



An update on the Auction Rate Securities market—February 14, 2008

The Funds leverage the returns to common stock shareholders through the issuance of preferred stock that pays dividends which are reset periodically through an auction process. These preferred stocks are generically referred to as “Auction Rate Securities” and several acronyms such as ARS, AMPS, and MMP[®].

The auction process allows an investor to determine the interest rate he or she would like to earn and “bid” in the auction to purchase securities. Existing holders of the securities may choose to continue to hold the securities, or offer them for sale in the auction. The periodic rate for the securities is set at the highest rate at which all available shares can be sold. If there is not sufficient interest from bidders in a particular auction to purchase all the shares being offered for sale, the market colloquially describes the auction as “failed.” In a “failed auction”, existing holders can sell some of their shares to the extent that there are buyers and will not be able to sell their remaining shares. Rather, they will continue to hold the securities and earn a “maximum rate” set according to a pre-determined formula.

There is a significant difference between a “failed” auction and a “default.” *A failed auction is not an event of default.* A failed auction does not require the redemption of auction rate securities by the Fund. Rather, the securities remain outstanding and pay a rate equal to the maximum rate until “buy” and “hold” orders again exceed “sell” orders in a future auction.

The auction rate securities market is much larger than just the issuance of preferred stock from closed-end funds. The majority of the auction rate issuance is associated with municipal bonds, student loans, CDOs (collateralized debt obligations), non-financial corporations, healthcare organizations and many others.

Closed-end funds that are registered under the Investment Company Act of 1940 are subject to restrictions that offer additional protections to buyers of auction rate securities issued by these funds. Specifically, the Investment Company Act requires that the market value of the assets of the fund *exceed* the amount of preferred stock outstanding by *at least* two times -- and in most cases the asset coverage is closer to 2.5 - 3.0 times. This means that the assets of the fund are 2-3 times *greater* than the liquidation value of the preferred stock that has been issued. This is referred to as “over-collateralization,” and is fairly unique to auction rate securities issued by registered closed-end funds.

For our Funds, the over-collateralization rates as of February 8, 2008 were: PFD – 2.7 times; PFO – 2.7 times; FFC – 2.5 times; and FLC – 2.5 times.

Most auction rate securities issued by closed-end funds, including all of those issued by the Flaherty & Crumrine funds, are of high credit quality and are highly rated by the rating agencies. The ratings of the auction rate preferred securities for FFC and FLC are Aaa/AAA and for PFD and PFO are Aa1/AAA by Moody’s and Fitch, respectively. In order to retain these ratings, the Funds must agree to regular monitoring by the agencies. More importantly, they must agree to maintain sufficient asset coverage— using conservative valuation methodologies – to repay the



auction rate securities and any other liabilities of the Funds at all times. Should a Fund breach any of these coverage thresholds, the Fund is required to remedy the violation either by increasing the credit quality and/or liquidity of its portfolio or by retiring all or a portion of its outstanding auction rate securities. These agency requirements are *in addition to* the over-collateralization requirements of the 1940 Act.

The broader auction rate securities market has experienced disruptions over the past four-to-five months, but those disruptions have increased dramatically in the last week. The result has been an increasing number of “failed” auctions, which leads to the interest rates on such auctions being set at their maximum rates.

For your Funds specifically, the disruptions in the market for auction rate securities have led to “failed” auctions in the last couple of days, which may continue for a period of time. However, the maximum rates on these preferred stocks are currently not as onerous from the point of view of the Fund’s common stock shareholders as one may think. While they are high relative to the short-term benchmarks to which they are often compared, they are currently lower than rates that were paid by the Funds only a few months ago. This is primarily due to the reductions to short-term interest rates as the Federal Reserve eased monetary policy. This means that the disruptions in the market for auction rate securities may not have an immediate negative impact on the distributable income of the Funds, although there can be no assurance of this at this time given the uncertainty in the market. The Funds have been experiencing higher auction rates for some time as the Federal Reserve was increasing short-term rates, so much of these higher costs are reflected in current projections of distributable income. These costs could certainly change, but they will largely be driven by changes in short-term interest rates. As a point of reference, the maximum rates on a few of the Funds’ auctions that took place on February 13, 2008 were between 5.25% and 5.49%.

As mentioned above, a failed auction does not require the Funds to immediately redeem the securities. While this is true, we would also acknowledge that continuous failed auctions over a long period of time may not be in the best interest of either the holders of the auction rate securities or the common stock of the Funds. The provisions allowing for failed auctions are intended to provide fair compensation for the holders of auction rate securities during periods of disruptions, while also allowing the Fund the necessary time to properly consider the situation and explore potential alternatives.

At this point in time, it is unclear how the market for auction rate securities will behave. There are indications that this could be a relatively temporary disruption (perhaps weeks or months) as new investors are attracted to the market by the relatively high interest rates being paid on such securities. This may depend on the willingness of dealers to facilitate auctions, which they are not required to do. Issuers of auction rate securities may choose to leave these securities outstanding and allow the disruptions to work themselves out, or they could seek alternative sources of financing to replace the auction rate securities over time.

Management and the Funds’ Boards of Directors are currently assessing the situation and considering various alternatives. We will keep our shareholders apprised of developments.