

**SEC STAFF ISSUES NO-ACTION LETTER AND IRS ISSUES NOTICE
RELATING TO NEW TYPE OF CLOSED-END FUND PREFERRED STOCK**

In a letter issued to Eaton Vance Management dated June 13, 2008,¹ the staff of the Securities and Exchange Commission cleared the way for the issuance of liquidity-protected preferred stock (“LPP stock”) by closed-end funds to be sold on a private placement basis to money market mutual funds. The letter also granted no-action relief to allow the LPP stock to be sold in remarketings without complying with the tender offer requirements of Rule 13e-4 and Regulations 14D and 14E under the Securities Exchange Act of 1934. Finally, the staff agreed that the LPP stock would not be a “redeemable security” within the meaning of Section 2(a)(32) of the Investment Company Act of 1940 if the LPP stock contractually obligates the issuing fund or its affiliate to purchase the LPP stock from the liquidity provider under certain conditions.

In a related development, the Internal Revenue Service agreed that if LPP stock met certain criteria, the IRS would not challenge the characterization of the LPP stock as equity for federal income tax purposes if a put to the issuing fund or its affiliate were included in the structure. Separately, the IRS noted that it would not challenge the equity status of interests in a liquidating partnership that aggregates auction rate preferred stock, if certain requirements are met.

I. SEC No-Action Letter**Background**

In February 2008, the auction market for closed-end preferred stock became disrupted, and since then auctions have continued to “fail.” As a result, holders of closed-end fund preferred stock have been unable to sell their shares and the issuing funds have been paying dividends on those shares at higher “maximum” rates.

Certain closed-end funds have been evaluating the creation of a new type of preferred stock that would be eligible for investment by money market mutual funds consistent with Rule 2a-7 under the Investment Company Act. (A traditional issuance of preferred stock by a closed-end fund would not meet the quality or maturity requirements of Rule 2a-7.) Merrill Lynch Investment Managers received a no-action letter² from the SEC staff in 2002, allowing money market funds to purchase closed-end fund preferred stock issued with a demand feature. In reviewing the MLIM Letter’s utility, it appeared that the structure of the demand feature described in the MLIM Letter raised a question regarding whether the demand feature would be considered financial guarantee insurance under state law because the demand feature was exercisable following a failure by a fund to pay dividends, redemption proceeds or the preferred stock’s liquidation preference when due. The MLIM Letter also did not address whether a third party’s issuance of a liquidity or demand feature

¹ Eaton Vance Management, SEC No-Action Letter (June 13, 2008) (the “Eaton Vance Letter”).

² Merrill Lynch Investment Managers, SEC No-Action Letter (May 10, 2002) (the “MLIM Letter”).

constituted a continuing tender offer for the preferred stock. The Eaton Vance Letter addresses these issues.

The Eaton Vance Letter

A. Terms of LPP Stock and Liquidity Arrangements

The Eaton Vance group of closed-end funds proposed issuing LPP stock and structuring it so that money market funds relying on Rule 2a-7 under the Investment Company Act could purchase the stock. To achieve this result, the funds would enter into a liquidity agreement (“Liquidity Agreement”) with a third party (the “Liquidity Provider”) that would be required to purchase, at its liquidation preference plus accumulated but unpaid dividends, any LPP stock that was not matched with purchase orders in a remarketing. The purchase by the Liquidity Provider would happen automatically, without any further action by a selling LPP stock holder. A Liquidity Provider would have a short-term rating in one of the two highest rating categories from a Nationally Recognized Statistical Rating Organization with respect to a class of its debt obligations that is comparable in priority and security to the liquidity feature provided for the LPP stock. Prior to the termination of a Liquidity Agreement that is not renewed or replaced with a substantially similar Liquidity Agreement, holders of LPP stock would be notified of the termination and given the opportunity to sell their LPP stock in at least two remarketings prior to termination of the arrangement.

Following a remarketing where sell orders exceeded buy orders, additional terms under the Liquidity Agreement could take effect. These additional terms could include dividend rates that increase based on the percentage of LPP stock held by the Liquidity Provider and additional fees that the issuing fund would pay to the Liquidity Provider.

The Eaton Vance Letter also provides that a fund or its affiliate may grant the Liquidity Provider a “put” right to sell all of the LPP stock held by the Liquidity Provider to the fund or its affiliate at the liquidation preference of the LPP stock. A fund would issue a put right only if the IRS issued new guidance clarifying that such a feature would not cause the LPP stock to become taxable as debt rather than equity for federal income tax purposes. As discussed below, the IRS has issued such guidance.

B. Addressing the Non-Payment Triggers in the MLIM Letter

The liquidity feature proposed by the Eaton Vance Letter is substantially the same as the demand feature in the MLIM Letter except that the liquidity feature is not exercisable upon a failure by a fund to make scheduled payments of (i) dividends or redemption proceeds of the LPP stock or (ii) the required liquidation preference plus accumulated dividends (the “Non-Payment Triggers”). Consequently, the Liquidity Provider is only obligated to unconditionally purchase all LPP stock subject to sell orders in one situation—where sell orders have not been matched with purchase orders in a remarketing.

By removing the Non-Payment Triggers, the risk that a Liquidity Feature would be considered insurance under state law is mitigated. The staff agreed with Eaton Vance that the removal of the Non-Payment Triggers would not significantly diminish the rights a shareholder would have under

the MLIM Letter, noting “at worst a Fund’s failure to make a dividend payment or redemption payment would require the Money Market Fund to wait six days until the next scheduled remarketing to sell its shares, when it would be entitled to the liquidation preference of the shares plus any accumulated and unpaid dividends.”

C. *Redeemable Securities*

A Liquidity Provider could be issued a put to allow it to sell LPP stock it held either to the issuing fund (a “Fund Put”) or to Eaton Vance Corp. (the “EVC Put”), the parent company of the fund’s investment adviser,³ under certain conditions. The precise terms of the puts would be subject to negotiation between the parties. The Eaton Vance Letter notes that it was expected that the Liquidity Provider could exercise the EVC Put at any time after three months following the effective date of the arrangement for not less than the entire issue of LPP stock. In addition, if the Liquidity Provider owned any amount of outstanding LPP stock a year from the effective date of the Liquidity Agreement, the Liquidity Provider could exercise the EVC Put to require Eaton Vance Corp. to purchase its entire holdings of LPP stock. It was expected that a Fund Put would be exercisable only (i) upon the expiration of not less than one year from the effective date of the Liquidity Agreement and (ii) with respect to any LPP stock that the Liquidity Provider held for no less than three consecutive months and unsuccessfully attempted to sell in remarketings. In each case, a Liquidity Provider would be entitled to receive a price per share equal to the LPP stock’s liquidation preference.

The right of the Liquidity Provider under the EVC Put and the Fund Put, as well as the ability of a LPP stock holder to sell its shares to the Liquidity Provider, raised the issue of whether the LPP stock constituted a “redeemable security” under the Investment Company Act. Section 2(a)(32) defines a “redeemable security” as “any security...under the terms of which the holder, upon presentation to the issuer or a person designated by the issuer, is entitled...to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.” In addressing this question, the SEC staff agreed that the LPP stock was not a redeemable security because any payment made on the LPP stock would come from either the Liquidity Provider’s assets (in the case of a LPP stock holder exercising the liquidity feature) or Eaton Vance Corp.’s assets (in the case of the Liquidity Provider exercising the EVC Put) and not from a “proportionate share of the *issuer’s* current net assets.” (Emphasis added.) In addition, drawing on prior staff positions, the staff agreed that the Fund Put does not render the LPP stock a redeemable security because the exercise of the Fund Put is subject to significant restrictions.

D. *Tender Offer Issues*

The Eaton Vance Letter states that the Division of Corporation Finance believes that the offers to purchase LPP stock pursuant to the liquidity feature may constitute a tender offer, but that the Division will not recommend that the SEC take enforcement action if the offers are conducted without complying with the tender offer rules set forth in Rule 13e-4 and Regulations 14D and 14E.

³ Eaton Vance noted in its letter that it did not expect that the EVC Put would be an ongoing feature and would only be offered to the Liquidity Provider for the LPP stock issued in the first LPP stock offering by a fund.

Assuming that these purchases were a tender offer, the requirements of the tender offer rules with respect to, among other things, the minimum time that an offer must remain open would not have allowed the liquidity feature to work as described above.

In taking a no-action position regarding an Eaton Vance fund's not complying with the tender offer rules, the staff noted a long list of specific factors, including the following:

- at the time of issuance and of each remarketing, the Eaton Vance funds and the Liquidity Provider will make all offers and sales of LPP stock and any related security pursuant to an effective registration statement or in reliance on an exemption from registration;
- the offers to purchase LPP stock will have fixed terms and conditions, such offers will be open to all LPP stockholders and the offer price will be the same for all LPP stockholders;
- an offering memorandum that details the operation of the liquidity feature and the impact on the dividend rate of a non-clearing remarketing will be provided to investors at the initial offer and sale of LPP stock and on every remarketing date;
- the Liquidity Provider will promptly pay for LPP stock purchased by it;
- neither the Liquidity Provider nor the Eaton Vance funds will take any steps to encourage or discourage LPP stock holders from triggering the liquidity feature;
- the Liquidity Provider will be required to sell all LPP stock that it holds in the next remarketing at the rate set by the remarketing agent; and
- in the event that the Liquidity Agreement will not be renewed or will otherwise be terminated, holders of the LPP stock will be notified by the paying agent at least two remarketings in advance of such event.

The staff also noted that its position was based on the opinion of Eaton Vance and its counsel that offers to purchase LPP stock pursuant to the liquidity feature do not constitute a tender offer.

Under the liquidity feature described in the Eaton Vance Letter, a holder's LPP stock is purchased by the Liquidity Provider only after the holder has first attempted to sell the holder's LPP stock in a remarketing and that remarketing has failed. Structures that vary from that outlined in the Eaton Vance Letter could potentially require additional tender offer relief.

II. IRS Guidance for Liquidity Facilities and Liquidating Partnerships for Auction Rate Preferred Stock

On June 13, 2008, the IRS issued Notice 2008-55 ("the Notice") dealing with the equity characterization of auction rate preferred stock issued with a liquidity feature whereby the liquidity provider has the right to require the redemption or repurchase of the stock by the issuer. The Notice also allows for the creation of liquidating partnerships designed to accumulate positions in auction rate preferred stock. It is clear from the timing of the Notice that it was intended to work for the LPP stock described in the Eaton Vance Letter.

Liquidity Protected Preferred Stock as Equity

In the Notice, the IRS states that if the auction rate preferred stock and the liquidity facilities meet certain criteria, the IRS will not challenge the characterization of the auction rate preferred stock as equity for federal income tax purposes. The treatment of the preferred stock as equity and not as debt for tax purposes permits closed-end funds to continue to pass through to the preferred shareholders favorable tax treatment from the income earned by a fund's portfolio, such as by classifying income as tax-exempt.

A. Eligible Funds

To obtain equity status under the Notice, the auction rate preferred stock must both be issued in the United States and be issued by a closed-end fund (i) that is a regulated investment company under the Internal Revenue Code and (ii) that invests "exclusively" in either tax-exempt debt instruments or taxable debt instruments, or a combination of both. *Because of these limitations, the Notice by its terms does not apply to equity-oriented closed-end funds or to bond funds that invest even to a limited extent in other instruments, such as options, futures, forwards or swaps.* Dividends paid on the auction rate preferred stock must be duly declared and paid out of legally available funds pursuant to applicable state law.

B. The Liquidity Arrangement

Under the terms of the liquidity arrangement, a holder of auction rate preferred stock must have the right to sell the stock to the liquidity provider at the stock's liquidation preference plus accrued but unpaid dividends only if one of two trigger events occurs: either (i) a failed auction or remarketing, or (ii) a failure to renew, replace, or extend an existing liquidity facility (either with the same liquidity provider or another liquidity provider) on or before the date occurring two remarketing dates prior to the stated expiration date of the current liquidity facility. Current and future holders of auction rate preferred stock covered by a liquidity facility may be designated third-party beneficiaries with the right to require the liquidity provider to fulfill its obligations under the liquidity facility as if they were parties to the liquidity facility. Neither the liquidity provider nor the fund may have a direct or indirect controlling interest in the other, nor may they both be majority owned directly or indirectly by the same third-party.

C. Timing

The Notice only benefits auction rate preferred stock outstanding on February 12, 2008 or issued after that date in order to be used to refinance, directly or indirectly, auction rate preferred stock that was outstanding on that date. The Notice provides relief only for liquidity arrangements entered into between February 12, 2008 and December 31, 2009 or that renew, replace or extend arrangements initially entered into within that time period.

D. Right To Require Repurchase By Fund

Under the Notice, the liquidity provider is permitted to have a contractual right to require the closed-end fund that issued the auction rate preferred stock to repurchase any auction rate preferred stock that the liquidity provider acquired pursuant to a trigger event, if certain conditions are met.

The right to require repurchase must be limited by applicable state law restrictions on redemptions of stock applicable to any holder of the auction rate preferred stock. The liquidity provider must hold the auction rate preferred stock continuously for at least one year before the repurchase of the stock and during the one-year period must offer the stock for resale at each periodic auction or remarketing held under the terms of the stock. Moreover, the liquidity provider and any subsequent holder may not have any greater rights (other than the right to require repurchase) with respect to the stock than other holders under the terms of the liquidity facility, the terms of the auction rate preferred stock or applicable state law. If the liquidity provider does not have a right to require repurchase, the liquidity provider must not have any greater redemption or other rights than other holders of the stock.

Liquidating Partnerships Aggregating Auction Rate Preferred Stock

The Notice indicates that the IRS will not challenge the equity status of interests in a liquidating partnership that aggregates outstanding auction rate preferred stock, issues interests intended to qualify as money-market eligible debt in a tender option bond structure, then gradually liquidates as the underlying auction rate securities are redeemed or refinanced. The described structure would incorporate a liquidity arrangement and a periodic auction or remarketing procedure to create synthetic short-term notes and inverse floating interest rate interests. The short-term note would be eligible for purchase by money market funds. The desired tax treatment of the note and inverse interest would be for each to be treated for tax purposes as equity interests in a partnership, particularly if the note and inverse interest are desired to produce tax-exempt income.

The Notice states that the IRS will not challenge this desired equity treatment under certain conditions. Under the terms of the Notice, at least 95 percent of the assets of the partnership must consist of auction rate preferred stock meeting the criteria above. The partnership must issue two classes of equity interests: (i) interests entitled to a preferred variable return on capital payable out of partnership income and (ii) residual interests that are entitled to all of the remaining income of the partnership. The partnership must offer to sell the auction rate preferred stock at each periodic auction or remarketing and promptly apply proceeds received from sales, redemptions or other dispositions of the auction rate preferred stock it holds to redeem partnership interests. The partnership may not reinvest the disposition proceeds (except for temporary reinvestments of the proceeds for a reasonable time pending redemption of partnership interests). A partnership meeting these conditions would be eligible to follow the general tender option bond administrative requirements previously issued by the IRS.

The Notice indicates that, other than the relief granted by the Notice itself, no inference should be drawn regarding additional tax issues related to the liquidity arrangements, such as the debt or equity character of the auction rate preferred stock or tender option bonds, material modifications of securities for tax purposes, or other tax issues. The Notice is effective immediately, within the time frames indicated above.

Conclusion

Building on the MLIM Letter, the Eaton Vance Letter allows a registered closed-end fund to issue liquidity protected preferred stock that may be purchased by money market funds consistent with Rule 2a-7 under the Investment Company Act. The Eaton Vance Letter and the Notice provide important guidance and assurances, furthering a fund's ability to replace or supplement existing auction rate preferred stock with a new liquidity-protected preferred stock. LPP stock could benefit tax-exempt closed-end funds in particular. The ability of funds to utilize the relief the SEC staff and the IRS have given will, obviously, depend on market conditions, as well as on the ability of funds to negotiate liquidity arrangements on acceptable terms and the appetite for the new security among money market funds.

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If you have any questions concerning the foregoing or would like additional information, please contact Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), Margery K. Neale (212-728-8297, mneale@willkie.com), or P. Jay Spinola (212-728-8970, jspinola@willkie.com) on Investment Company Act issues; David Boston (212-728-8625, dboston@willkie.com) or Cristopher Greer (212-728-8214, cgreer@willkie.com) on tender offer issues; or James R. Brown (212-728-8287, jbrown@willkie.com), Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), or Joseph A. Riley (212-728-8715, jriley@willkie.com) on tax matters. You may, of course, also contact the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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