelerate the speed with which the industry has been able to obtain necessary clarifications and relief. For example, the SEC staff has already issued a letter clarifying the eligibility of liquidity supported preferred stock, such as Demand Preferred, for purchase by money market funds, and Treasury has issued guidance that confirms that certain types of Demand Preferred are equity securities for tax purposes.<sup>2</sup> These interpretations are critical building blocks in the industry's efforts to create a viable market for Demand Preferred.

We believe additional regulatory actions are needed to ensure the economic feasibility of permanent or long-term refinancing solutions for ARPS issued by closed-end funds. While the potential supply of new municipal Demand Preferred is estimated to range from \$15 billion to as much as \$25 billion, to date only \$500 million of Demand Preferred has been issued, a sharp contrast to developments

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<sup>2</sup> With respect to the SEC action, see Eaton Vance Management, SEC No-Action Letter (June 13, 2008), which clarified the situations under which a liquidity provider purchases Demand Preferred, as well as whether or not Demand Preferred is a redeemable security under the Investment Company Act, and which allows Demand Preferred to be tendered for purchase by a liquidity provider without compliance with the tender offer requirements of the federal securities laws. With respect to the Treasury action, see Notice 2008-55, 2008-27 Internal Revenue Bulletin, 11, June 13, 2008 (revised June 25, 2008), which explains that where the issuer of ARPS adds a liquidity facility to support the stock (or replaces the stock with Demand Preferred), the IRS will not challenge the treatment of the ARPS or Demand Preferred as equity for income tax purposes provided certain conditions are satisfied. Among the conditions that must be met, the ARPS enhanced or replaced must have been outstanding in February 2008, and the issuer's portfolio must consist primarily of debt.

in the municipal bond market where \$50 billion or more of municipal auction rate securities have been refinanced. Further, we estimate that, due at least in part to regulatory constraints, only about \$2 billion of additional liquidity support for new issuance of Demand Preferred has been publicly announced to date. Liquidity support has been elusive despite the fact that almost all of the ARPS issued by closed-end funds have long-term preferred stock ratings in the highest tiers (AAA or AA), and are over-collateralized, as indicated by asset coverage levels substantially in excess of Investment Company Act asset maintenance requirements, and otherwise are potentially attractive business opportunities for liquidity providers.

The success of Demand Preferred as a replacement for outstanding ARPS issued by closed-end funds hinges on the Demand Preferred being eligible for purchase by money market funds in accordance with Rule 2a-7 under the Investment Company Act. The eligibility and desirability of Demand Preferred as an investment for money market funds in turn depends on the ability and willingness of financial institutions to provide, at a reasonable cost to its closed-end fund issuers, liquidity to shareholders of the Demand Preferred in the form of an unconditional purchase obligation or guarantee consistent with the requirements of Rule 2a-7. Other critical factors include preserving the equity character of Demand Preferred stock and, for the tax-exempt market, the tax-exempt character of Demand Preferred dividends.

Below, we suggest, with greater specificity than the similar discussion earlier in this written testimony, a number of banking, tax and securities law actions that we believe would benefit the development and success of both the Demand Preferred market. These initiatives would facilitate Rule 2a-7 eligibility and enhance the attractiveness of Demand Preferred as an investment for money market funds, and create other means to finance the replacement of outstanding closed-end fund ARPS, all while adhering to the policy objectives of the relevant regulatory regimes.

#### Matters Relating to Banks Acting as Liquidity Providers

*1. Eligible Collateral for Extensions of Credit by a Federal Reserve Bank* - We have found through our discussions with potential liquidity providers that the ability and willingness of banks to act as liquidity providers for Demand Preferred issued by closed-end funds, in sufficient volume to replace a meaningful amount of ARPS, is primarily subject to such banks obtaining regulatory approval to use Demand Preferred as eligible collateral for extensions of credit by the Federal Reserve. Absent such approval, these liquidity provider facilities may be too expensive to provide a meaningful solution for Demand Preferred.

We understand that the Federal Reserve has been reviewing requests to treat various structures of Demand Preferred as eligible collateral but that no action has yet been taken. In our view, there should not be any economic or policy objection to permitting the use of Demand Preferred as eligible collateral. This is because, as discussed below, Demand Preferred must constitute an eligible bank investment in order for a bank to acquire Demand Preferred in its role as liquidity provider (see next sub-section below); Demand Preferred will be investment-grade rated at the time of issuance; the issuer will be subject to both ratings maintenance covenants and regulation under the Investment Company Act with respect to the amount of permissible leverage; and Demand Preferred may have a final term through a scheduled mandatory redemption. We seek only to level the playing field between Demand Preferred and other income-oriented and creditworthy collateral already permitted and, accordingly, an expedited favorable resolution of this matter from the Federal Reserve would be highly beneficial to the development of the Demand Preferred market.

*2. Eligible Investments for Banks* - National banks, state banks and even foreign banks doing business in the U.S. through domestic branches may act as liquidity provider for Demand Preferred of closed-end funds only to the extent that such securities constitute eligible investments under applicable Federal and state banking regulations. These regulations require, among other things, that the assets of every closed-end fund issuing the Demand Preferred consist solely of assets that themselves constitute eligible investments for banks. This regulatory “look through” has caused significant obstacles for banks seeking to serve as liquidity providers for certain closed-end funds that invest, even to a miniscule extent, in “ineligible investments.”<sup>3</sup> Those closed-end funds must either alter their investment policies to invest only in bank eligible investments or must look to financial institutions other than banks to serve as liquidity providers for their Demand Preferred.

To permit closed-end funds issuing Demand Preferred broader and more meaningful access to banks as liquidity providers, while preserving their ability to invest in accordance with their stated investment objectives and policies described in their prospectuses and shareholder reports, the applicable banking regulations would need to be revised to treat Demand Preferred of a closed-end fund as an eligible bank investment, without “looking through” to the assets of the closed-end fund. Alternatively,

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<sup>3</sup> For example, we are told that these regulations prohibit a bank from investing in (and therefore from serving as liquidity provider for) preferred shares of a closed-end fund that itself invests in shares of another fund (a “2nd layer fund”) if any of that 2nd layer fund’s assets are “ineligible” under the banking laws (in industry parlance, the closed-end fund issuer of Demand Preferred would need to “look through” the 2nd layer fund to that fund’s portfolio). Since the investing closed-end fund cannot typically assure itself that the 2nd layer fund owns no “ineligible” investments at all times, it cannot own shares of such a 2<sup>nd</sup> layer fund. This prohibition occurs regardless of whether the 2nd layer fund holding is 0.1% of the portfolio or 10%.

the regulations could be revised to permit the closed-end fund to satisfy the eligible investment requirements based on “looking through” to its assets, so long as the closed-end fund does not invest more than a limited percentage (for example, up to 10.0%) of its portfolio assets that may not meet the definition of eligible investments, but in any event subject to the investment restrictions imposed under the Investment Company Act. Either such change would be consistent with the policies underlying the regulation of eligible bank investments, because (1) the Demand Preferred will be an investment-grade income-producing security that is highly rated at the time of issuance, and subject to ratings maintenance covenants, and (2) the Investment Company Act contains ongoing ceilings with respect to the amount of permissible leverage. We believe that expedited favorable regulatory action on this issue alone would be highly beneficial to the development of the Demand Preferred market, without compromising the banks acting as liquidity providers or existing investors in the closed-end funds.

### Federal Income Tax Matters

*1. Equity Character of Demand Preferred Stock* – Significant tax impediments have arisen in connection with closed-end funds issuing Demand Preferred to refinance outstanding ARPS. In particular, both the engagement of a liquidity provider for a closed-end fund’s Demand Preferred, and the granting to such a liquidity provider the right to put back to the closed-end fund the Demand Preferred acquired pursuant to the liquidity provider’s purchase obligation, may jeopardize the classification of the Demand Preferred as stock for Federal income tax purposes. For a municipal bond closed-end fund, Demand Preferred must be classified as stock for Federal income tax purposes to assure that the dividend paid on the Demand Preferred is itself tax-exempt. Such a result would render the Demand Preferred unusable for municipal bond funds. It would be very beneficial if Treasury could continue to clarify (as it did in Notice 2008-55) and, if appropriate, liberalize its standards for closed-end funds treating Demand Preferred stock as equity for tax purposes.

If the Demand Preferred, standing alone, would otherwise be classified as stock under ordinary tax principles, we believe that engaging a liquidity provider to assure a regular and ordinary market for the Demand Preferred should not cause the Demand Preferred to be reclassified as debt. We particularly believe this should be the result where the Demand Preferred adheres to specified parameters that help ensure that the liquidity provider was engaged primarily to assure a regular and ordinary market for the Demand Preferred. For example, the liquidity provider could be required to hold the Demand Preferred for a least six months before exercising its right to put it to the closed-end fund. In addition, preferred stock qualifying for such tax treatment could be limited to stock with a scheduled mandatory redemption

date not less than 20 years from the date of issue, and the closed-end fund could be required to engage the liquidity provider at a time when (i) the closed-end fund had no foreseeable basis for expecting that the liquidity provider would have to buy the stock and hold it for an extended period, and (ii) the closed-end fund had more than 200% asset coverage for the Demand Preferred.

Alternatively, and much more simply, it would be beneficial if Treasury were to adopt a policy permitting a closed-end fund to itself determine and declare the debt versus equity character of its Demand Preferred. This is similar to what Treasury did a decade ago with its “check-the-box” regulations for corporation versus partnership status, and would require all holders of Demand Preferred to treat their investment in the Demand Preferred as being of the character determined and declared by the closed-end fund.

At the very least, we believe that Treasury could modify its recent guidance on Demand Preferred (in Notice 2008-55) in two important respects. First, the relief should apply to all liquidity-supported preferred stock issued in the future, not just the stock issued to refinance ARPs that were outstanding on February 12, 2008. By so doing, there would be no competitive advantage to those funds that already have issued ARPS and no barrier to entry for new closed-end fund issuances. Second, Treasury’s relief should apply to all closed-end funds, not just those that invest predominantly in debt. If the Treasury’s reluctance to broaden the scope of that relief to equity funds – such as concerns about the tax abuse that might ensue if a fund were permitted to pay all of its Dividends Received Deduction-eligible income to one class of shareholder comprised of investors that benefit from such deductions, and to pay DRD-ineligible income to another class of shareholder comprised of investors that do not benefit from such deduction – the market may well be better served by regulations specifically tailored to the troubling abuse in question.

2. *Exempt Character of Demand Preferred Dividends* – Municipal bond funds need greater flexibility in distributing their earnings. A closed-end fund that invests in tax-exempt municipal bonds should be allowed to classify all of the dividends paid to its Demand Preferred shareholders as consisting entirely of tax-exempt income from the investments of the closed-end fund. To comply with a 1989 IRS ruling (Revenue Ruling 89-81), a closed-end fund having more than one class of stock and more than one type of income must allocate to each class of stock its proportionate share of each type of income. This means, for example, that even if 99.9% of a closed-end fund’s income is tax-exempt and only .1% of its income is subject to the regular tax or the alternative minimum tax (or capital gains tax), the closed-end fund will still allocate a portion of the .1% of taxable income to its Demand Preferred.

Certain potential shareholders, such as certain tax-exempt money market funds, cannot or will not accept any allocation of taxable income. For that reason alone, they will not acquire Demand Preferred even if the Demand Preferred is otherwise economically attractive. It is important for the Treasury to modify Revenue Ruling 89-81 to permit a leveraged municipal closed-end fund greater flexibility in allocating all of its taxable income or at least all of certain types of its taxable income (for example, its income subject to alternative minimum tax) to its common shareholders.

### Investment Company Act Matters

Significant policy issues as well as modest technical issues under the Investment Company Act have impeded the resolution of certain ARPS issues.

*1. Section 18 of the Investment Company Act* - Section 18 of the Investment Company Act requires that closed-end funds maintain asset coverage of at least 200% for preferred stock they issue and at least 300% for debt they issue. In connection with the failed auctions for ARPS issued by closed-end funds, a number of fund complexes are seeking exemptive relief from the SEC so that the 200% asset coverage requirement (rather than the 300% asset coverage requirement) would apply to debt issued to redeem ARPS outstanding prior to February 2008. These applications have been pending for a number of months. This exemptive relief is needed on an expedited basis. Furthermore, it would be helpful if the SEC adopted a temporary rule making the requested exemptive relief available to all closed-end funds similarly situated or otherwise provided expedited treatment for all applicants seeking substantially similar exemptive relief.

The requested exemptive orders seek only temporary relief (i.e., two years from the date that a fund borrows in reliance on the order) from the 300% asset coverage requirements for borrowings. We believe that Congress should consider amending the Investment Company Act to permanently change the asset coverage requirement to 200% (or at least some amount substantially less than 300%) in the case of privately arranged borrowings by closed-end funds from banks or other financial institutions, because such institutions do not require the protections of the Investment Company Act.

*2. Section 12(d)(1)(A) and (B) of the Investment Company Act* – To prevent fund pyramiding, Sections 12(d)(1)(A) and (B) of the Investment Company Act restrict investments by an investment company in another investment company. Specifically, these sections limit a registered investment company from (i)

acquiring more than 3% of the outstanding voting stock of another investment company, (ii) acquiring securities of another investment company in excess of 5% of the value of the acquiring company's total assets, and (iii) acquiring in the aggregate securities of other investment companies in excess of 10% of the value of the acquiring company's assets.

One reason for these limitations is to avoid the duplication and layering of fees that result from a fund investing in other funds without a corresponding benefit. In the case of closed-end fund preferred shares such as Demand Preferred, however, there is no such duplication or layering of fees. The fees and expenses of Demand Preferred and similar preferred shares are borne by the common shareholders, not the issuing fund's preferred shareholders. Consequently, an investment company purchasing Demand Preferred does not experience the duplication and layering of fees that Section 12 is intended to limit.

Another reason for the Section 12 limitations is to prevent complicated and opaque capital structures and to prevent one fund from gaining undue influence over another fund through a pyramid capital structure. The risk that a money market fund could exercise undue influence over an issuing closed-end fund through the ownership of Demand Preferred is low because Demand Preferred is typically created in institutional-sized preferred shares (e.g., a liquidation preference of \$25,000 or \$100,000) representing only a very small percentage of the closed-end fund's voting securities.

While we believe the Section 12(d)(1) limits should not apply to money market funds investing in Demand Preferred, in particular, it would be helpful if the 10% aggregate limit on investment in other investment companies be eliminated or raised, for example to 25%, by SEC rulemaking in the case of money market funds buying Demand Preferred of closed-end funds. This change would be especially helpful in facilitating the sale of Demand Preferred to money market funds. Furthermore, consideration should be given to removing by SEC rulemaking the 5% limit on investment by money market funds in the Demand Preferred of one closed-end fund, since the money market funds are already subject to the issuer and demand feature provider diversification requirements of Rule 2a-7.

*3. Determination of Whether a Liquidity Provider is an Affiliated Person of the Closed-End Fund Issuer of Demand Preferred* - A recurring question that arises in discussions between closed-end funds seeking to issue Demand Preferred and potential liquidity providers is whether a liquidity provider will be deemed to become an affiliated person of a closed-end fund issuer for purposes of the Investment Company Act and other Federal securities laws solely on the basis of the liquidity provider entering into the contractual

liquidity provider arrangements with the closed-end fund or acquiring Demand Preferred issued by the closed-end fund pursuant to its obligation as liquidity provider.

Because the Demand Preferred market is an institutional sized market as described above, such instruments are very unlikely to constitute more than a minimal amount (typically less than 0.1%) of a closed-end fund's total outstanding voting securities, among other reasons. Accordingly, we (and other members of the fund industry) take the view that no presumption of affiliated person (within the meaning of the Investment Company Act and other Federal securities laws) status is created solely on the basis of the liquidity provider entering into the contractual arrangements with the closed-end fund to provide liquidity support or by acquiring Demand Preferred issued by the closed-end fund pursuant to its obligation as liquidity provider. Given such limitation on ownership, the fact that the Investment Company Act gives preferred shareholders certain rights to elect directors does not negate this view, since the directors elected by the preferred shareholders have a fiduciary duty under state law to represent all shareholders (including the common shareholders that represent the vast majority of the total ownership), not just the interests of the liquidity provider or other preferred shareholders as a class.

A "no-action" letter request was submitted to the SEC staff in early July 2008 by an industry group seeking staff concurrence with the view expressed above. We believe that staff assurances along these lines would enhance the willingness of financial institutions to step forward to act as liquidity providers, and it would be beneficial if the SEC staff were to issue a positive response in the very near future.

*4. Redemption Notification Pursuant to Rule 23c-2 under the Investment Company Act - Rule 23c-2* requires that registered closed-end funds provide the SEC with at least 30 days' prior notification of redemptions of outstanding securities, such as ARPS. Further, such notification must be made not less than 10 days' prior to publication of notice to shareholders, if such publication is required. These requirements have added inefficiency and cost to the process of refinancing outstanding ARPS with new Demand Preferred, since the closed-end fund issuer cannot determine the terms of the redemption of the ARPS until the Demand Preferred have been issued. The SEC staff has provided temporary relief to various funds and fund groups on a case-by-case basis during the ARPS crisis, which has been very helpful to address the associated inefficiency.

Under the rule, the requirements relate only to notification; no review or other action by the SEC is involved. Accordingly, the prior notification requirements serve no apparent purpose, at least in the

context of refinancing ARPS. In order to eliminate the associated inefficiency and cost, the prior notification requirements should either be eliminated or, for example, amended so that the issuer may notify the SEC concurrently with the giving of notice to shareholders as required by the terms of the ARPS.

### Tender Offer Matters

The right of a holder of Demand Preferred to tender its securities for purchase by the liquidity provider has caused some persons to question whether the exercise of such rights may be subject to the Tender Offer Rules.<sup>4</sup> For the reasons set forth in Eaton Vance Management, SEC No-Action Letter (June 13, 2008) (the “Eaton Vance Letter”), among others, we and other industry participants believe the Tender Offer Rules do not apply and that the protections afforded by the Tender Offer Rules are superfluous in the context of Demand Preferred. While the SEC staff has granted certain relief in this regard, as set forth in the Eaton Vance Letter and in other contexts, a blanket exemption or similar relief recognizing the inapplicability of the Tender Offer Rules would be beneficial to the development and success of the Demand Preferred market, as it would provide greater certainty and enable closed-end fund issuers to continue to develop and modify the product to satisfy evolving needs of prospective investors without potentially having to repeatedly return to the SEC staff for relief.

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Thank you for the opportunity to testify today. I can assure you that our efforts to address the turmoil in the ARPS marketplace to relieve the significant financial burdens being experienced by common and preferred shareholders of leveraged closed-end funds will continue unabated. I welcome your questions.

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<sup>4</sup> Sections 13(e) and 14(d) of the Securities Exchange Act of 1934, as amended, and Rule 13e-4 and Regulations 14D and 14E thereunder.