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News Bulletin

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Closed-End Fund Auction Rate Securities Relief

At least a couple of times each week, there are press reports of the hardships associated with the liquidity meltdown in the auction rate securities market. With all this attention, we thought it might be useful to take a brief look at this market and a recent SEC determination that will bring some relief to a segment of the auction rate market—closed-end funds—that have issued such securities. Since the mid-1980's, auction rate securities have been used by municipalities and closed-end funds to raise capital. These securities are debt instruments or preferred shares bearing short-term interest or dividend rates that are reset periodically through an auction process and are tied to broad based short-term financial rates, such as LIBOR or the prevailing money market rate. Generally, auctions are held regularly—every seven, 28, 35 or 49 days. Beginning in February, financial intermediaries that serve as broker-dealers for auctions stopped bidding on these securities, resulting in virtually no liquidity in what had been a highly liquid market. In contrast to other segments of the market that are suffering from disruptions, the crisis in the $330 billion auction rate securities market is not a credit issue. There have been no defaults and these securities generally have not been downgraded. Rather, auction failures have been triggered by a liquidity crisis.

Auction rate securities traditionally were considered high-quality liquid investments for pension funds and other institutional and individual investors. These investors are now finding themselves forced to continue to hold securities following failed auctions or dispose of them at deep discounts. If an auction fails, the issuer continues to make interest or dividend payments to holders; however, interest rates or dividends increase sharply to a specified maximum rate, which typically is set at a premium over the prevailing short-term interest rates (e.g., based on LIBOR or commercial paper rates). Although the maximum rate payable on these securities following failed auctions is intended to compensate for the illiquidity, investors that need liquidity or must mark to market their securities portfolios may not find this comforting—especially when there appears not to be any immediate prospect of successful clearing auctions. Similarly, public companies that invested their cash on hand in auction rate securities, believing these to be liquid investments comparable to money market instruments, have now been forced to address difficult fair value accounting and disclosure questions.

Disgruntled investors, who purchased auction rate securities believing that these were highly liquid, have filed suits against brokerage firms alleging, among other things, deceptive marketing practices by the brokerage firms. Class actions against almost every significant financial institution already have been instituted. State securities regulators, the New York State Attorney General, the Financial Industry Regulatory Authority (FINRA) and the SEC all have commenced investigations into the auction rate securities market.

Amidst all of this turmoil, there are some signs of hope—at least for certain parts of the auction rate securities market. Closed-end funds, which are investment companies regulated under the 1940 Act, historically have relied on the issuance of auction rate securities in order to raise capital. Approximately 20 to 25% of the auction rate securities market is comprised of securities issued by closed-end funds. Closed-end funds generally have issued either auction rate preferred securities or auction rate notes as a form of leverage to enhance returns to the funds' common shareholders. Common shareholders of a leveraged closed-end fund benefit from the fund's issuance of auction rate securities because common shareholders receive (through enhanced yield) the spread between the short-term rate the fund pays auction rate securities holders and the return earned on portfolio securities purchased with the proceeds of the auction rate securities issuance. The amount of auction rate securities that a closed end fund may issue is limited by 1940 Act restrictions. For example, closed-end funds may only issue debt securities if there is asset coverage of at least 300 percent immediately after the issuance and preferred securities if there is asset coverage of at least 200 percent immediately after the issuance. Closed-end funds also are restricted in their ability to redeem securities. As closed-end funds have sought to restructure their outstanding auction rate securities, to some extent, they have been limited in their ability to do so by 1940 Act requirements.

Recent SEC Action

Several closed-end funds sought relief from the SEC in order to be able to issue a new class of preferred securities. On June 13, 2008, the SEC granted no-action relief to Eaton Vance Management in connection with the issuance by its closed-end funds of a new class of preferred stock. Liquidity protected preferred shares, or LPP shares, will be offered by closed-end funds in order to finance the repurchase or redemption of their outstanding auction rate securities and to provide an alternative to traditional auction rate securities going forward. Existing closed-end fund auction rate securities are generally not eligible for purchase by money market funds, or 2a-7 funds, because of maturity and quality requirements imposed on money market investments. The LPP shares include a put feature that addresses these concerns and should appeal to a broader investor audience, including money market funds. The LPP shares are similar to the variable rate demand preferred securities that Nuveen and other closed-end funds had sought to issue earlier this year. Closed-end funds are expected to rely on this no-action letter guidance to issue their own version of variable rate preferred securities with a liquidity backstop.

Features of the Securities

LPP shares will be offered pursuant to an exemption from registration under the Securities Act—either to one or more broker-dealers that will reoffer the securities to qualified institutional buyers ("QIBs"), or directly to QIBs through placement agents.

LPP shares will bear a dividend that resets every seven days through a remarketing process conducted by one or more financial institutions serving as remarketing agents. Buy and sell orders in any remarketing will be subject to a capped rate (the "Boundary Rate"), set either as (1) a specified interest rate (for instance, two-month LIBOR) plus a spread, or (2) a specified percentage of a specified interest rate (for instance, 85% of two-month LIBOR). Contemporaneously, the closed end fund will enter into an agreement with an unaffiliated liquidity provider (the "Liquidity Provider") pursuant to which the Liquidity Provider will have an unconditional obligation to purchase all LPP shares subject to sell orders not matched with purchase orders (referred to as a "Liquidity Event") in a failed remarketing. The Liquidity Provider must have received a short-term rating in one of the two highest short-term rating categories from a nationally recognized statistical rating organization with respect to a class of debt obligations comparable in priority and security to the obligation to purchase the LPP shares upon the occurrence of a Liquidity Event.

Upon the occurrence of a Liquidity Event, the dividend rate for the LPP shares is reset. If the Liquidity Provider is required to purchase less than a certain percentage (the "Trigger Percent") of the LPP shares in a failed remarketing, the dividend rate will be set at the Boundary Rate. If the Liquidity Provider is required to purchase more than the Trigger Percent of the LPP shares in a failed remarketing, the dividend rate will be the Boundary Rate plus an additional pre-determined percentage above the last Boundary Rate (the "Raised Boundary Rate"). If, in subsequent failed remarketings, the Liquidity Provider is required to continue to purchase LPP shares in amounts exceeding the Trigger Percent, the dividend rate will be set at the Boundary Rate plus an increasing Raised Boundary Rate up to a maximum specified interest rate. The fund also will pay the Liquidity Provider a bifurcated fee—with a fixed fee on the commitment amount and a fee based upon amounts actually drawn down upon the occurrence of a Liquidity Event.

There are additional features that are included in order to induce Liquidity Providers to step into this role. For example, for the first issuance, Eaton Vance Corp. ("EVC"), the parent corporation, will grant the Liquidity Provider a put option, exercisable in whole and not in part, relating to the LPP shares, if the Liquidity Provider holds all of the LPP shares, struck at the liquidation price of the shares. However, the put will be exercisable only during the nine-month period ending on the first anniversary of the effectiveness of the liquidity agreement. Alternatively, to the extent necessary to attract Liquidity Providers, both initially and on a more permanent basis, the closed-end fund itself may provide the Liquidity Provider with a put option on the LPP shares under certain circumstances.

In addition, on June 10, 2008, certain Eaton Vance closed-end funds filed an exemptive application seeking temporary relief from asset coverage requirements of the 1940 Act. The requested relief would allow them to replace their outstanding auction rate preferred securities with debt but to continue to subject these borrowings to the 200 percent asset coverage test for preferred securities (as opposed to the 300 percent asset coverage test required for debt). The requested relief would permit the funds to retain their portfolio investments and their current leverage ratios with little interruption. If the requested relief is granted, other closed-end funds are likely to seek similar relief.

IRS Guidance

Earlier this year, in order to address turmoil in the municipal auction rate securities market, the Internal Revenue Service issued Notices 2008-27 and 2008-41. These notices provided guidance to issuers of tax-exempt auction rate bonds that wished either to convert their outstanding auction rate bonds to bonds with a fixed or floating interest rate or to repurchase their auction rate securities. Pursuant to these IRS notices, under certain limited circumstances, the conversion of a tax-exempt auction rate bond into a bond with a fixed or floating interest rate would not be deemed to result in a reissuance for U.S. federal income tax purposes, and, in applying the tax-exempt bond rules, an issuer may purchase its own tax-exempt auction rate bonds without such purchase resulting in a retirement of the bonds for U.S. federal income tax purposes. The treatment of a conversion as a reissuance could result in adverse tax consequences to the issuer.

Last week, the IRS issued Notice 2008-55, which provides guidance relating to the tax treatment of variable rate demand securities, like the LPP shares. From a tax perspective, in order to preserve the "equity" status of auction rate preferred securities, it is particularly important that holders not be viewed as having the right to put such securities to the issuer on demand. Notice 2008-55 confirms that the IRS will not challenge the equity characterization of auction rate preferred securities, such as the LPP shares. As a result, payments on these securities should still be characterized as exempt-interest dividends (to the extent of the issuer's exempt interest) and not as taxable interest, which would have been the consequence if the auction rate securities were instead treated as debt for U.S. federal income tax purposes. In general, the notice only applies if, among other requirements, the auction rate securities are issued by closed-end funds that are registered investment companies and that invest exclusively in taxable or tax-exempt bonds, the auction rate securities were outstanding on February 12, 2008 (or issued after that date to refinance auction rate securities that were outstanding on that date) and the liquidity provider is unrelated to the issuer.

Conclusion

The Eaton Vance Management no-action letter is likely to form the basis for significant issuances of liquidity protected preferred shares or similar securities by closed-end funds and should be responsible for easing the liquidity challenges encountered by those closed-end funds that have relied upon the issuance of auction rate securities for leverage purposes. For issuers of auction rate securities other than closed-end funds, relief from liquidity woes remains an aspiration.

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