# Franklin Tax-Free Trust



P.O. Box 997151, Sacramento, CA 95899-7151 (800) DIAL BEN® /342-5236

		Glass		
	A	C	Advisor	
Franklin Alabama Tax-Free Income Fund	FRALX	FALEX	_	
Franklin Florida Tax-Free Income Fund	FRFLX	FRFIX	_	
Franklin Georgia Tax-Free Income Fund	FTGAX	FGAIX	_	
Franklin Kentucky Tax-Free Income Fund	FRKYX	_	_	
Franklin Louisiana Tax-Free Income Fund	FKLAX	FLAIX	_	
Franklin Maryland Tax-Free Income Fund	FMDTX	FMDIX	FMDZX	
Franklin Missouri Tax-Free Income Fund	FRMOX	FMOIX	FRMZX	
Franklin North Carolina Tax-Free Income Fund	FXNCX	FNCIX	FNCZX	
Franklin Virginia Tax-Free Income Fund	FRVAX	FVAIX	FRVZX	

## STATEMENT OF ADDITIONAL INFORMATION July 1, 2013

This Statement of Additional Information (SAI) is not a prospectus. It contains information in addition to the information in the Funds' (hereafter "the Fund") prospectus. The Fund's prospectus, dated July 1, 2013, which we may amend from time to time, contains the basic information you should know before investing in the Funds. You should read this SAI together with the Fund's prospectus.

The audited financial statements and Report of Independent Registered Public Accounting Firm in the Fund's Annual Report to shareholders, for the fiscal year ended February 28, 2013, are incorporated by reference (are legally a part of this SAI).

For a free copy of the current prospectus or annual report, contact your investment representative or call (800) DIAL BEN/342-5236.

#### CONTENTS

Goals, Strategies and Risks	2
State and U.S. Territory Risks	12
Officers and Trustees	24
Fair Valuation and Liquidity	30
Management and Other Services	31
Portfolio Transactions	34
Distributions and Taxes	34
Organization, Voting Rights and Principal Holders	42
Buying and Selling Shares	43
The Underwriter	48
Performance	51
Miscellaneous Information	53
Description of Ratings	54
State Tax Treatment	57

## Mutual funds, annuities, and other investment products:

 are not insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other agency of the U.S. government;

1

- are not deposits or obligations of, or guaranteed or endorsed by, any bank; and
- · are subject to investment risks, including the possible loss of principal.

TF2 SAI 07/13

## **SUPPLEMENT DATED MARCH 3, 2014** TO THE CURRENTLY EFFECTIVE STATEMENT OF ADDITIONAL INFORMATION OF **EACH OF THE LISTED FUNDS**

Franklin California Tax-Free Income Fund

Franklin California Tax-Free Trust

Franklin California Insured Tax-Free Income Fund

Franklin California Intermediate-Term Tax-Free Income Fund

Franklin California Tax-Exempt Money Fund

Franklin Federal Tax-Free Income Fund

Franklin Municipal Securities Trust

Franklin California High Yield Municipal Fund

Franklin Tennessee Municipal Bond Fund

Franklin New York Tax-Free Income Fund

Franklin New York Tax-Free Trust

Franklin New York Intermediate-Term Tax-Free Income Fund

Franklin Tax-Free Trust

Franklin Alabama Tax-Free Income Fund Franklin Arizona Tax-Free Income Fund

Franklin Colorado Tax-Free Income Fund Franklin Connecticut Tax-Free Income Fund

Franklin Double Tax-Free Income Fund

Franklin Federal Intermediate-Term Tax-Free Income Fund

Franklin Federal Limited-Term Tax-Free Income Fund

Franklin Florida Tax-Free Income Fund

Franklin Georgia Tax-Free Income Fund

Franklin High Yield Tax-Free Income Fund

Franklin Insured Tax-Free Income Fund

Franklin Kentucky Tax-Free Income Fund

Franklin Louisiana Tax-Free Income Fund

Franklin Maryland Tax-Free Income Fund

Franklin Massachusetts Tax-Free Income Fund

Franklin Michigan Tax-Free Income Fund

Franklin Minnesota Tax-Free Income Fund

Franklin Missouri Tax-Free Income Fund

Franklin New Jersey Tax-Free Income Fund

Franklin North Carolina Tax-Free Income Fund

Franklin Ohio Tax-Free Income Fund

Franklin Oregon Tax-Free Income Fund

Franklin Pennsylvania Tax-Free Income Fund

Franklin Virginia Tax-Free Income Fund

The Statement of Additional Information is amended as follows:

For all funds, the paragraph beginning with "Certain municipal issuers..." of the "State and U.S. Territory Risks – U.S. Territories – *Puerto Rico*" section is revised to add the following:

Certain municipal issuers in Puerto Rico continue to experience significant financial difficulties. In February 2014, credit rating firms Standard & Poor's, Fitch Ratings, and Moody's Investors Service downgraded their respective ratings of Puerto Rico's general obligation debt to below investment grade, along with the ratings of certain related Puerto Rican issuers. Additionally, each rating agency maintained a negative outlook on certain Puerto Rican issuers, and further downgrades are possible. The Fund is not required to sell securities that have been downgraded to below investment grade, but it is prohibited from making further purchases of such securities as long as the securities are not rated investment grade by at least one U.S. nationally recognized rating service.

The latest downgrades could create additional strain on a commonwealth already facing economic stagnation and fiscal imbalances, including budget deficits, underfunded pensions, high unemployment, significant debt service obligations, and liquidity issues. Although many investors not permitted to hold below-investment grade debt may have already sold certain Puerto Rican municipal securities amidst the recent market turmoil, these further downgrades could potentially lead to less market demand, less liquidity, wider spreads, and lower prices for such securities. Puerto Rico's continued financial difficulties could reduce its ability to access financial markets, potentially increasing the likelihood of a restructuring or default for Puerto Rican municipal securities that may affect the Fund's investments and its performance.

Please keep this supplement for future reference.

## **SUPPLEMENT DATED AUGUST 15. 2013** TO THE CURRENTLY EFFECTIVE STATEMENT OF ADDITIONAL INFORMATION **OF**

#### **EACH OF THE LISTED FUNDS**

#### Franklin California Tax-Free Income Fund

#### Franklin California Tax-Free Trust

Franklin California Insured Tax-Free Income Fund Franklin California Intermediate-Term Tax-Free Income Fund

Franklin California Tax-Exempt Money Fund

#### Franklin Custodian Funds

Franklin DynaTech Fund Franklin Income Fund

Franklin U.S. Government Securities Fund

Franklin Utilities Fund Franklin Growth Fund

#### Franklin Federal Tax-Free Income Fund

#### Franklin Global Trust

Franklin Global Real Estate Fund

Franklin International Small Cap Growth Fund

Franklin International Growth Fund

Franklin Large Cap Equity Fund

Franklin Templeton Emerging Market Debt

Opportunities Fund

#### Franklin Gold and Precious Metals Fund

#### Franklin High Income Trust

Franklin High Income Fund

#### Franklin Investors Securities Trust

Franklin Adjustable U.S. Government

Securities Fund

Franklin Balanced Fund

Franklin Convertible Securities Fund

Franklin Equity Income Fund

Franklin Floating Rate Daily Access Fund Franklin Limited Maturity U.S. Government

Securities Fund

Franklin Low Duration Total Return Fund

Franklin Real Return Fund

Franklin Total Return Fund

#### Franklin Managed Trust

Franklin Rising Dividends Fund

#### Franklin Money Fund

#### Franklin Municipal Securities Trust

Franklin California High Yield Municipal Fund Franklin Tennessee Municipal Bond Fund

#### Franklin Mutual Recovery Fund

#### Franklin Mutual Series Funds

Mutual Beacon Fund

Mutual European Fund

Mutual Financial Services Fund

Mutual Global Discovery Fund

Mutual International Fund

Mutual Quest Fund

Mutual Shares Fund

#### Franklin New York Tax-Free Income Fund

#### Franklin New York Tax-Free Trust

Franklin New York Intermediate-Term Tax-Free Income Fund

#### Franklin Real Estate Securities Trust

Franklin Real Estate Securities Fund

#### Franklin Strategic Mortgage Portfolio

#### Franklin Strategic Series

Franklin Biotechnology Discovery Fund

Franklin Flex Cap Growth Fund

Franklin Focused Core Equity Fund

Franklin Growth Opportunities Fund Franklin Natural Resources Fund

Franklin Small Cap Growth Fund Franklin Small-Mid Cap Growth Fund

Franklin Strategic Income Fund

#### Franklin Tax-Free Trust

Franklin Alabama Tax-Free Income Fund Franklin Arizona Tax-Free Income Fund

Franklin Colorado Tax-Free Income Fund

Franklin Connecticut Tax-Free Income Fund

Franklin Double Tax-Free Income Fund

Franklin Federal Intermediate-Term Tax-Free Income Fund

Franklin Federal Limited-Term Tax-Free

Income Fund

Franklin Florida Tax-Free Income Fund Franklin Georgia Tax-Free Income Fund

Franklin High Yield Tax-Free Income Fund

Franklin Insured Tax-Free Income Fund Franklin Kentucky Tax-Free Income Fund

Franklin Louisiana Tax-Free Income Fund

Franklin Maryland Tax-Free Income Fund Franklin Massachusetts Tax-Free Income Fund

Franklin Michigan Tax-Free Income Fund

Franklin Minnesota Tax-Free Income Fund

Franklin Missouri Tax-Free Income Fund Franklin New Jersey Tax-Free Income Fund

Franklin North Carolina Tax-Free Income Fund

Franklin Ohio Tax-Free Income Fund Franklin Oregon Tax-Free Income Fund

Franklin Pennsylvania Tax-Free Income Fund

Franklin Virginia Tax-Free Income Fund

## Franklin Templeton Fund Allocator Series

Franklin Templeton Conservative Allocation Fund Franklin Templeton Corefolio Allocation Fund Franklin Templeton Founding Funds

Allocation Fund

Franklin Templeton Growth Allocation Fund Franklin Templeton Moderate Allocation Fund

Franklin LifeSmart™ 2015 Retirement Target Fund

Franklin LifeSmart™ 2020 Retirement

Target Fund

Franklin LifeSmart™ 2025 Retirement Target Fund

Franklin LifeSmart™ 2030 Retirement Target Fund

Franklin LifeSmart™ 2035 Retirement Target Fund

Franklin LifeSmart™ 2040 Retirement Target Fund

Franklin LifeSmart™ 2045 Retirement Target Fund

Franklin LifeSmart™ 2050 Retirement Target Fund

Franklin Templeton Multi-Asset Real Return Fund

#### Franklin Templeton Global Trust

Franklin Templeton Hard Currency Fund

#### Franklin Templeton International Trust

Franklin India Growth Fund

Franklin Templeton Global Allocation Fund Franklin World Perspectives Fund

Templeton Foreign Smaller Companies Fund

## Franklin Templeton Money Fund Trust

Franklin Templeton Money Fund

#### Franklin Value Investors Trust

Franklin All Cap Value Fund

Franklin Balance Sheet Investment Fund

Franklin Large Cap Value Fund

Franklin MicroCap Value Fund

Franklin MidCap Value Fund

Franklin Small Cap Value Fund

## **Institutional Fiduciary Trust**

Money Market Portfolio

#### **Templeton China World Fund**

#### **Templeton Developing Markets Trust**

#### **Templeton Funds**

Templeton Foreign Fund

Templeton World Fund

#### **Templeton Global Investment Trust**

Templeton Asian Growth Fund

Templeton BRIC Fund

Templeton Emerging Markets Balanced Fund

Templeton Emerging Markets Small Cap Fund

Templeton Frontier Markets Fund Templeton Global Balanced Fund

#### **Templeton Global Opportunities Trust**

## **Templeton Global Smaller Companies Fund**

Templeton Growth Fund, Inc.

#### **Templeton Income Trust**

Templeton Emerging Markets Bond Fund

Templeton Global Bond Fund Templeton Global Total Return Fund Templeton International Bond Fund

## **Templeton Institutional Funds**

**Emerging Markets Series** 

Foreign Equity Series Foreign Smaller Companies Series

Global Equity Series

The Statement of additional information is amended as follows:

The second paragraph under "The Underwriter – Distribution and service (12b-1) fees" is replaced with the following: Under each plan, the Fund pays Distributors or others for the expenses of activities that are primarily intended to sell shares of the class. These expenses also may include service fees paid to securities dealers or others who have executed a servicing agreement with the Fund, Distributors or its affiliates and who provide service or account maintenance to shareholders (service fees); and the expenses of printing prospectuses and reports used for sales purposes, of marketing support and of preparing and distributing sales literature and advertisements. Together, these expenses, including the service fees, are "eligible expenses." The 12b-1 fees charged to each class are based only on the fees attributable to that particular class and are calculated, as a percentage of such class' net assets, over the 12-month period of February 1 through January 31. Because this 12-month period may not match the Fund's fiscal year, the amount, as a percentage of a class' net assets, for the Fund's fiscal year may vary from the amount stated under the applicable plan, but will never exceed that amount during the 12-month period of February 1 through January 31.

Please retain this supplement with your prospectus for reference.

## **Goals, Strategies and Risks**

The following information provided with respect to the Fund is in addition to that included in the Fund's prospectus.

In addition to the main types of investments and strategies undertaken by the Fund as described in the prospectus, the Fund also may invest in other types of securities and engage in and pursue other investment strategies, which are described in this SAI. Investments and investment strategies with respect to the Fund are discussed in greater detail in the section below entitled "Glossary of Investments, Techniques, Strategies and Their Risks."

Generally, the policies and restrictions discussed in this SAI and in the prospectus apply when the Fund makes an investment. In most cases, the Fund is not required to sell a security because circumstances change and the security no longer meets one or more of the Fund's policies or restrictions. If a percentage restriction or limitation is met at the time of investment, a later increase or decrease in the percentage due to a change in the value or liquidity of portfolio securities will not be considered a violation of the restriction or limitation, with the exception of the Fund's limitations on borrowing as described herein.

If a bankruptcy or other extraordinary event occurs concerning a particular security the Fund owns, the Fund may receive stock, real estate or other investments that the Fund would not, or could not, buy. If this happens, the Fund intends to sell such investments as soon as practicable while trying to maximize the return to shareholders.

The Fund has adopted certain investment restrictions as fundamental and non-fundamental policies. A fundamental policy may only be changed if the change is approved by (i) more than 50% of the Fund's outstanding shares or (ii) 67% or more of the Fund's shares present at a shareholder meeting if more than 50% of the Fund's outstanding shares are represented at the meeting in person or by proxy, whichever is less. A non-fundamental policy may be changed without the approval of shareholders.

For more information about the restrictions of the Investment Company Act of 1940, as amended (1940 Act), on the Fund with respect to borrowing and senior securities, see "Glossary of Investments, Techniques, Strategies and Their Risks - Borrowing" below.

#### Fundamental Investment Policies

Each Fund's investment goal is to provide investors with as high a level of income exempt from federal income taxes as is consistent with prudent investment management and the preservation of shareholders' capital. Each Fund also tries to provide a maximum level of income exempt from personal income taxes, if any, for resident shareholders of that Fund's state.

Under normal market conditions, the Fund invests at least 80% of its total assets in securities whose interest is free from federal income taxes, including the federal alternative minimum tax. In addition, under normal market conditions, each Fund invests at

least 80% of its total assets in securities that pay interest free from the personal income taxes, if any, of that Fund's state.

## The Fund may not:

- 1. Borrow money, except to the extent permitted by the Investment Company Act of 1940, as amended (1940 Act), or any rules, exemptions or interpretations thereunder that may be adopted, granted or issued by the U.S. Securities and Exchange Commission (SEC).
- 2. Act as an underwriter, except to the extent the Fund may be deemed to be an underwriter when disposing of securities it owns or when selling its own shares.
- 3. Make loans if, as a result, more than 33 1/3% of its total assets would be lent to other persons, including other investment companies to the extent permitted by the 1940 Act or any rules, exemptions or interpretations thereunder that may be adopted, granted or issued by the SEC. This limitation does not apply to (i) the lending of portfolio securities, (ii) the purchase of debt securities, other debt instruments, loan participations and/or engaging in direct corporate loans in accordance with its investment goals and policies, and (iii) repurchase agreements to the extent the entry into a repurchase agreement is deemed to be a loan.
- 4. Purchase or sell real estate unless acquired as a result of ownership of securities or other instruments and provided that this restriction does not prevent the Fund from (i) purchasing or selling securities or instruments secured by real estate or interests therein, securities or instruments representing interests in real estate or securities or instruments of issuers that invest, deal or otherwise engage in transactions in real estate or interests therein, and (ii) making, purchasing or selling real estate mortgage loans.
- 5. Purchase or sell physical commodities, unless acquired as a result of ownership of securities or other instruments and provided that this restriction does not prevent the Fund from (i) engaging in transactions involving currencies and futures contracts and options thereon or (ii) investing in securities or other instruments that are secured by physical commodities.
- 6. Issue senior securities, except to the extent permitted by the 1940 Act or any rules, exemptions or interpretations thereunder that may be adopted, granted or issued by the SEC.
- 7. Invest more than 25% of the Fund's net assets in securities of issuers in any one industry (other than securities issued or guaranteed by the U.S. government or any of its agencies or instrumentalities or securities of other investment companies).<sup>1</sup>
- 8. Purchase the securities of any one issuer (other than the U.S. government or any of its agencies or instrumentalities or securities of other investment companies, whether registered or excluded from registration under Section 3(c) of the 1940 Act) if immediately after such investment (i) more than 5% of the value of the Fund's total assets would be invested in such issuer or (ii) more than 10% of the outstanding voting securities of such issuer

would be owned by the Fund, except that up to 25% of the value of the Fund's total assets may be invested without regard to such 5% and 10% limitations.

 Although not part of the Fund's fundamental investment restriction, consistent with SEC Staff interpretations and guidance, governments or their political subdivisions that issue tax-exempt municipal securities are not considered by the Fund to be members of any industry.

#### Non-Fundamental Investment Policies

Municipal securities issued by a state or that state's counties, municipalities, authorities, agencies, or other subdivisions, as well as qualifying municipal securities issued by U.S. territories such as Guam, Puerto Rico, the Mariana Islands or the U.S. Virgin Islands, generally pay interest free from federal income tax and from state personal income taxes, if any, for residents of that state.

The Fund tries to invest all of its assets in tax-free municipal securities. The issuer's bond counsel generally gives the issuer an opinion on the tax-exempt status of a municipal security when the security is issued.

Some states may require the Fund to invest a certain amount of its assets in securities of that state, or in securities that are otherwise tax-free under the laws of that state, in order for any portion of the Fund's distributions to be free from the state's personal income taxes. If the Fund's state requires this, the Fund will try to invest its assets as required so that its distributions will be free from personal income taxes for resident shareholders of the Fund's state.

## Additional Strategies

The Fund may invest up to 15% of its assets in illiquid securities. Glossary of Investments, Techniques, Strategies and Their Risks

Certain words or phrases may be used in descriptions of Fund investment policies and strategies to give investors a general sense of the Fund's levels of investment. They are broadly identified with, but not limited to, the following percentages of Fund total assets:

"small portion"	less than 10%
"portion"	10% to 25%
"significant"	25% to 50%
"substantial"	50% to 66%
"primary"	66% to 80%
"predominant"	80% or more

If the Fund intends to limit particular investments or strategies to no more than specific percentages of Fund assets, the prospectus or SAI will clearly identify such limitations. The percentages above are not limitations unless specifically stated as such in the Fund's prospectus or elsewhere in this SAI.

The Fund may invest in securities that are rated by various rating agencies such as Moody's Investors Service (Moody's) and Standard & Poor's (S&P®), as well as securities that are unrated.

The value of your shares in the Fund will increase as the value of the investments owned by the Fund increases and will decrease as the value of the Fund's investments decreases. In this way, you participate in any change in the value of the investments owned by the Fund. In addition to the factors that affect the value of any particular investment that the Fund owns, the value of the Fund's shares may also change with movements in the stock and bond markets as a whole.

The following is a description of various types of securities, instruments and techniques that may be purchased and/or used by the Fund. Other types of municipal securities or strategies, not specifically described below, may become available or attractive that are similar to those described below and in which the Fund also may invest, if consistent with its investment goal and policies.

Municipal securities – general description Municipal securities are issued by a state or that state's counties, municipalities, authorities, agencies, or other subdivisions, as well as by the District of Columbia. These municipal securities generally pay interest free from federal income tax and from state personal income taxes, if any, for residents of that state. In addition, U.S. territories such as principally, Puerto Rico, but also Guam, the Mariana Islands or the U.S. Virgin Islands also issue qualifying municipal securities that generally pay interest free from federal income tax and from state personal income taxes. Generally for all municipal securities, the issuer pays a fixed, floating or variable rate of interest, and must repay the amount borrowed (the "principal") at maturity. Municipal securities are issued to raise money for a variety of public or private purposes, including financing state or local government, specific projects or public facilities. Municipal securities generally are classified as general or revenue obligations.

The value of the municipal securities may be highly sensitive to events affecting the fiscal stability of the municipalities, agencies, authorities and other instrumentalities that issue securities. In particular, economic, legislative, regulatory or political developments affecting the ability of the issuers to pay interest or repay principal may significantly affect the value of the Fund's investments. These developments can include or arise from, for example, insolvency of an issuer, uncertainties related to the tax status of municipal securities, tax base erosion, state or federal constitutional limits on tax increases or other actions, budget deficits and other financial difficulties, or changes in the credit ratings assigned to municipal issuers.

There could be a limited market for certain municipal securities, and the Fund could face illiquidity risks. Information about the financial condition of an issuer of municipal bonds may not be as extensive as that which is made available by corporations for their publicly-traded securities. The absence or inaccuracy of such information may impact the investment manager's evaluation of credit and valuation risk.

From time to time, proposals have been introduced before Congress to restrict or eliminate the federal income tax exemption for interest on municipal bonds. Also, from time to time, proposals have been introduced before state and local legislatures to restrict or eliminate the state and local income tax exemption for interest on municipal bonds. Similar proposals may be introduced in the future. If any such proposal were enacted, it might restrict or eliminate the ability of the Fund to achieve its investment objectives.

General obligation bonds. Issuers of general obligation bonds include states, counties, cities, towns and regional districts. The proceeds of these obligations are used to fund a wide range of public projects, including construction or improvement of schools, highways and roads. The basic security behind general obligation bonds is the issuer's pledge of its full faith, credit and taxing power for the payment of principal and interest. The taxes that can be levied for the payment of debt service may be limited or unlimited as to the rate or amount of special assessments.

Revenue bonds. The full faith, credit and taxing power of the issuer do not secure revenue bonds. Instead, the principal security for a revenue bond generally is the net revenue derived from a particular facility, group of facilities, or, in some cases, the proceeds of a special excise tax or other specific revenue source. Revenue bonds are issued to finance a wide variety of capital projects, including: electric, gas, water and sewer systems; highways, bridges and tunnels; port and airport facilities; colleges and universities; and hospitals. The principal security behind these bonds may vary. For example, housing finance authorities have a wide range of security, including partially or fully insured mortgages, rent subsidized and/or collateralized mortgages, and/or the net revenues from housing or other public projects. Many bonds provide additional security in the form of a debt service reserve fund that may be used to make principal and interest payments. Some authorities have further security in the form of state assurances (although without obligation) to make up deficiencies in the debt service reserve fund. As a result, an investment in revenue obligations is subject to greater risk of delay or non-payment if revenue does not accrue as expected or if other conditions are not met for reasons outside the control of the Fund. Conversely, if revenue accrues more quickly than anticipated, the Fund may receive payment before expected and have difficulty re-investing the proceeds on equally favorable terms.

**Anticipation notes** Anticipation notes are issued to provide interim financing of various municipal needs in anticipation of the receipt of other sources of money for repayment of the notes.

Bond anticipation notes are normally issued to provide interim financing until a long-term bond financing can be arranged which provides the money for the repayment of the notes.

Revenue anticipation notes are issued in expectation of the receipt of revenue sources, other than tax receipts, such as anticipated revenues from a source such as turnpike tolls.

Tax anticipation notes are issued to finance the short-term working capital needs of municipalities in anticipation of the receipt of various seasonal tax revenues that are used to repay the notes. They are usually general obligations of the issuer and

are secured by the taxing power for the payment of principal and interest.

**Borrowing** The 1940 Act and the SEC's current rules, exemptions and interpretations thereunder, permit the Fund to borrow up to one-third of the value of its total assets (including the amount borrowed, but less all liabilities and indebtedness not represented by senior securities) from banks. The Fund is required to maintain continuous asset coverage of at least 300% with respect to such borrowings and to reduce the amount of its borrowings (within three days) to restore such coverage if it should decline to less than 300% due to market fluctuations or otherwise. In the event that the Fund is required to reduce its borrowings, it may have to sell portfolio holdings, even if such sale of the Fund's holdings would be disadvantageous from an investment standpoint.

If the Fund makes additional investments while borrowings are outstanding, this may be considered a form of leverage. Leveraging by means of borrowing may exaggerate the effect of any increase or decrease in the value of portfolio securities on the Fund's net asset value, and money borrowed will be subject to interest and other costs (which may include commitment fees and/or the cost of maintaining minimum average balances), which may or may not exceed the income or gains received from the securities purchased with borrowed funds.

In addition to borrowings that are subject to 300% asset coverage and are considered by the SEC to be permitted "senior securities," the Fund is also permitted under the 1940 Act to borrow for temporary purposes in an amount not exceeding 5% of the value of its total assets at the time when the loan is made. A loan will be presumed to be for temporary purposes if it is repaid within 60 days and is not extended or renewed.

Segregation of assets. Consistent with SEC staff guidance, financial instruments that involve the Fund's obligation to make future payments to third parties will not be viewed as creating any senior security provided that the Fund covers its obligations as described below. Those financial instruments can include, among others, (i) securities purchased on a when-issued, delayed delivery, or to be announced basis, (ii) futures contracts, (iii) forward currency contracts, (iv) swaps, (v) written options, (vi) unfunded commitments, (vii) securities sold short, and (viii) reverse repurchase agreements.

Consistent with SEC staff guidance, the Fund will consider its obligations involving such a financial instrument as "covered" when the Fund (1) maintains an offsetting financial position, or (2) segregates liquid assets (constituting cash, cash equivalents or other liquid portfolio securities) equal to the Fund's exposures relating to the financial instrument, as determined on a daily basis. Dedicated Fund compliance policies and procedures, which the Fund's board has approved, govern the kinds of transactions that can be deemed to be offsetting positions for purposes of (1) above, and the amounts of assets that need to be segregated for purposes of (2) above (Asset Segregation Policies).

The Fund's Asset Segregation Policies may require the Fund to sell a portfolio security or exit a transaction, including a transaction in a financial instrument, at a disadvantageous time or price in order for the Fund to be able to segregate the required amount of assets. If segregated assets decline in value, the Fund will need to segregate additional assets or reduce its position in the financial instruments. In addition, segregated assets may not be available to satisfy redemptions or for other purposes, until the Fund's obligations under the financial instruments have been satisfied. In addition, the Fund's ability to use the financial instruments identified above may under some circumstances depend on the nature of the instrument and amount of assets that the Asset Segregation Policies require the Fund to segregate.

**Callable securities** Callable securities give the issuer the right to redeem the security on a given date or dates (known as the call dates) prior to maturity. In return, the call feature is factored into the price of the debt security, and callable debt securities typically offer a higher yield than comparable non-callable securities. Certain securities may be called only in whole (the entire security is redeemed), while others may be called in part (a portion of the total face value is redeemed) and possibly from time to time as determined by the issuer. There is no guarantee that the Fund will receive higher yields or a call premium on an investment in callable securities.

The period of time between the time of issue and the first call date, known as call protection, varies from security to security. Call protection provides the investor holding the security with assurance that the security will not be called before a specified date.

Documentation for callable securities usually requires that investors be notified of a call within a prescribed period of time. If a security is called, the Fund will receive the principal amount and accrued interest, and may receive a small additional payment as a call premium. Issuers are more likely to exercise call options in periods when interest rates are below the rate at which the original security was issued, because the issuer can issue new securities with lower interest payments. Callable securities are subject to the risks of other debt securities in general, including prepayment risk, especially in falling interest rate environments.

**Commercial paper** Commercial paper is an unsecured, short-term loan to a corporation, typically for financing accounts receivable and inventory with maturities of up to 270 days. The Fund may invest in taxable commercial paper only for temporary defensive purposes.

Convertible zero-coupon and step coupon bonds Convertible zero-coupon securities have no coupon until a predetermined date, at which time they convert to a specified coupon security. Zero-coupon bonds tend to react more sharply to changes in interest rates than traditional bonds.

**Distressed and defaulted debt securities** Investments in securities of issuers that are, or are about to be, involved in reorganizations, financial restructurings, or bankruptcy (generally

referred to as "distressed debt") typically involve the purchase of lower-rated or defaulted debt securities, comparable unrated debt securities, or other indebtedness of such issuers. By purchasing all or a part of an issuer's direct indebtedness, the Fund, in effect, steps into the shoes of the lender. If the loan is secured, the Fund will generally have a priority claim to the assets of the issuer ahead of unsecured creditors and stockholders. The risk that the Fund may lose its entire investment in defaulted bonds is greater in comparison to investing in non-defaulted bonds.

If the issuer of a debt security in the Fund's portfolio defaults, the Fund may have unrealized losses on the security, which may lower the Fund's net asset value. Defaulted securities tend to lose much of their value before they default. Thus, the Fund's net asset value may be adversely affected before an issuer defaults. The Fund will incur additional expenses if it tries to recover principal or interest payments on a defaulted security. Defaulted debt securities often are illiquid.

The Fund is not required to sell a debt security that has defaulted if the investment manager believes it is advantageous to continue holding the security.

**Illiquid securities** Generally, an "illiquid security" is any security that cannot be disposed of within seven days at approximately the amount at which the Fund has valued the instrument. Illiquid securities generally include securities for which no market exists or which are legally restricted as to their transfer.

The risk to the Fund in holding illiquid securities is that they may be more difficult to sell if the Fund wants to dispose of the security in response to adverse developments or in order to raise money for redemptions or other investment opportunities. Illiquid trading conditions may also make it more difficult for the Fund to realize a security's fair value.

**Insurance** The Fund may also invest in insured municipal securities. Normally, the underlying rating of an insured security is one of the top three ratings of Fitch, Moody's or S&P. An insurer may insure municipal securities that are rated below the top three ratings or that are unrated if the securities otherwise meet the insurer's quality standards.

The Fund will only enter into a contract to buy an insured municipal security if either permanent insurance or an irrevocable commitment to insure the municipal security by a qualified municipal bond insurer is in place. The insurance feature guarantees the scheduled payment of principal and interest, but does not guarantee (i) the market value of the insured municipal security, (ii) the value of the Fund's shares, or (iii) the Fund's distributions.

Types of insurance. There are three types of insurance: new issue, secondary and portfolio. A new issue insurance policy is purchased by the issuer when the security is issued. A secondary insurance policy may be purchased by the Fund after a security is issued. With both new issue and secondary policies, the insurance continues in force for the life of the security and, thus, may increase the credit rating of the security, as well as its resale

value. However, in response to market conditions rating agencies have lowered their ratings on some municipal bond insurers below BBB or withdrawn ratings. In such cases the insurance is providing little or no enhancement of credit or resale value to the municipal security and the security's rating will reflect the higher of the insurer rating or the underlying rating of the security.

The Fund may buy a secondary insurance policy at any time, if the investment manager believes the insurance would be in the best interest of the Fund. The Fund is likely to buy a secondary insurance policy if, in the investment manager's opinion, the Fund could sell a security at a price that exceeds the current value of the security, without insurance, plus the cost of the insurance. The purchase of a secondary policy, if available, may enable the Fund to sell a defaulted security at a price similar to that of comparable securities that are not in default. The Fund would value a defaulted security covered by a secondary insurance policy at its market value.

The Fund also may buy a portfolio insurance policy. Unlike new issue and secondary insurance, which continue in force for the life of the security, portfolio insurance only covers securities while they are held by the Fund. If the Fund sells a security covered by portfolio insurance, the insurance protection on that security ends and, thus, cannot affect the resale value of the security. As a result, the Fund may continue to hold any security insured under a portfolio insurance policy that is in default or in significant risk of default and, absent any unusual or unforeseen circumstances as a result of the portfolio insurance policy, would likely value the defaulted security, or security for which there is a significant risk of default, at the same price as comparable securities that are not in default. While a defaulted security is held in the Fund's portfolio, the Fund continues to pay the insurance premium on the security but also collects interest payments from the insurer and retains the right to collect the full amount of principal from the insurer when the security comes due.

The insurance premium the Fund pays for a portfolio insurance policy is a Fund expense. The premium is payable monthly and is adjusted for purchases and sales of covered securities during the month. If the Fund fails to pay its premium, the insurer may take action against the Fund to recover any premium payments that are due. The insurer may not change premium rates for securities covered by a portfolio insurance policy, regardless of the issuer's ability or willingness to meet its obligations.

Qualified municipal bond insurers. Insurance policies may be issued by a qualified municipal bond insurer. The bond insurance industry is a regulated industry. Any bond insurer must be licensed in each state in order to write financial guarantees in that jurisdiction. Regulations vary from state to state. Most regulators, however, require minimum standards of solvency and limitations on leverage and investment of assets. Regulators also place restrictions on the amount an insurer can guarantee in relation to the insurer's capital base. Neither the Fund nor the investment manager makes any representations as to the ability

of any insurance company to meet its obligation to the Fund if called upon to do so.

If an insurer is called upon to pay the principal or interest on an insured security that is due for payment but that has not been paid by the issuer, the terms of payment would be governed by the provisions of the insurance policy. After payment, the insurer becomes the owner of the security, appurtenant coupon, or right to payment of principal or interest on the security and is fully subrogated to all of the Fund's rights with respect to the security, including the right to payment. The insurer's rights to the security or to payment of principal or interest are limited, however, to the amount the insurer has paid.

State regulators have from time to time required municipal bond insurers to suspend claims payments on outstanding insurance in force. Certain municipal bond insurers have withdrawn from the market. These circumstances have led to a decrease in the supply of insured municipal securities and a consolidation among municipal bond insurers concentrating the insurance company credit risk on securities in the Fund's portfolio amongst fewer municipal bond insurers. Due to this consolidation, events involving one or more municipal bond insurers could have a significant adverse effect on the value of the securities insured by the insurer and on the municipal markets as a whole.

## Mandatory tender (mandatory put) municipal

**securities** Mandatory tender (mandatory put) municipal securities may be sold with a requirement that a holder of a security surrender the security to the issuer or its agent for cash at a date prior to the stated maturity. On the predetermined tender date, the holder receives principal and accrued interest.

**Maturity** Municipal securities are issued with a specific maturity date—the date when the issuer must repay the amount borrowed. Maturities typically range from less than one year (short term) to 30 years (long term). In general, securities with longer maturities are more sensitive to interest rate changes, although they may provide higher yields.

Municipal lease obligations Municipal lease obligations generally are issued to support a government's infrastructure by financing or refinancing equipment or property acquisitions or the construction, expansion or rehabilitation of public facilities. In such transactions, equipment or property is leased to a state or local government, which, in turn, pays lease payments to the lessor consisting of interested and principal payments on the obligations. Municipal lease obligations differ from other municipal securities because each year the lessee's governing body must appropriate (set aside) the money to make the lease payments. If the money is not appropriated, the issuer or the lessee typically can end the lease without penalty. If the lease is cancelled, investors who own the municipal lease obligations may not be paid.

The Fund may also gain exposure to municipal lease obligations, through certificates of participation, which represent a

proportionate interest in the payments under a specified lease or leases.

Because annual appropriations are required to make lease payments, municipal lease obligations generally are not subject to constitutional limitations on the issuance of debt, and may allow an issuer to increase government liabilities beyond constitutional debt limits. When faced with increasingly tight budgets, local governments have more discretion to curtail lease payments under a municipal lease obligation than they do to curtail payments on other municipal securities. If not enough money is appropriated to make the lease payments, the leased property may be repossessed as security for holders of the municipal lease obligations. If this happens, there is no assurance that the property's private sector or re-leasing value will be enough to make all outstanding payments on the municipal lease obligations or that the payments will continue to be tax-free.

While cancellation risk is inherent to municipal lease obligations, the Fund believes that this risk may be reduced, although not eliminated, by its policies on the credit quality of municipal securities in which it may invest.

Refunded bonds The issuer of a refunded bond (also known as pre-refunded or escrow-secured bonds) "pre-refunds" the bond by setting aside in advance all or a portion of the amount to be paid to the bondholders when the bond is called. Generally, an issuer uses the proceeds from a new bond issue to buy high grade, interest bearing debt securities, including direct obligations of the U.S. government, which are then deposited in an irrevocable escrow account held by a trustee bank to secure all future payments of principal and interest on the refunded bonds. Because refunded bonds still bear the same interest rate as when they were originally issued and are of very high credit quality, their market value may increase. However, as the refunded bond approaches its call or ultimate maturity date, the bond's market value will tend to fall to its call or par price.

Stripped securities Stripped securities are debt securities that have been transformed from a principal amount with periodic interest coupons into a series of zero coupon bonds, each with a different maturity date corresponding to one of the payment dates for interest coupon payments or the redemption date for the principal amount. Stripped securities are subject to all the risks applicable to zero coupon bonds as well as certain additional risks.

Like zero coupon bonds, stripped securities do not provide for periodic payments of interest prior to maturity. Rather they are offered at a discount from their face amount that will be paid at maturity. This results in the security being subject to greater fluctuations in response to changing interest rates than interest-paying securities of similar maturities.

**Tax-exempt commercial paper** Tax-exempt commercial paper typically represents an unsecured short-term obligation (270 days or less) issued by a municipality.

Tax-exempt or qualified private activity and industrial development revenue bonds Tax-exempt industrial development revenue and other similar bonds are part of a category of securities sometimes known as tax-exempt or qualified private activity bonds. These bonds are typically issued by or on behalf of public authorities to finance various privately operated facilities which are expected to benefit the municipality and its residents, such as business, manufacturing, housing, sports and pollution control, as well as public facilities such as airports, mass transit systems, ports and parking. The payment of principal and interest is solely dependent on the ability of the facility's user to meet its financial obligations and the pledge, if any, of the facility or other property as security for payment. As a result, these bonds may involve a greater degree of corporate credit risk than other municipal securities.

**Temporary investments** When the investment manager believes market or economic conditions are unusual or unfavorable for investors, the investment manager may invest up to 100% of the Fund's assets in temporary defensive investments, including cash, cash equivalents or other high quality short-term investments, such as short-term debt instruments, including U.S. government securities, high grade commercial paper, repurchase agreements, negotiable certificates of deposit, non-negotiable fixed time deposits, bankers acceptances, and other money market equivalents. To the extent allowed by exemptions from and rules under the 1940 Act and the Fund's other investment policies and restrictions, the investment manager also may invest the Fund's assets in shares of one or more money market funds managed by the investment manager or its affiliates. Unfavorable market or economic conditions may include excessive volatility or a prolonged general decline in the securities markets, the securities in which the Fund normally invests, or the economies of the states and territories where the Fund invests. Temporary defensive investments can and do experience default. The likelihood of default on a temporary defensive investment may increase in the market or economic conditions which are likely to trigger the Fund's investment therein.

Temporary defensive investments generally may include securities that pay taxable interest, including (i) for the state Funds, municipal securities issued by a state or local government other than the Fund's state; (ii) high quality commercial paper; or (iii) securities issued by or guaranteed by the full faith and credit of the U.S. government. The Fund also may invest all of its assets in municipal securities issued by a U.S. territory such as Guam, Puerto Rico, the Mariana Islands or the U.S. Virgin Islands. The investment manager also may invest in these types of securities or hold cash when securities meeting the Fund's investment criteria are unavailable or to maintain liquidity. When the Fund's assets are invested in temporary investments, the Fund may not be able to achieve its investment goal.

**Unrated debt securities** Not all debt securities or their issuers are rated by rating agencies, sometimes due to the size of or manner of the securities offering, the decision by one or

more rating agencies not to rate certain securities or issuers as a matter of policy, or the unwillingness or inability of the issuer to provide the prerequisite information and fees to the rating agencies. Some debt securities markets may have a disproportionately large number of unrated issuers.

In evaluating unrated securities, the investment manager may consider, among other things, the issuer's financial resources, its sensitivity to economic conditions and trends, its operating history, the quality of the issuer's management and regulatory matters. Although unrated debt securities may be considered to be of investment grade quality, issuers typically pay a higher interest rate on unrated than on investment grade rated debt securities. Less information is typically available to the market on unrated securities and obligors, which may increase the potential for credit and valuation risk.

**U.S. government securities** U.S. government securities include obligations of, or guaranteed by, the U.S. federal government, its agencies, instrumentalities or sponsored enterprises. Some U.S. government securities are supported by the full faith and credit of the U.S. government. These include U.S. Treasury obligations and securities issued by the Government National Mortgage Association (GNMA). A second category of U.S. government securities are those supported by the right of the agency, instrumentality or sponsored enterprise to borrow from the U.S. government to meet its obligations. These include securities issued by Federal Home Loan Banks.

A third category of U.S. government securities are those supported by only the credit of the issuing agency, instrumentality or sponsored enterprise. These include securities issued by the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC). In the event of a default, an investor like the Fund would only have legal recourse to the issuer, not the U.S. government. Although the U.S. government has provided support for these securities in the past, there can be no assurance that it will do so in the future. The U.S. government has also made available additional guarantees for limited periods to stabilize or restore a market in the wake of an economic, political or natural crisis. Such guarantees, and the economic opportunities they present, are likely to be temporary and cannot be relied upon by the Fund. Any downgrade of the credit rating of the securities issued by the U.S. government may result in a downgrade of securities issued by its agencies or instrumentalities, including government-sponsored entities.

Variable or floating rate securities. The Fund may invest in variable or floating rate securities, including variable rate demand notes, municipal inflation protected securities, indexbased floating rate securities, and auction rate securities, which have interest rates that change either at specific intervals from daily up to semiannually, or whenever a benchmark rate changes. The interest rate adjustments are designed to help stabilize the security's price or maintain a fixed spread to a predetermined benchmark. While this feature may protect against a decline in the security's market price when interest rates or benchmark rates

rise, it lowers the Fund's income when interest rates or benchmark rates fall. Of course, the Fund's income from its variable and floating rate investments also may increase if interest rates rise.

Variable or floating rate securities may include a demand feature, which may be unconditional. The demand feature allows the holder to demand prepayment of the principal amount before maturity, generally on one to 30 days' notice. The holder receives the principal amount plus any accrued interest either from the issuer or by drawing on a bank letter of credit, a guarantee or insurance issued with respect to the security. The Fund generally uses variable or floating rate securities as short-term investments while waiting for long-term investment opportunities.

Movements in the relevant index or benchmark on which adjustments are based will affect the interest paid on these securities and, therefore, the current income earned by the Fund and the securities' market value. The degree of volatility in the market value of the variable rate securities held by the Fund will generally increase along with the length of time between adjustments, the degree of volatility in the applicable index, benchmark or base lending rate and whether the index, benchmark or base lending rate to which it resets or floats approximates short-term or other prevailing interest rates. It will also be a function of the maximum increase or decrease of the interest rate adjustment on any one adjustment date, in any one year, and over the life of the security.

The income earned by the Fund and distributed to shareholders will generally increase or decrease along with movements in the relevant index, benchmark or base lending rate. Thus the Fund's income will be more unpredictable than the income earned on similar investments with a fixed rate of interest.

When-issued transactions Municipal securities may be offered on a "when-issued" basis. When so offered, the price, which is generally expressed in yield terms, is fixed at the time the commitment to buy is made, but delivery and payment take place at a later date. During the time between purchase and settlement, no payment is made by the Fund to the issuer and no interest accrues to the Fund. If the other party to the transaction fails to deliver or pay for the security, the Fund could miss a favorable price or yield opportunity, or could experience a loss.

When the Fund makes the commitment to buy a municipal security on a when-issued basis, it records the transaction and includes the value of the security in the calculation of its net asset value. The Fund does not believe that its net asset value or income will be negatively affected by its purchase of municipal securities on a when-issued basis. The Fund will not engage in when-issued transactions for investment leverage purposes.

Although the Fund generally will buy municipal securities on a when-issued basis with the intention of acquiring the securities, it may sell the securities before the settlement date if it is considered advisable. When the Fund is the buyer, it will segregate liquid assets as set forth in "Segregation of assets" under "Borrowing." If assets of the Fund are held in cash pending

the settlement of a purchase of securities, the Fund will not earn income on those assets. When-issued transactions also are subject to the risk that a counterparty may become bankrupt or otherwise fail to perform its obligations due to financial difficulties, including making payments to the Fund. The Fund may obtain no or only limited recovery in a bankruptcy or other organizational proceedings, and any recovery may be significantly delayed.

**Zero coupon and deferred interest securities** Zero coupon or deferred interest bonds are debt securities that make no periodic interest payments until maturity or a specified date when the securities begin paying current interest (the "cash payment date"). Zero coupon and deferred interest bonds generally are issued and traded at a discount from their face amount or par value.

The original discount on zero coupon or deferred interest bonds approximates the total amount of interest the bonds will accumulate over the period until maturity or the first cash payment date and compounds at a rate of interest reflecting the market rate of the security at the time of issuance. The discount varies depending on the time remaining until maturity or the cash payment date, as well as prevailing interest rates, liquidity of the market for the security, and the perceived credit quality of the issuer. The discount, in the absence of financial difficulties of the issuer, typically decreases as the final maturity or cash payment date approaches. The discount typically increases as interest rates rise, the market becomes less liquid or the creditworthiness of the issuer deteriorates.

For accounting and federal tax purposes, holders of bonds issued at a discount, such as the Fund, are deemed to receive interest income over the life of the bonds even though the bonds do not pay out cash to their holders before maturity or the cash payment date. That income is distributable to Fund shareholders even though no cash is received by the Fund at the time of accrual, which may require the liquidation of other portfolio securities to satisfy the Fund's distribution obligations.

Because investors receive no cash prior to the maturity or cash payment date, an investment in debt securities issued at a discount generally has a greater potential for complete loss of principal and/or return than an investment in debt securities that make periodic interest payments. Such investments are more vulnerable to the creditworthiness of the issuer and any other parties upon which performance relies.

The following is a description of the general risks associated with the Fund's investments in municipal securities.

**Credit quality** All things being equal, the lower a security's credit quality, the higher the risk and the higher the yield the security generally must pay as compensation to investors for the higher risk.

A security's credit quality depends on the issuer's ability to pay interest on the security and, ultimately, to repay the principal. Independent rating agencies, such as Moody's and S&P, often rate

municipal securities based on their analysis of the issuer's credit quality. Most rating agencies use a descending alphabet scale to rate long-term securities, and a descending numerical scale to rate short-term securities. Securities in the top four long term ratings categories (or comparable short-term rated or unrated securities) are "investment grade," although securities in the fourth highest rating may have some speculative features. These ratings are described at the end of this SAI under "Description of Ratings." Lower-rated securities may be subject to all the risks applicable to high-yield debt securities and changes in economic conditions or other circumstances are more likely to lead to a weakened capacity to make principal and interest payments than is the case with higher grade debt securities.

A number of risks associated with rating organizations apply to the purchase or sale of investment grade debt securities.

An insurance company, bank or other foreign or domestic entity may provide credit support for a municipal security and enhance its credit quality. For example, some municipal securities are insured, which means they are covered by an insurance policy that guarantees the timely payment of principal and interest. Other municipal securities may be backed by letters of credit, guarantees, or escrow or trust accounts that contain high quality securities, including securities backed by the full faith and credit of the U.S. government to secure the payment of principal and interest.

Any limitations on the credit quality of the securities the Fund may buy generally are applied when the Fund makes an investment so that the Fund is not required to sell a security because of a later change in circumstances.

In addition to considering ratings in its selection of the Fund's portfolio securities, the investment manager may consider, among other things, information about the financial history and condition of the issuer, revenue and expense prospects and, in the case of revenue bonds, the financial history and condition of the source of revenue to service the bonds. Securities that depend on the credit of the U.S. government are regarded as having the same or equivalent rating as U.S. government securities.

Credit risk Debt securities are subject to the risk of an issuer's (or other party's) failure or inability to meet its obligations under the security. Multiple parties may have obligations under a debt security. An issuer or borrower may fail to pay principal and interest when due. A guarantor, insurer or credit support provider may fail to provide the agreed upon protection. A counterparty to a transaction may fail to perform its side of the bargain. An intermediary or agent interposed between the investor and other parties may fail to perform the terms of its service. Also, performance under a debt security may be linked to the obligations of other persons who may fail to meet their obligations. The credit risk associated with a debt security could increase to the extent that the Fund's ability to benefit fully from its investment in the security depends on the performance by multiple parties of their respective contractual or other

obligations. The market value of a debt security is also affected by the market's perception of the creditworthiness of the issuer.

The Fund may incur substantial losses on debt securities that are inaccurately perceived to present a different amount of credit risk than they actually do by the market, the investment manager or the rating agencies. Credit risk is generally greater where less information is publicly available, where fewer covenants safeguard the investors' interests, where collateral may be impaired or inadequate, where little legal redress or regulatory protection is available, or where a party's ability to meet obligations is speculative. Additionally, any inaccuracy in the information used by the Fund to evaluate credit risk may affect the value of securities held by the Fund.

Obligations under debt securities held by the Fund may never be satisfied or, if satisfied, only satisfied in part.

A change in the credit rating of any one or more of the municipal bond insurers that insure securities in the Fund's portfolio may affect the value of the securities they insure, the Fund's share price and Fund performance. The Fund might also be adversely impacted by the inability of an insurer to meet its insurance obligations.

**Debt securities ratings** The investment manager may perform its own independent investment analysis of securities being considered for the Fund's portfolio. The investment manager also considers the ratings assigned by various investment services and independent rating organizations, such as Moody's and S&P, that publish ratings based upon their assessment of the relative creditworthiness of the rated debt securities. Generally, a lower rating indicates higher credit risk. Higher yields are ordinarily available from debt securities in the lower rating categories. These ratings are described at the end of this SAI under "Description of Ratings."

Using credit ratings to evaluate debt securities can involve certain risks. For example, ratings assigned by the rating agencies are based upon an analysis completed at the time of the rating of the obligor's ability to pay interest and repay principal. Rating agencies typically rely to a large extent on historical data which may not accurately represent present or future circumstances. Ratings do not purport to reflect the risk of fluctuations in market value of the debt security and are not absolute standards of quality and only express the rating agency's current opinion of an obligor's overall financial capacity to pay its financial obligations. A credit rating is not a statement of fact or a recommendation to purchase, sell or hold a debt obligation. Also, credit quality can change suddenly and unexpectedly, and credit ratings may not reflect the issuer's current financial condition or events since the security was last rated. Rating agencies may have a financial interest in generating business, including from the arranger or issuer of the security that normally pays for that rating, and providing a low rating might affect the rating agency's prospects for future business. While rating agencies have policies and procedures to address this potential conflict of interest, there is

a risk that these policies will fail to prevent a conflict of interest from impacting the rating.

**Extension risk** The market value of some debt securities may be adversely affected when bond calls or prepayments on underlying assets are less or slower than anticipated. This risk is extension risk. Extension risk may result from, for example, rising interest rates or unexpected developments in the markets for the underlying assets. As a consequence, the security's effective maturity will be extended, resulting in an increase in interest rate sensitivity to that of a longer-term instrument. Extension risk generally increases as interest rates rise. This is because, in a rising interest rate environment, the rate of prepayment and exercise of call or buy-back rights generally falls and the rate of default and delayed payment generally rises. When the maturity of an investment is extended in a rising interest rate environment, a below-market interest rate is usually locked-in and the value of the security reduced. This risk is greater for fixed-rate than variable-rate debt securities.

**Focus** Because each Fund predominantly invests in the municipal securities of its state, its performance is closely tied to the ability of issuers of municipal securities in its state to continue to make principal and interest payments on their securities. The issuers' ability to do this is in turn dependent on economic, political and other conditions within the state or territory. The ability of issuers of municipal securities to continue to make principal and interest payments is dependent in large part on their ability to raise revenues, primarily through taxes, and to control spending. Many factors can affect a state's revenues including the rate of population growth, unemployment rates, personal income growth, federal aid, and the ability to attract and keep successful businesses. A number of factors can also affect a state's spending including the need for infrastructure improvements, increased costs for education and other services, current debt levels, and the existence of accumulated budget deficits.

The greater the Fund's exposure to any single type of investment — including investment in a given sector, region, issuer, or type of security — the greater the losses the Fund may experience upon any single economic, business, political, regulatory, or other occurrence.

The ability of issuers of municipal securities to continue to make principal and interest payments on their securities is dependent on economic, political and other conditions within the state. The ability of issuers of municipal securities to continue to make principal and interest payments is dependent in large part on their ability to raise revenues, primarily through taxes, and to control spending. Many factors can affect a state's revenues including the rate of population growth, unemployment rates, personal income growth, federal aid, and the ability to attract and keep successful businesses. A number of factors can also affect a state's spending including the need for infrastructure improvements, increased costs for education and other services,

current debt levels, and the existence of accumulated budget deficits.

The Fund may invest more than 25% of its assets in municipal securities that finance similar types of projects, such as utilities, hospitals, higher education and transportation. A change that affects one project, such as proposed legislation on the financing of the project, a shortage of the materials needed for the project, or a declining need for the project, would likely affect all similar projects, thereby increasing market risk.

**Income risk** The Fund is subject to income risk, which is the risk that the Fund's income will decline during periods of falling interest rates or when the Fund experiences defaults on debt securities it holds. The Fund's income declines when interest rates fall because, as the Fund's higher-yielding debt securities mature or are prepaid, the Fund must re-invest the proceeds in debt securities that have lower, prevailing interest rates. The amount and rate of distributions that the Fund's shareholders receive are affected by the income that the Fund receives from its portfolio holdings. If the income is reduced, distributions by the Fund to shareholders may be less. Fluctuations in income paid to the Fund are generally greater for variable rate debt securities. The Fund will be deemed to receive taxable income on certain securities which pay no cash payments until maturity, such as zero-coupon securities. The Fund may be required to sell portfolio securities that it would otherwise continue to hold in order to obtain sufficient cash to make the distribution to shareholders required for U.S. tax purposes.

**Inflation risk** The market price of debt securities generally falls as inflation increases because the purchasing power of the future income and repaid principal is expected to be worth less when received by the Fund. Debt securities that pay a fixed rather than variable interest rate are especially vulnerable to inflation risk because variable-rate debt securities may be able to participate, over the long term, in rising interest rates which have historically corresponded with long-term inflationary trends.

Inside information risk The investment manager (through its representatives or otherwise) may receive information that restricts the investment manager's ability to cause the Fund to buy or sell securities of an issuer for substantial periods of time when the Fund otherwise could realize profit or avoid loss. This may adversely affect the Fund's flexibility with respect to buying or selling securities.

Interest rate risk The market value of debt securities generally varies in response to changes in prevailing interest rates. Interest rate changes can be sudden and unpredictable. During periods of declining interest rates, the market value of debt securities generally increases. Conversely, during periods of rising interest rates, the market value of debt securities generally declines. This occurs because new debt securities are likely to be issued with higher interest rates as interest rates increase, making the old or outstanding debt securities less attractive. In general, the market prices of long-term debt securities or securities that make little (or no) interest payments are more sensitive to interest rate

fluctuations than shorter-term debt securities. The longer the Fund's average weighted portfolio maturity, the greater the impact a change in interest rates will have on its share price.

**Liquidity** Liquidity risk exists when particular investments are or become difficult to purchase or sell at the price at which the Fund has valued the security, whether because of current market conditions or the specific type of investment. If the market for a particular security becomes illiquid (for example, due to changes in the issuer's financial condition), the Fund may be unable to sell such security at an advantageous time or price due to the difficulty in selling such securities. Additionally, the market for certain debt securities may become illiquid under adverse market or economic conditions independent of any specific adverse changes in the conditions of a particular issuer. Liquidity risk generally increases (meaning that securities become more illiquid) as the number, or relative need, of investors seeking to liquidate in a given market increases. To the extent that the Fund and its affiliates hold a significant portion of an issuer's outstanding securities, the Fund may be subject to greater liquidity risk than if the issuer's securities were more widely held.

The Fund may also need to sell some of the Fund's more liquid securities when it otherwise would not do so in order to meet redemption requests, even if such sale of the liquid holdings would be disadvantageous from an investment standpoint. Reduced liquidity may also have an adverse impact on a security's market value and the sale of such securities often results in higher brokerage charges or dealer discounts and other selling expenses. Reduced liquidity in the secondary market for certain securities will also make it more difficult for the Fund to obtain market quotations based on actual trades for purposes of valuing the Fund's portfolio and thus pricing may be prone to error when market quotations are volatile, infrequent and/or subject to large spreads between bid and ask prices.

**Management** The investment manager's judgments about markets, interest rates or the attractiveness, relative values or potential appreciation of particular investment strategies or sectors or securities purchased for the Fund's portfolio may prove to be incorrect, all of which could cause the Fund to perform less favorably and may result in a decline in the Fund's share price.

The investment manager selects investments for the Fund based in part on information and data that the issuers of such securities file with various government agencies or make directly available to the investment manager or that the investment manager obtains from other sources. The investment manager is not in a position to confirm the completeness, genuineness or accuracy of such information and data, and in some cases, complete and accurate information is not readily available. It is also possible that information on which the investment manager relies could be wrong or misleading. Additionally, legislative, regulatory, or tax developments may affect the investment techniques available to the investment manager in connection with managing the Fund and may also adversely affect the ability of the Fund to achieve its investment goal. Management risk is greater when less

qualitative information is available to the investment manager about an investment.

Market risk The market value of securities owned by the Fund may go up or down, sometimes rapidly or unpredictably due to general market conditions which are not specifically related to a single security issuer. These general market conditions include real or perceived adverse economic or regulatory conditions, changes in interest or rates or adverse investor sentiment generally. Market values may also decline due to factors which affect a particular industry or sector, or a particular segment, such as municipal or government securities. During a general downturn in the securities markets, multiple asset classes may decline in value simultaneously. When markets perform well, there can be no assurance that the Fund's securities will participate in or otherwise benefit from the advance.

**Portfolio turnover** Portfolio turnover is a measure of how frequently the Fund's portfolio securities are bought and sold. High portfolio turnover rates generally increase transaction costs, which are Fund expenses. Such portfolio transactions may also result in the realization of taxable capital gains, including short-term capital gains, which are generally taxable at ordinary income tax rates for federal income tax purposes for shareholders subject to income tax and who hold their shares in a taxable account. Higher transaction costs reduce the Fund's returns.

The SEC requires annual portfolio turnover to be calculated generally as the lesser of a fund's purchases or sales of portfolio securities during a given fiscal year, divided by the monthly average value of the Fund's portfolio securities owned during that year (excluding securities with a maturity or expiration date that, at the time of acquisition, was less than one year). For example, a fund reporting a 100% portfolio turnover rate would have purchased and sold securities worth as much as the monthly average value of its portfolio securities during the year. The portfolio turnover rates for the Fund are disclosed in the sections entitled "Portfolio Turnover" and "Financial Highlights" of the Fund's prospectus.

Portfolio turnover is affected by factors within and outside the control of the Fund and its investment manager. The investment manager's investment outlook for the type of securities in which the Fund invests may change as a result of unexpected developments in domestic or international securities markets, or in economic, monetary or political relationships. High market volatility may result in the investment manager using a more active trading strategy than it might have otherwise pursued. The Fund's investment manager will consider the economic effects of portfolio turnover but generally will not treat portfolio turnover as a limiting factor in making investment decisions. Investment decisions affecting turnover may include changes in investment policies or management personnel, as well as individual portfolio transactions.

**Prepayment risk** Debt securities, especially bonds that are subject to "calls," are subject to prepayment risk if their terms allow the payment of principal and other amounts due before

their stated maturity. Amounts invested in a debt security that has been "called" or "prepaid" will be returned to an investor holding that security before expected by the investor. In such circumstances, the investor, such as a fund, may be required to re-invest the proceeds it receives from the called or prepaid security in a new security which, in periods of declining interest rates, will typically have a lower interest rate. Prepayment risk is especially prevalent in periods of declining interest rates.

Securities subject to prepayment risk are often called during a declining interest rate environment and generally offer less potential for gains and greater price volatility than other incomebearing securities of comparable maturity.

Call risk is similar to prepayment risk and results from the ability of an issuer to call, or prepay, a debt security early. If interest rates decline enough, the debt security's issuer can save money by repaying its callable debt securities and issuing new debt securities at lower interest rates.

## State and U.S. Territory Risks

**State** Because each Fund predominantly invests in the municipal securities of its state, its performance is closely tied to the ability of issuers of municipal securities in its state to continue to make principal and interest payments on their securities. The issuers' ability to do this is in turn dependent on economic, political and other conditions within the state. Below is a discussion of certain conditions that may affect municipal issuers in the Fund's various states. It is not a complete analysis of every material fact that may affect the ability of issuers of municipal securities to meet their debt obligations or the economic or political conditions within any state and is subject to change. The information below is based on data available to the Fund from historically reliable sources, but the Fund has not independently verified it. In addition, the disclosure below reflects only the information available to the Fund as of June 1, 2013. The information and risks set forth below could change quickly and without notice due to new or different information becoming available, market or economic changes or other unforeseen events, among other things. The Fund generally only updates the information below on or before July of each year and therefore the disclosure may not reflect any new or different information that becomes available.

The ability of issuers of municipal securities to continue to make principal and interest payments is dependent in large part on their ability to raise revenues, primarily through taxes, and to control spending. Many factors can affect a state's revenues including the rate of population growth, man-made or natural disasters, unemployment rates, personal income growth, federal aid, and the ability to attract and keep successful businesses. A number of factors can also affect a state's spending including the need for infrastructure improvements, increased costs for education and other services, current debt levels, and the existence of accumulated budget deficits.

The following gives more information about the risks of investing in the Fund. Please read this information together with the section "Principal Risks" in the prospectus.

Alabama. Alabama has a large and fairly diversified economic base. Prior to 2009, economic growth was largely driven by the automotive industry with transportation equipment manufacturing accounting for 20% of total manufacturing jobs in the state. The national recession was felt through a loss of manufacturing and construction jobs. More recently, Alabama's recovery has been led by growth in durable manufacturing (motor vehicles), retail trade and governmental activities.

In 2012, Alabama's economic activity expanded at a slightly slower pace with GDP growing 1.9%, sales tax receipts growing 4.2%, state tax revenues up 3.1% and income tax receipts rising 6.2%. Alabama's per capita personal income levels are on the lower-end at \$35,625 and ranked 42 nationwide compared to the U.S. average of \$42,693 in 2012. The state's reported unemployment rate of 7.2% in 2012 compares favorably with the national average of 7.8% and is down significantly from the 10.5% peak during the 2009 recession. Non-agricultural employment is expected to increase slightly by 1% in 2013, driven by growth from large manufacturing and services employers. Going forward, the state's economic output is expected to expand 1.9% in 2013.

Manufacturing output grew by 3.4% with an upsurge of 10.3% and 8.4% for manufacturers of motor vehicles and metal fabrication, respectively, in 2012. Construction output showed some improvement growing 1.2%, but employment in this sector continued to decline. According to the U.S. Census Bureau, the state's exports hit another record level, rising 9.4% to \$19.5 billion in 2012. Alabama's top export sectors, ranked by dollar value, were transportation equipment at \$7.65 billion (39% of total) and chemicals at \$2.6 billion (13.3% of total). The Americas, including Canada, Mexico, and Latin America, continued to maintain the largest market share of Alabama exports in 2012 with a 34.1% share and an overall export value increase from \$6.1 billion to \$7.0 billion. Asia represented 27% of Alabama's exports in 2012 and increased 8.3% in export value. Canada alone accounted for 20.1% of total exports in 2012 and has been the number one export destination for the past four years.

Alabama's total revenues for governmental activities decreased \$445 million (2%) and spending also declined 2% in 2012. Tax revenues of \$7.6 billion were up \$231 million (3.1%), increasing for the second consecutive year as the economy continues to show signs of recovery. Tax revenues contributed 39% of total governmental revenues in 2012 which is up from 37% in the prior year. Income tax receipts increased \$193 million (6.2%) to \$3.3 billion and sales and use taxes increased \$93 million (4.2%) to \$2.3 billion. Revenues from program grants and contributions decreased \$914 million in 2012 due to a reduction in federal stimulus money. Total operating expenses for governmental activities were up \$86 million (0.5%) to \$19.0 billion in 2012.

The state's General Fund revenues increased \$53 million (4%) in 2012 due largely to gains in taxes, licenses, permits and fees. General Fund expenditures increased \$168 million (13%) due to higher health expenditures. The ending unassigned balance for 2012 was \$7.4 million, the non-spendable fund balance was \$4 million and the assigned fund balance was \$2 million. While the positive fund balance was an improvement over the \$20.2 million deficit in 2011, exclusive of the \$212 million in other financing sources the state's General Fund balance would have been negative in 2012. The Education Trust Fund's (ETF) ending fund balance deficit grew \$89 million to \$295 million due to a \$68 million reduction in taxes receivable and a \$24 million net increase in payables. The ETF still owes \$423 million to replenish the Education Rainy Day Account in the Alabama Trust Fund for amounts borrowed in fiscal year 2009. The Alabama Trust Fund had \$2.98 billion at the end of fiscal year 2012. The state's governmental funds reported combined ending balances of \$4.85 billion (\$4.5 billion reserved) which is down slightly from \$4.87 billion at the end of 2011.

Alabama continues to exhibit generally conservative financial management (deficit spending is prohibited by Alabama's Constitution), but has had to rely on non-recurring revenues to support its General Fund. The General Fund budget for fiscal year 2013 is \$52 million greater than the prior year due to Amendment 856 to the state's constitution. This amendment revises the method for distributions from the Alabama Trust Fund beginning with fiscal year 2013 and also provides for annual transfers of \$146 million to the General Fund through 2015. Total tax collections are up roughly 3.5% for the first five months of 2013; however, unemployment benefits have largely been exhausted for the states unemployed workers.

Due to constitutional limits of general obligation debt and the requirement that three-fifths of the legislature and a majority of the popular vote approve new debt, Alabama only has \$708 million of general obligation debt outstanding. The state issues tax-supported revenue debt and lease debt more routinely and there was a total of \$1.59 billion of such debt outstanding (a decrease of \$57 million from 2011) at the end of 2012.

As of May 2013, Moody's and S&P rated Alabama's general obligation bonds Aa1 and AA, respectively.

Florida. Florida's population growth was substantial between the 1980s and the early 2000s. Between 2002 and 2006, population growth moderated to about 2% per annum but has fallen since then with a growth rate of just 0.9% in 2012. The fastest growing segment in those boom years was the senior citizen population, particularly among older age levels. By 2020, projections indicate that over 20% of the state's population will be in the 65 and over age group, compared to 17.3% in 2010. Florida's population reached 19.1 million in 2012, making it the 4th largest state by population. The population growth was a driver for the economy but it has also placed pressure on vital government services such as education, corrections, transportation and health services.

Because of its substantial retirement age population, investment income and transfer payments, such as social security and pension benefits, make up a significant proportion of Florida's income distribution. This income mix historically has led to relatively stable personal income levels across different economic cycles, although it also has created some vulnerability to changes in the consumer price index at the federal level vis-à-vis transfer payments. The state's per capita personal income was \$40,522 compared to national per capita personal income of \$42,499 in 2012. Median household income of \$47,827 was also below the national level.

During the mid 2000s, the state enjoyed robust growth in residential housing and has therefore suffered the consequences of the precipitous housing downturn. The housing market's plummet brought both a sharp increase in unemployment due to the high concentration of construction jobs and a steep decline in housing prices. There was some improvement in the housing and construction sector in the last year. Total private housing starts ended the third quarter of 2012 at an annual rate of 65,000 units. This figure was better than the July estimate of 58,000 units. However, it will likely be a while before housing starts reach their pre-recession level of 272,000. Foreclosures remain an issue throughout the state. In 2012, Florida became the state with the highest foreclosure rate. Florida's unemployment rate, which peaked in 2010 at 11.3%, has slowly started to decline. For 2012, the state's annual unemployment rate was 8.6%.

Florida's tax base is relatively narrow with no personal income tax and the bulk of its revenues derived from the state's sales tax. Other large revenue sources for the state include other taxes and fees. In the early 2000s, revenues were led by dramatic gains in real estate documentary stamp taxes that outpaced expectations resulting in annual surpluses. During the recession, Florida relied on non-recurring revenues including federal stimulus funds, settlement proceeds and trust fund sweeps (savings) to plug gaping holes.

Florida's general fund revenue peaked in fiscal year 2006 at the height of the real estate boom at \$32.2 billion. After the residential real estate market collapse, revenue declined for three consecutive years. Since reaching a low of \$24.1 billion in fiscal year 2009, general fund revenues have recovered slightly, increasing to \$26.0 billion in fiscal year 2010, \$27.3 billion in fiscal year 2011, and \$28.6 billion in fiscal year 2012. The main contributor to the recovery in revenue has been sales tax revenue. Sales tax revenue increased by \$854.9 million in fiscal year 2012 to \$18.6 billion, but is still below the \$20.7 billion in revenue reached in fiscal year 2006. Once revenue started to fall in fiscal year 2007, the state made necessary expenditure reductions and relied on reserves to balance budgets. General fund expenditures were \$24.8 billion in fiscal year 2012, down 15.8% from fiscal year 2006. The state's general fund reserve finished fiscal year 2012 with an adequate \$4.8 billion or 19.4% of general fund expenditures. General fund reserves were \$8.0 billion prior to the recession. A high level of reserves is important to the state's

financial stability given the volatility of its primary revenue source, sales taxes.

Florida's debt burden has grown substantially with the increased need for schools, health care and environmental protection programs designed to help protect the state's important tourism industry. The debt burden has stabilized in recent years and remains moderately above the national median. The state had \$22.6 billion direct debt outstanding at fiscal year end 2012, or \$1,187 per capita and 3.0% of personal income. Current debt service from all funds is a low 3.6% of general fund expenditures. The state has built a complex debt structure with several special debt programs as the state may not issue debt without identifying a revenue source to support it.

The state's pension system is in decent shape relative to other states. It was reported to be over 100% funded through 2009 but fell to 86.9% funded in 2011. The state fully funds its annual contributions and its constitution requires that any benefit enhancements be funded on an actuarially sound basis.

As of April 1, 2013, Moody's rated Florida Aa1 Stable and S&P rated it AAA Stable.

Georgia. Georgia had enjoyed total employment growth from 2004 through 2007, which increased by an average of 2% a year. The recession was more severe in the state when compared to the nation overall. During 2008, the state's unemployment rate jumped to a high of 9.3% from a low of 4.4% in 2007. The unemployment rate continued to creep up during 2009 and 2010 to a high of 10.2%. The state's employment rate has slowly improved over the last three years and stood at 8.4% as of March 2013, outpacing the national average by 0.7%. The state's economic recovery has been driven by improvements in education, transportation, utilities and professional and business services sectors. Manufacturing, which had been losing jobs for several years, has seen a reversal, benefited by recent investments by Toyota to open a plant in Jackson County in addition to the sizable auto manufacturer presence of Kia and Blue Bird Corporation, a school bus manufacturer. Gulfstream Aerospace plans another expansion which will add an estimated 1,000 jobs to its current 5.500. Recovery continued to be hindered by contractions in construction, finance and the government sectors. Georgia is home to thirteen military bases and federal cuts to defense will hurt the economies of several metro areas. Also slowing economic recovery is the state's troubled housing market, which has seen a small recovery with house prices up 0.1% year over year according to the S&P/Case-Shiller Home Price Index for September 2012, but in general the market continues to see high mortgage delinquency and foreclosure rates. On a positive note, the national recovery will serve to strengthen the state's logistics and transportation industry. Georgia's recovery will benefit from the fact that the state is home to one of the world's busiest airports, the Atlanta Hartsfield Airport, and the second busiest port on the east coast, the Port of Savannah.

During fiscal year 2012, Georgia finally saw revenue growth after continued decline in fiscal year 2011. The General Fund revenues

saw a total increase of 3.6% during the year to \$34.6 billion. This revenue growth followed a 2.2% decline in fiscal year 2011 and a 10.5% decline in fiscal year 2010. The increase was primarily driven by a 4.7% increase in tax revenues to approximately \$16.0 billion, which represented over 46% of the state's revenue sources. Tax revenues had actually began to recover in fiscal year 2011 with a 4.2% increase, following two years of declines measuring 4.0% in fiscal year 2010 and 11.8% in fiscal year 2009. Federal revenues also saw an improvement of 3.9% to \$15.3 billion in fiscal year 2012 compared to a 10.7% decline in fiscal year 2011. Federal revenues comprised approximately 44% of the state's total General Fund revenue. After a small decrease in expenditures in fiscal year 2011 of 2.0%, total general fund expenditures saw an increase of 3.5% to \$31.4 billion in fiscal year 2012. The increase was driven by a 6.4% increase the state's largest expenditure, health and welfare (50%), to \$15.7 billion. Education expenditures, the state's second largest expense (32%), increased by 1.2% to \$10.1 billion, following a 6.9% decline in fiscal year 2010. The General Fund had a surplus of \$5.7 million, after transfers, which led to an increase in the General Fund Balance to \$3.7 billion. The General Fund had an unrestricted, unassigned balance of \$334.7 million. The state did not use any funds from the Revenue Shortfall Reserve (RSR) in fiscal years 2012 or 2011, and the balance grew to \$520.7 million from \$494.0 million at the end of fiscal year 2011. The balance of \$520.7 million in the RSR represented 3% of net revenue collections. It is expected the state will appropriate \$172.7 million for mid-year K-12 funding adjustment, leaving a balance of \$348.0 million.

Although Georgia's debt burden is growing, according to Moody's, it is still moderate in relation to the median level for the 50 states. Moody's 2012 state debt median report showed Georgia's net tax-supported debt per capita was approximately \$1,099, compared to a national median of \$1,117. Debt-to-personal income was 3.1% compared to a national median of 2.8%. A positive for the state's debt profile is that the state has a strong pension funded status compared to state medians. At the end of fiscal year 2011, the state's Employee's Retirement System was estimated to be 76% funded, while the Teacher's Retirement System was 84% funded. The state has traditionally had a consistent history of making 100% of its annually required contributions.

As of April 2013, Moody's rated Georgia Aaa and S&P rated it AAA. *Kentucky.* Like most of the U.S., Kentucky is experiencing signs of an easing economic downturn. However, the state continues to lag the nation in many key measures such as employment, population and personal income growth. Due to the state's heavy reliance on the manufacturing sector, in particular transportation equipment, the state's labor market remained weak with a March 2012 unemployment rate of 8.0% compared to the national average of 7.6%. Job growth is improving with improvement seen in the professional and business services, trade, transportation, leisure and hospitality and financial services. The manufacturing sector also saw strengthening. Estimated per capita income of \$33,667

in fiscal year 2011 compares favorably to the \$32,316 in fiscal year 2010, although continues to lag the nation as Kentucky ranks 47th in the nation.

As Kentucky's employment base is dominated by manufacturing and construction, it has typically lagged the national economy. The manufacturing sector accounts for 12% of all jobs in Kentucky compared to the national average of 9%. Kentucky's low cost structure and affordable housing may serve as a catalyst for net migration to the state. However, limited education levels will likely provide an impediment to various industry expansions or relocation to the state. According to the U.S. Census Bureau, Kentucky's estimated 2012 population was 4.380 million.

After seeing a surplus of \$156 million in fiscal year 2011, the General Fund experienced a deficit of \$200.6 million in fiscal year 2012. The primary reason for the deficit was additional federal participation in Medicaid, thus increasing Kentucky's share of these expenditures. Increased pension costs also contributed to the decline in the General Fund balance. During fiscal year 2012, total revenues in the general fund experienced an increase of 4.5% to \$8.94 billion. Total expenditures actually saw a slight decline of 1.15% to \$8.91 billion. The decline was primarily driven by a decrease in the General Fund's largest expenditure, education and humanities (46% of total revenues), of 11.7% in fiscal year 2012 to \$4.1 billion. Offsetting this large decrease were increases in human resources and justice expenses. Kentucky's General Fund balance totaled \$95.1 million at the end of fiscal year 2012, representing a decrease of \$200.6 million or 60.74% over the prior year. This followed an increase of \$225.8 million in fiscal year 2011 or 262% over fiscal year 2010. The unreserved balance was \$54.0 million.

Kentucky does not issue general obligation bonds; instead it relies on appropriation-backed debt issued through several agencies. S&P maintained an AA- Issuer rating and an A+ lease rating and revised the rating outlooks to negative on February 1, 2013. Moody's maintained an Aa2 Issuer rating and an Aa3 lease rating on the commonwealth with revised negative outlooks on March 6, 2012. The commonwealth has a policy of limiting debt service to 6% of total state revenue, a goal that has been effectively managed over the past decade. Kentucky's total long-term debt obligations increased by \$267.6 million to \$8.23 billion during the fiscal year; however, the commonwealth's debt burden remains manageable. Debt service as a percent of total General Fund expenditures was relatively low in 2011 at 3.44%. According to Moody's 2012 state debt median report, Kentucky's net taxsupported debt per capita was approximately \$2,035, compared to a national median of \$1,117, ranking the commonwealth 10th highest. A negative credit factor for the state is its weakened pension funded levels. The Kentucky Teacher's Retirement System has a reported/estimated funded level of 54.5% and the Kentucky Employees Retirement System has a reported/estimated funded ratio of just 30.2%. The funded statuses are likely to see continued pressure presuming the state contributes lower than the actuarially required contributions.

Louisiana. The state of Louisiana continues to recover from one of the worst natural disasters in U.S. history from hurricanes Katrina and Rita in 2005 and hurricanes Gustav and Ike in 2008. Catastrophic damage was widespread in southern Louisiana and impacted critical infrastructure. Louisiana's economy has been historically cyclical due to its reliance on oil and gas production and petro-chemical products, but due to the disasters the state has been on a different economic cycle from the rest of the nation. The state made some improvements towards a more diversified economy, with growth in its service sector, but such efforts were set back by the hurricanes. The nation's slow recovery from the "great recession" continues to impact Louisiana's economy. Additionally, the lingering effects of a lengthy offshore drilling permit process after the moratorium on drilling was lifted in the Gulf of Mexico following the 2010 Deep Horizon oil spill on Louisiana's extraction-oriented regions are expected to impact the state's economy over the next couple of years.

The national recession has negatively impacted Louisiana's economy; however, it has been less severe in Louisiana than in many other states. The state has seen improvement to the unemployment rate at 6.2% as of the end of March 2013, following an increase from 7.1% in fiscal year 2010 to 7.8% in fiscal year 2011. This compares favorably to the nation's unemployment rate which stood at 7.6% in March 2013.

The state's total revenue was largely comprised of operating grants and contributions at 47%, charges for services at 13%, sales tax at 11%, income tax at 12% and capital grants at 4% in fiscal year 2012. The largest expenses were for health and welfare at 38%, education at 26% and general government at 20%. Louisiana's General Fund revenues decreased by 9.46% in fiscal year 2012, after seeing an increase of 3.5% in fiscal year 2011. The large decline was driven by a decline in motor fuel collections, interest earnings and various agency receipts. The state did see increases in sales tax, income tax, corporate income tax, and royalties. Historically, these revenue sources have fluctuated with economic cycles and created budget instability. The state also saw a decline in expenditures of 3.0% to \$23.3 billion primarily driven by a decline in general government of 16.4%. This was the state's third consecutive deficit, which amounted to approximately \$353.4 million and reduced the General Fund balance to \$3.64 billion, or 15.6% of expenditures. The General Fund increased by \$2.97 billion in fiscal year 2011 to a balance of \$3.9 billion. This large increase resulted from the implementation of GASB Statement 54 which created fund balance classifications. There were 248 funds that did not meet the new special revenue definition under GASB 54 and were subsequently merged into the General Fund in fiscal year 2011. Amounts previously reported as reserved and unreserved fund balance are now reported under the following fund balance classifications: Non-spendable, Restricted, Committed, Assigned, or Unassigned. Finally, the Budget Stabilization Fund is now accounted for within the General Fund and had a restricted balance of \$443 million at the end of 2012. According to Moody's, reporting on a basis consistent with

previous reporting standards before the implementation of GASB 54 would bring the General Fund balance to \$1.3 billion in 2012.

The state debt burden has improved as a result of reduced borrowing, economic gains and the adoption of debt limitation measures. Louisiana's net tax supported debt per capita and personal income was ranked 17th and 19th, respectively, according to the 2012 Moody's State Debt Medians report. The report stated Louisiana's debt per capita stood at \$1,398, compared to the national median of \$1,117. The combination of the state's growing health care liabilities and unfunded risk management claims against the state could affect the state's performance in future years. The state's retirement system is reported to be underfunded with a reported funding ratio for its four defined benefit plans of 55.9% at the end of fiscal year 2012.

General Obligation bond ratings were raised to an AA from an AA- in 2011 by S&P and the rating was confirmed on May 7, 2013. Moody's raised its rating to Aa2 from A1 in 2010 and the rating was confirmed on April 23, 2013. Credit outlooks by both rating agencies remain stable.

Maryland. The state's diversified economy has allowed Maryland to weather the national economic decline better than most. The leading employment sectors include Government (19.7%), Trade/ Transportation/Utilities (17.7%), Professional & Business services (16.0%) and Education & Health (15.8%). Maryland depends on the government sector more than other states primarily due to its close proximity to Washington D.C., as well as the presence of the National Security Agency headquarters and several military bases. Federal government jobs account for more than 5.7% of employment in Maryland compared to the national average of just over 2%. The state gained high-paying professional and business services jobs as a result of the Base Realignment and Closure (BRAC) process, which caused the relocation of many military personnel. Maryland's prestigious education and health institutions, combined with the state's sizable federal presence, contribute to Maryland's high wage and income levels; Maryland's per capita income was 122% of the U.S. average in 2012 based on preliminary data (ranked 5th highest in the U.S.). Maryland's reliance on the manufacturing sector (4.6% of 2011 employment) has been smaller than most other states and insulated it somewhat from weak consumer demand. However, Maryland was not immune to the recession, which hindered the state's real estate market and caused the local economy to contract. The housing market appears to have bottomed as median house prices in Maryland increased in 2012 for the first time in five years. Consumer sentiment also appears to be improving as retail sales and sales and use tax receipts are both up. While Maryland experienced a shorter and less severe recession than the rest of the U.S. due primarily to their sizable level of federal employment, the state's large federal presence creates uncertainty for future growth as federal policymakers consider austerity measures. However, the state's workforce is highly educated and will likely support long-term growth in medical research, information technology and defense contractors. Maryland's unemployment at

the end of 2012 remained one percentage point below the national average (Maryland: 6.8%; U.S. average: 7.8%) and has continued to decline year to date.

Looking forward to 2013, the state faces a budget gap of approximately \$1 billion. While the state's fiscal management has been sound historically, it has been forced to rely increasingly on one-time revenue sources and transfers to balance the budget along with spending cuts and tax increases. Maryland is required to maintain a Revenue Stabilization Fund equal to 5% of General Fund revenues. At 2007 fiscal year-end, the balance was \$1.4 billion (11% of revenues); however, declining revenues have led to draw downs, leaving \$672 million at the end of 2012, nearing the 5% target of general fund revenues. Debt levels, while high relative to other states, have remained manageable. This relatively high debt level (ranked 14th nationally in debt per capita) is somewhat offset by the rapid amortization of the debt, which is due to a constitutional provision requiring it be retired within 15 years. In addition, the Capital Debt Affordability Committee limits total debt to 4% of the state's personal income and debt service to below 8% of revenues.

The Governor's budget for 2013 was balanced by primarily relying on spending cuts, tax increases, fund transfers and borrowing. The budget includes almost \$800 million of spending reductions and constrains budget growth to 1.9%, excluding the appropriation to the Rainy Day Fund. While the 2013 budget cuts the structural deficit by more than half, budget shortfalls are still projected for the next couple of years.

As of April 2013, Moody's rated Maryland Aaa and S&P rated the state AAA.

Missouri. Missouri maintains a diversified economy that includes sizeable manufacturing, agricultural, and financial sectors. St. Louis and Kansas City, the two major metropolitan areas, are home to 55% of the state's population and provide the majority of the state's income. The state's employment base has moved toward services, but there are economic advantages associated with its central geographic location for trade and manufacturing. The economy steadily improved beginning in fiscal year 2012 as the unemployment rate is at the lowest point in four years. Exports also continue to be an area of growth as the state reported 13.9 billion in total exports in 2012, according to the U.S. Census Bureau Trade Division and WISERTrade.

Missouri's population grew 7.2% from 2000 to 2010 to 5.988 million, making it the fifth most populous state west of the Mississippi River. The population in 2012 was estimated at 6.021 million representing a small, albeit positive, growth of 0.2% from the prior year. Incomes remain just below the national averages with per capita personal income of \$39,049 compared to national per capita personal income of \$42,693 in 2012. The state reported some positive signs of economic growth, including a 3% increase in personal income in 2012 and a 2.2% increase in taxable sales in the fourth quarter of 2012. Additionally, according to the Bureau of Labor Statistics, unemployment rates have made

a recovery dropping to 6.7% as of March 2013 compared to the 9.6% peak in 2009.

Missouri has maintained a balanced budget without raising taxes over the last several years. The state continues to proactively address its budget concerns and maintains a conservative financial management policy indicative of the top rating category. The Missouri Constitution limits the amount of taxes that can be imposed in addition to giving the Governor line-item veto power and the authority to withhold allotments of appropriated funds in the course of a fiscal year whenever actual revenues are below projections. The major components of general revenue include individual income taxes (67%), sales use taxes (25%) and corporate income/franchise taxes (4.6%). Net general revenue collections increased 3.2% in fiscal year 2012. The revised revenue estimate calls for growth of 4.8% in fiscal year 2013 which reflects modest growth in income and sales taxes with an additional one-time boost from the national mortgage settlement. The state's 2013 budget includes \$8.03 billion in general revenue appropriation and \$22.98 billion in total appropriations. Going forward, the franchise tax phase out and federal tax changes is expected to limit growth to 3.1% in fiscal year 2014.

Missouri's cautious approach to debt issuance and legal limits provide for below-average debt levels compared to the nation. Missouri's net tax supported debt burden was \$741 per capita with debt to personal income of 2.0% compared to national median levels of approximately \$1,117 per capita and 2.8% of personal income. Lastly, while the state continues to make 100% of their annual required contributions (ARC) payments every year, the state's primary public retirement system overall funding ratio declined to 73% in June 2012 as a result of a 1.6% drop in the asset valuation and a 23% increase in accrued liabilities. The state implemented pension reforms effective fiscal year 2011 which included increasing new employee contributions from 0% to 4% and increased the retirement age from 62 to 67. These reforms were estimated to provide \$78 million in annual savings by fiscal year 2020 and \$400 million of savings over the next eight years.

As of May 2013, Moody's rated Missouri Aaa and S&P rated it AAA.

North Carolina. North Carolina is recovering from the impact of the "Great Recession" at a slow, yet steady pace. The state continues to deal with a sluggish economy, a soft housing market, and depressed consumer demand. Fortunately, the constitutionally mandated balanced budget requirement, a conservative debt policy, and sound financial management have allowed the state of North Carolina to maintain the highest credit rating of AAA by S&P, AAA by Fitch and Aaa by Moody's as of March 2013. North Carolina is one of eight states to carry a rating of AAA by all three rating agencies.

North Carolina has a diverse economy, anchored by a popular banking center, agriculture, trade and a strengthening service sector. The state also benefits from a high technology base and numerous highly regarded universities. As has been the case in recent years, the main economic weaknesses continues to be the state's large exposure to the textile and tobacco industries coupled with the impact from the extensive job losses in the manufacturing and construction sectors. Diversification in the previously mentioned sectors has been a key driver in the steady recovery of the economy since the Great Recession. As a result manufacturing posted employment gains, while modest, for the first time in 16 years in fiscal year 2011 and continued through fiscal year 2012. However, even with slight employment growth in many sectors, North Carolina has regained less than half of the 334,400 jobs lost during the economic downturn. North Carolina's unemployment rate of 9.3% in December 2012 was 1.4% above the national average. The unemployment rate is expected remain above 9% in fiscal year 2013, but gradually drop to an estimated 8.8% by the end of fiscal year 2014.

North Carolina's General Fund performed relatively well over the course of the recession, relying on temporary tax increases, expense reductions, budgetary reserve funds, and federal recovery funds. However, due to the temporary taxes expiring, combined with a significant increase in Medicaid, the surplus General Fund balance of \$1.02 billion at June 30, 2012, represented a 13.6% decrease over fiscal year end 2011. The General Fund had a balance of \$594 million in fiscal year 2010 and deficits of \$114 million and \$775 million in fiscal year 2008 and 2009, respectively. North Carolina closed the budgetary gap primarily through expenditure reductions. To date, the state is currently meeting its revenue forecasts. Although outstanding debt has increased dramatically since 1993, debt levels on a per capita basis still remain moderate when compared to national levels.

Virginia. Virginia continues to be rated in the highest rating category by Moody's, S&P and Fitch as of May 2013. The AAA rating is reflective of the commonwealth's history of conservative fiscal management, relatively low debt ratios and diversified economic base. While Virginia, like most states, was impacted by the "Great Recession," the commonwealth has begun to show signs of improvement with steady, albeit modest growth.

For most of the past decade, Virginia has experienced solid personal income growth, typically exceeding that of the U.S. As a result of the recession, in 2009 the state's personal income fell 2.8%, which actually was significantly less severe than the 4.8% national decline in personal income. In 2010 and 2011, the state experienced annual growth of 4.1% and 5.4%, respectively. Personal income per capita is approximately \$46,107, or 111% of the national average, and the eighth highest out of all 50 states. Furthermore, eight of the top 25 US counties with the highest median household income are in Virginia, and the state benefits from a well-educated workforce.

Virginia's unemployment rate continued to improve in fiscal year 2011 and fiscal year 2012, and as of December 2012 stood at 5.5%, or just 71% of the national average for the same month. Virginia's job market has historically benefited from its close proximity to the nation's capital, the importance of the defense industry, the location of military personnel and Virginia's location on the eastern seaboard.

Although Virginia's economy has diversified over the years, it maintains a high concentration of federal government jobs that has historically served as a buffer during recessions. Government represents nearly 20% of the commonwealth's employment. While Virginia's large government and military sectors have historically insulated the state from economic downturns, due to the sizeable federal deficit and the pending contraction of the Federal Government, Virginia expects to see federal job losses and decreases in the related private sector—which are a significant part of the state's northern economy. However, it is expected that the overall strength of the state's economy should enable the commonwealth to easily absorb at least a portion of these federal job losses. In recent years, Virginia has benefited from consistently strong population growth, which increased 13.4% from 2000 to 2010 and to an estimated 2012 population of 8.03 million. The housing market saw its first post-recession gain in 2011 with a 2.5% increase in new housing unit authorizations.

During the course of the 2010-2012 biennium, the state's revenue performance and overall economic indicators steadily improved. In May 2011, the state adopted various mid-biennium budget adjustments, which allocated an additional \$480 million in projected biennium revenues to fund health and human services, higher education and K-12. Actual revenues continued to outperform forecasts through the end of fiscal year 2012, which, in conjunction with spending finishing below budget, resulted in a \$449 million biennium surplus as of June 30, 2012.

**U.S. Territories** Since the Fund may invest up to 35% of its assets in municipal securities issued by U.S. territories, the ability of municipal issuers in U.S. territories to continue to make principal and interest payments also may affect the Fund's performance. As with municipal issuers, the ability to make these payments is dependent on economic, political and other conditions. Below is a discussion of certain conditions within some of the territories where the Fund may invest. It is not a complete analysis of every material fact that may affect the ability of issuers of U.S. territory municipal securities to meet their debt obligations or the economic or political conditions within the territories and is subject to change. It is based on data available to the Fund from historically reliable sources, but it has not been independently verified by the Fund. In addition, the information provided is updated only through the information available as of the date of this SAI. The information and risks set forth below could change quickly and without notice due to additional information available, market or economic changes or other unforeseen events, among other things.

Guam. The island of Guam has an estimated population of 159,358. Its economy is largely driven by tourism and U.S. military activity. The government of Guam also receives significant support from the U.S. Treasury. Japan accounts for a substantial amount of Guam's tourism (71% of visitors as of February 2013), which makes the island's economy very sensitive to fluctuations in the Japanese economy. Economic weakness in Japan and other parts of Asia has had a negative impact on Guam tourism. Tourism

declined in the early to mid-part of the 2000s, hindered by a typhoon in 1997, a "super-typhoon" in 2002, the September 11, 2001 terrorist attacks ("9/11"), Severe Acute Respiratory Syndrome (SARS) fears and the war in Iraq. However, tourism has seen improvement in more recent years, helped by favorable weather and a steadying Japanese economy. In August 2007, visitor arrivals hit their highest mark since 9/11. However, arrivals dropped off with the global recession, declining 6.8% in 2008 and 7.8% in 2009. Guam started seeing improvement in 2010 with year-over-year growth of 11% by December 2010. Tourism declined in March 2011 after the Japanese earthquake and tsunami, but by the end of the year it had rebounded somewhat, and rebounded nearly 13% in 2012. As of February 2013, visitor arrivals were up 8.9% from February 2012 and 9.2% fiscal year-to-date as compared to the prior year, with sizeable increases in visitors from Korea, Taiwan and China. Hotel occupancy taxes increased 16.5% in 2012 and were running ahead of last year through the first two months of 2013.

Employment has been quite volatile in Guam since 1998. Total employment reached a peak of 62,350 in March of 1999. Following small increases in 2000 and 2001, employment fell by nearly 10% in early 2002. Employment slowly increased, reaching 62,600 in December 2010 amid growth in services and wholesale trade. Employment contracted in 2011 with decreases in construction and transportation that outweighed increases in the public sector. Preliminary 2012 information showed employment grew about 0.5%, with growth in the construction industry. The unemployment rate remains high and was 10.9% in September 2012, the last time it was officially calculated.

The U.S. military presence on Guam has always been a positive contributor to the economy. Its strategic location close to Asia has increased its importance in the overall military strategy of the U.S. Guam had been planning for a significant buildup after a proposed relocation of nearly 8,000 Marines and their 9,000 dependents to Guam from Okinawa, Japan scheduled to take place between 2014 and 2018. However, it now appears that this will not happen to the extent originally planned. The governments of Japan and the U.S. continue to discuss options, and recently the U.S. has discussed moving a missile defense system to Guam as a result of heightened tensions with North Korea.

Guam's overall financial condition has deteriorated due to a number of misfortunes, mismanagement and economic weakness. Natural disasters, the economic crisis in Japan, and the events of 9/11 have all contributed to Guam's financial hardship. Guam has seen negative financial results for most of the past decade. Its fiscal year 2007 accumulated deficit had grown to almost \$523 million. Guam was able to post a small surplus in fiscal year 2007 followed by larger ones in fiscal years 2008 and 2009, but fiscal year 2010 results were worse than projected with an operating deficit of about \$9.0 million and an overall deficit of nearly \$71 million. For fiscal year 2011, its accumulated deficit increased slightly to \$345 million from \$336 million in fiscal year 2010. It has a large unfunded liability in its pension fund

and a large liability to its residents for unpaid tax refunds. The government issued debt in 2007 and again in 2011 in order to fund some of these liabilities, restructure debt and pay debt service on current obligations for which cash was not available. Guam issued additional debt for these purposes in mid-2012. The fiscal year 2012 budget was about 4.8% larger than the 2011 budget. Guam has identified several steps that can be taken to improve its financial condition, but successful implementation is uncertain. The expected economic boost from the planned military buildup could also improve the territory's financial picture, but it is unclear whether Guam will be able to erase its fiscal deficits in the foreseeable future. The government has not yet released its 2012 audit.

As of April 2013, S&P has assigned a rating of B+ to Guam's general obligation debt with a stable outlook.

Mariana Islands. The Mariana Islands became a U.S. territory in 1975. At that time, the U.S. government agreed to exempt the islands from federal minimum wage and immigration laws in an effort to help stimulate industry and the economy. As a result, the islands were able to build a large garment industry which at one time encompassed 40% of the economy, and its rapid growth from 1980-1995 helped put the Commonwealth of the Northern Mariana Islands (CNMI) at the top of the list of economic growth worldwide. Critical to this growth was duty-free access to U.S. markets and local authority over immigration and the minimum wage. However, in 2005 when the World Trade Organization (WTO) eliminated quotas on apparel imports from other textile producing countries, the CNMI lost its main competitive advantage. In 2007, the CNMI's immigration and minimum wage laws were federalized. The CNMI must now follow all U.S. immigration and minimum wage laws. The minimum wage which was \$3.05 has been increasing by \$0.50 each year until 2015 when it reaches the current U.S. minimum wage. This has raised the production costs to a level that renders the garment industry uncompetitive. Under new immigration laws, all non-U.S. born residents were required to leave the CNMI by 2012 unless they qualified for a working visa. As a result of these changes, the garment industry has rapidly declined, affecting jobs, population, income and government

Tourism, now the main economic driver other than government, is still depressed compared to pre-recessionary levels. The CNMI continues its heavy dependence on Asian markets for tourism. In 2008, 51% of visitors were from Japan, 26% from Korea and 12% from Russia and China. Tourism hit its high in 2004 with 589,000 visitors. However, in 2008 the loss of direct flights from Japan resulted in a 30% decline in arrivals, causing visitors to drop to 408,000. To diversify its visitor base, the CNMI has been targeting Russia and China. Tourism is showing signs of improvement. Arrivals were up 17% in calendar year 2012 compared to the prior year, but it is important to note that this was still 32% below what it was in 2004. Tourists from Japan are a significant part of the tourism base in the CNMI, which was negatively impacted by the March 2011 earthquake and tsunami. Post-tsunami recovery of

Japanese visitors contributed to the CNMI's increase in arrivals in 2012. While arrivals from Japan were up 6% in December 2012, arrivals were down 3% in both January and February of 2013.

The CNMI financials have been in a deficit position since 1994. At the end of fiscal year 2009, the commonwealth had an accumulated deficit of \$273 million. In fiscal year 2009, revenues were under budget by 11.8% as a result of economic weakness. The large accumulated deficit was created from years of deficit operations resulting from both incorrect revenue and expenditure assumptions and the consequences from not adopting a budget. The CNMI has a history of not adopting budgets which means it spends at the prior budget's levels, which in some cases were four years old. As a result it was spending more than it collected in revenue. As a result of the significant deficits, the CNMI is often forced to forego funding its retirement to meet cash obligations. The elimination of retirement funding has also left the pension fund grossly underfunded. The government reduced the number of full-time equivalents by 45% between 2003 and 2012 in order to improve the government's liquidity problems. The budget for fiscal year 2013 was \$114 million, an 11.7% increase over the 2012 budget.

The population of all the islands combined was 53,883 according to the 2010 Census which represents a 22.2% decline from the 2000 Census population of 69,221.

As of April 2013, Moody's rated the commonwealth B2 and S&P rated it B+.

*Puerto Rico.* The Commonwealth of Puerto Rico is the fourth largest island in the Caribbean, and an estimated 3.7 million people call it home. Puerto Rico's economy has traditionally tracked that of the U.S. mainland. However, Puerto Rico entered its own recession about two years prior to the mainland entering its recession in 2006. Tourism, an important component of the Puerto Rican economy, had improved in late 2007 and early 2008. However, with the U.S. recession, tourism slowed down and had a negative effect on Puerto Rico's economy and tax revenues. Hotel occupancy rates dropped from 64% in December 2007 to 59% in December 2008, then rose to 64.7% in November 2009 and 66.2% in December 2011 before dropping to 65.1% as of October 2012. From 2002 until 2007, the commonwealth reported its economy expanded at a moderate annual rate of 2.3%. But for fiscal years 2008, 2009 and 2010, the real gross national product declined 2.9%, 4.0% and 3.8%, respectively. The Puerto Rico Planning Board reported that real gross national product declined another 1.5% in 2011 and projected it would increase 0.9% in 2012, 0.6% in 2013 (revised downwards) and 1.2% in 2014. The Planning Board is expected to release updated numbers for 2013 and 2014 soon and a downward revision seems likely.

The island's unemployment rate dropped from 13.6% in 1998 down to 10.6% as of 2005, after which it rose to an estimated 16.1% in October 2011. It has since improved to 13.8% as of February 2013. Total employment (seasonally adjusted) was flat on a year-over-year basis for 2011, dropped 0.2% for 2012 and has dropped a projected 5.6% from December 2012 through

February 2013. On a year-over-year basis as of February 2013, private sector jobs have declined nearly across the board with the exception of services which showed growth of almost 1%. The biggest decline was in manufacturing which lost 9% on a year-over-year basis. The largest employment sectors include services (35%), government (28%), trade (17%) and manufacturing (8%). While the manufacturing sector only makes up 9% of employment, it is the largest sector in terms of gross domestic product. The manufacturing sector has undergone some major changes. Pharmaceuticals, biotechnology and technology became growth areas in the 1990s, but this trend has reversed since then, with pharmaceutical manufacturing employment declining 30% from fiscal years 2007 to 2011.

The commonwealth has had deficit financial results for over ten years. Its financial situation reached a critical point in May 2006, when the government disclosed a significant fiscal year budget gap of \$738 million. After a political impasse, the commonwealth's Governor ordered the closing of certain non-essential government offices and schools due to the lack of money available for operations. A four-person commission of non-elected citizens was charged with resolving the fiscal crisis, the largest resolution of which was implementation of a sales tax.

A new administration took over in January 2009, with the challenge of dealing with a projected \$3.2 billion deficit for fiscal year 2009. The Governor announced and began implementing a Fiscal Stabilization and Economic Reconstruction Plan to comprehensively overhaul the government, both financially and organizationally. The main components of the fiscal year 2010 plan included job cuts, several temporary tax increases, increased tax enforcement, a reorganization of the government and a combination of the federal and a local stimulus plan. The commonwealth was unable to realize all of its goals, but did make notable progress. Revenues increased 5.8% or \$449.3 million in fiscal year 2011, bringing total revenues to \$8.165 billion. Individual income taxes declined by \$407 million or 15.7% as a result of tax reform, but an excise tax that was implemented raised \$678 million. Expenditures were \$9.153 billion with the gap financed largely by debt. The fiscal year 2012 General Fund budget estimated revenues would be \$8.65 billion and expenditures estimated at \$9.260 billion. The gap was financed again through debt borrowing.

In November 2012, a new administration was elected. In March 2013, the new administration identified a fiscal year 2013 budget gap projected to be more than \$2 billion. The administration acted quickly to increase and extend an excise tax, implement a tax amnesty program as well as other measures to reduce the current-year budget deficit. The government predicted this could reduce the 2013 gap to just over \$1.1 billion. In May 2013, the governor released his proposed fiscal year 2014 budget. The governor's proposal to close the budget gap and fund increased spending would be financed by an increase in taxes due to an expansion of the sales taxbase, a tax amnesty program and a program to increase compliance with the sales tax as well as

other smaller measures. The governor has proposed an overall sales tax rate decrease which would reduce the amount received by municipalities but allocate the same percentage to the central government. The governor further proposes that the government reduce, but not yet end, its reliance on debt issuance to fund annual debt service payments. The legislature is currently debating the budget proposal. The fiscal year end is June 30th.

While Puerto Rico's debt per capita levels are at the higher end of the spectrum compared to U.S. states, this is partly explained by the fact that Puerto Rico generally centralizes the majority of its debt issuance at the territory level. These debt levels have increased as Puerto Rico financed significant capital and infrastructure improvements. Puerto Rico continues to maintain a very large unfunded pension liability and its primary pension fund has an estimated funded ratio of just 6%. It also has an estimated unfunded other post-employment benefits (OPEB) liability of \$2.3 billion. The commonwealth issued pension obligation bonds in early 2008, secured by future employer contributions. In March 2013, the governor and legislature approved significant pension reforms which should help mitigate the huge increases in annual funding required of the government when assets are depleted. This reform should reduce potential annual funding requirements from as high as \$700-900 million a year to closer to \$200 million.

As of April 2013, S&P rated Puerto Rico's general obligation debt at BBB-, with a negative outlook. Moody's rated the island's general obligation debt Baa3 with a negative outlook. And Fitch rated the commonwealth at BBB- with a negative outlook.

Puerto Rico continues to face challenges stemming from the 1996 passage of a bill eliminating Section 936 of the Internal Revenue Code that had given certain U.S. corporations operating in Puerto Rico significant tax advantages. These incentives had helped drive Puerto Rico's economic growth, especially with the development of its manufacturing sector. U.S. firms that had benefited from these incentives provided a significant portion of Puerto Rico's revenues, employment and deposits in local financial institutions. The Section 936 incentives were phased out over a 10-year period ending in 2006.

Outstanding issues relating to the potential for a transition to statehood may also have broad implications for Puerto Rico and its financial and credit position. The U.S. House of Representatives has considered legislation that would allow the residents of Puerto Rico to vote on its political status. If approved by Congress, Puerto Ricans would first hold a referendum asking residents if they prefer to be a self-governing commonwealth or to change the island's status. If a majority were to vote for a different status, the island would then hold a second election to decide what status they want. One of these options would be statehood. The president has recommended Congress appropriate money for Puerto Rico to hold a non-partisan election on the question of political status. It isn't clear what the timeline, outcome or repercussions could be of such a vote.

U.S. Virgin Islands. The United States Virgin Islands is an organized, unincorporated U.S. territory located 40 miles east of the Commonwealth of Puerto Rico. The economy is small and narrow, with tourism and related industries accounting for approximately 80% of annual economic activity. The scope of the economy subjects the Virgin Islands to considerable revenue volatility.

General fund revenues declined materially during the peak of the economic recession, decreasing by 29% from fiscal year 2008 to fiscal year 2009. The Virgin Islands' general fund has continued to struggle to generate operating surpluses over the last two fiscal years, with a combination of gross receipts tax (GRT) rate increases, salary rollbacks, and debt issuance providing the necessary funds to finance operating deficits. Immediately following the enactment of the fiscal year 2012 budget, the governor's office forecast a roughly \$67.5 million operating deficit. In response, U.S. Virgin Islands terminated 500 employees, providing \$20 million in annual savings, and attempted to increase the GRT rate further. In January 2012, Hovensa, a petroleum refinery located on the island of St. Croix in the Virgin Islands, announced its imminent closure. Following this announcement, the legislature approved the requested GRT rate increase to help offset the estimated \$50 million annual revenue loss from the closure of the refinery. The remaining \$60 million budget gap was closed through the issuance of additional debt in August 2012.

The closure of the Hovensa facility is also expected to have a severe impact on the overall economy. Prior to its closure, the refinery employed approximately 2,000 residents of St. Croix, representing 4.5% of total U.S. Virgin Islands' employment. The facility will continue to provide 100 jobs, but the overall impact of the refinery closure has been an increase in the U.S. Virgin Islands' unemployment rate to 13.3% as of March 2013, compared to 7.6% nationally. While tourism indicators have begun to stabilize after a sharp decline during the recession, they are unlikely to materially improve unemployment in the short-term

U.S. Virgin Islands' liabilities remain extremely high. Tax-supported debt totaled \$2 billion as of November 1, 2012, which is the equivalent to 75% of personal income. In comparison, the national average for debt-to-personal income is just 2.8%. In addition, persistent underfunding has led to a large pension liability. The U.S. Virgin Islands' pension system had a funding ratio of 49.9% as of September 2010 (latest available), down from 52.4% the prior year. The roughly \$1.5 billion unfunded liability was the equivalent to 56% of personal income during the fiscal year. Other post-employment benefits totaled \$1.12 billion at the end of fiscal year 2010, further pressuring fixed costs.

Policies and Procedures Regarding the Release of Portfolio Holdings

The Fund's overall policy with respect to the release of portfolio holdings is to release such information consistent with applicable legal requirements and the fiduciary duties owed to shareholders.

Subject to the limited exceptions described below, the Fund will not make available to anyone non-public information with respect to its portfolio holdings, until such time as the information is made available to all shareholders or the general public.

For purposes of this policy, portfolio holdings information does not include aggregate, composite or descriptive information that does not present risks of dilution, arbitrage, market timing, insider trading or other inappropriate trading for the Fund. Information excluded from the definition of portfolio holdings information generally includes, without limitation: (1) descriptions of allocations among asset classes, regions, countries or industries/ sectors; (2) aggregated data such as average or median ratios, market capitalization, credit quality or duration; (3) performance attributions by industry, sector or country; or (4) aggregated risk statistics. Such information, if made available to anyone, will be made available to any person upon request, but, because such information is generally not material to investors, it may or may not be posted on the Fund's website. In addition, other information may also be deemed to not be portfolio holdings information if, in the reasonable belief of the Fund's Chief Compliance Officer (or his/her designee), the release of such information would not present risks of dilution, arbitrage, market timing, insider trading or other inappropriate trading for the Fund.

Consistent with current law, the Fund releases complete portfolio holdings information each fiscal quarter through regulatory filings with no more than a 60-day lag.

In addition, a complete list of the Fund's portfolio holdings is generally released no sooner than 20 calendar days after the end of each calendar quarter. Commentaries and other materials that may reference specific holdings information of the Fund as of the most recent calendar quarter end are also subject to the same 20-day lag requirement. Other descriptive information, such as the Fund's top 10 holdings, may be released monthly, no sooner than five days after the end of each month. Released portfolio holdings information can be viewed on franklintempleton.com.

To the extent that this policy would permit the release of portfolio holdings information regarding a particular portfolio holding for the Fund that is the subject of ongoing purchase or sale orders/programs, or if the release of such portfolio holdings information would otherwise be sensitive or inappropriate, the portfolio manager for the Fund may request that the release of such information be withheld.

Exceptions to the portfolio holdings release policy will be made only when: (1) the Fund has a legitimate business purpose for releasing portfolio holdings information in advance of release to all shareholders or the general public; (2) the recipient is subject to a duty of confidentiality pursuant to a signed non-disclosure agreement; and (3) the release of such information would not otherwise violate the antifraud provisions of the federal securities laws or fiduciary duties owed to Fund shareholders. The determination of whether to grant an exception, which includes the determination of whether the Fund has a legitimate business purpose for releasing portfolio holdings information in advance of

release to all shareholders or the general public shall be made by the Fund's Chief Compliance Officer or his/her designee, following a request submitted in writing.

The eligible third parties to whom portfolio holdings information may be released in advance of general release fall into the following categories: data consolidators (including rating agencies), fund rating/ranking services and other data providers, service providers to the Fund, and municipal securities brokers using the Investor Tools product which brings together buyers and sellers of municipal securities in the normal operation of the municipal securities markets. In addition, should the Fund process a shareholder's redemption request in-kind, the Fund may, under certain circumstances, provide portfolio holdings information to such shareholder to the extent necessary to allow the shareholder to prepare for receipt of such portfolio securities.

The specific entities to whom the Fund may provide portfolio holdings in advance of their release to the general public are:

- Bloomberg, Capital Access, CDA (Thomson Reuters), FactSet, Fidelity Advisors, Standard & Poor's, Vestek, and Fidelity Trust Company, all of whom may receive portfolio holdings information 15 days after the quarter end.
- Service providers to the Fund that receive portfolio holdings information from time to time in advance of general release in the course of performing, or to enable them to perform, services for the Fund, including: Custodian Bank: The Bank of New York Mellon; Independent Registered Public Accounting Firm: PricewaterhouseCoopers LLP; Outside Fund Legal Counsel: Stradley Ronon Stevens & Young, LLP; Independent Directors'/ Trustees' Counsel: Bleakley, Platt & Schmidt, LLP; Proxy Voting Services: Glass, Lewis & Co., LLC and Institutional Shareholder Services, Inc.; Brokerage Analytical Services: Sanford Bernstein, Brown Brothers Harriman, Royal Bank of Canada Capital Markets, JP Morgan Securities Inc.; Financial Printers: RR Donnelley & Sons Company or GCOM Solutions, Inc.

In all cases, eligible third parties are required to execute a nondisclosure agreement. Non-disclosure agreements include the following provisions:

- The recipient agrees to keep confidential, and to limit the dissemination of, any portfolio holdings information received.
- The recipient agrees not to trade on the non-public information received, including some or all of the following: (1) agreeing not to purchase or sell any portfolio securities based on any information received; (2) agreeing not to trade against any U.S. registered Franklin or Templeton fund, including the Fund; (3) agreeing not to knowingly engage in any trading practices that are adverse to any such fund; and (4) agreeing not to trade in shares of any such fund.
- The recipient agrees to refresh its representation as to confidentiality and abstention from trading upon request from Franklin Templeton.

In no case does the Fund receive any compensation in connection with the arrangements to release portfolio holdings information to any of the above-described recipients of the information.

Several investment managers within Franklin Templeton Investments (F-T Managers) serve as investment managers to offshore funds that are registered or otherwise authorized for sale with foreign regulatory authorities. The release of portfolio holdings information for such offshore funds is excluded from the Fund's portfolio holdings release policy if such information is given to offshore banks, broker-dealers, insurance companies, registered investment managers and other financial institutions (offshore investment managers) with discretionary authority to select offshore funds on behalf of their clients. Because such offshore funds may from time to time invest in securities substantially similar to those of the Fund, there is the risk that such portfolio holdings information may be used to trade inappropriately against the Fund. To mitigate such risks, such information may only be disclosed for portfolio analytics, such as risk analysis/asset allocation, and the offshore investment manager will be required to execute a non-disclosure agreement, whereby such offshore investment manager: (1) agrees to maintain such information as confidential, including limiting the dissemination of such information, (2) is prohibited from trading on the information received, including (a) purchasing or selling any portfolio securities based on any information received; (b) trading against any U.S. registered Franklin or Templeton fund, including the Fund; (c) knowingly engaging in any trading practices that are adverse to any such fund: and (d) trading in shares of any such fund that is substantially similar to the offshore fund, and (3) agrees to refresh its representation as to confidentiality and abstention from trading upon request from Franklin Templeton. In addition, an offshore fund may release information regarding the top contributors and detractors to such fund's portfolio performance monthly to those recipients who have executed a non-disclosure agreement containing the provisions described above, or who have confirmed electronically its agreement to such provisions. Country-specific offshore funds that are not, in the aggregate, substantially similar to the holdings of a U.S. registered Franklin or Templeton fund, are not subject to the restrictions imposed by the policy.

Certain F-T Managers serve as investment advisers to privately placed funds that are exempt from registration, including Canadian institutional pooled funds and commingled trusts maintained by a Franklin Templeton trust company. In certain circumstances, such unregistered private funds may have portfolio holdings that are not, in the aggregate, substantially similar to the holdings of a U.S. registered fund, as determined by the Chief Compliance Officer or his/her designee. Under such circumstances the release of portfolio holdings information to

a client or potential client of the unregistered private fund may be permissible. In circumstances where an unregistered private fund invests in portfolio securities that, in the aggregate, are substantially similar to the holdings of a U.S. registered fund, such private funds are subject to the restrictions imposed by the policy, except that the release of holdings information to a current investor in the private fund is permissible conditioned upon such investor's execution of a non-disclosure agreement to mitigate the risk that portfolio holdings information may be used to trade inappropriately against a fund. Such non-disclosure agreement must provide that the investor: (1) agrees to maintain such information as confidential, including limiting the dissemination of such information (except that the investor may be permitted to disseminate such information to an agent as necessary to allow the performance of portfolio analytics with respect to the investor's investment in the private fund), and (2) is prohibited from trading on the information received, including (a) trading against any U.S. registered Franklin or Templeton fund, including the Fund; (b) knowingly engaging in any trading practices that are adverse to any such fund; and (c) trading in shares of any U.S. registered Franklin or Templeton fund that is managed in a style substantially similar to that of the private fund.

Some F-T Managers serve as sub-advisers to other mutual funds not within the Franklin Templeton Investments fund complex ("other funds"), which may be managed in a style substantially similar to that of a U.S. registered Franklin or Templeton fund. Such other funds are not subject to the Fund's portfolio holdings release policy. The sponsors of such funds may disclose the portfolio holdings of such funds at different times than the Fund discloses its portfolio holdings.

In addition, some F-T Managers also serve as investment managers to separate accounts, which are subject to the Fund's policy with respect to the release of the separate account's holdings to consultants and potential clients. Separate accounts that are not, in the aggregate, substantially similar to the holdings of a U.S. registered Franklin or Templeton fund, however, are not subject to the restrictions imposed by the policy.

The Fund's portfolio holdings release policy and all subsequent amendments have been reviewed and approved by the Fund's board, and any other material amendments shall also be reviewed and approved by the board. The investment manager's compliance staff conducts periodic reviews of compliance with the policy and provides at least annually a report to the board regarding the operation of the policy and any material changes recommended as a result of such review. The investment manager's compliance staff also will supply the board yearly with a list of exceptions granted to the policy, along with an explanation of the legitimate business purpose of the Fund that is served as a result of the exception.

#### Officers and Trustees

The Trust has a board of trustees. Each trustee will serve until that person resigns and/or a successor is elected and qualified. The board is responsible for the overall management of the Trust, including general supervision and review of the Fund's investment activities. The board, in turn, elects the officers of the Trust who are responsible for administering the Trust's day-to-day operations. The board also monitors the Fund to ensure that no material conflicts exist among share classes. While none are expected, the board will act appropriately to resolve any material conflict that may arise.

The name, year of birth and address of the officers and board members, as well as their affiliations, positions held with the Trust, principal occupations during at least the past five years and number of portfolios overseen in the Franklin Templeton fund complex are shown below.

## **Independent Board Members**

Name, Year of Birth and Address	Position	Length of Time Served	Number of Portfolios in Fund Complex Overseen by Board Member¹	Other Directorships Held During at Least the Past 5 Years
Harris J. Ashton (1932)	Trustee	Since 1984	135	Bar-S Foods (meat packing company) (1981-
One Franklin Parkway				2010).
San Mateo, CA 94403-1906				

#### Principal Occupation During at Least the Past 5 Years:

Director of various companies; and **formerly**, Director, RBC Holdings, Inc. (bank holding company) (until 2002); and President, Chief Executive Officer and Chairman of the Board, General Host Corporation (nursery and craft centers) (until 1998).

Sam Ginn (1937) One Franklin Parkway San Mateo, CA 94403-1906	Trustee	Since 2007	109	ICO Global Communications (Holdings) Limited (satellite company) (2006-2010), Chevron Corporation (global energy company) (1989-2009), Hewlett-Packard Company (technology company) (1996- 2002), Safeway, Inc. (grocery retailer) (1991-1998) and TransAmerica Corporation
				(1991-1998) and TransAmerica Corporation (insurance company) (1989-1999).

## Principal Occupation During at Least the Past 5 Years:

Private investor; Chairman, First Responder Network Authority (FirstNet) (interoperable wireless broadband network) (August 2012); and **formerly**, Chairman of the Board, Vodafone AirTouch, PLC (wireless company) (1999-2000); Chairman of the Board and Chief Executive Officer, AirTouch Communications (cellular communications) (1993-1998) and Pacific Telesis Group (telephone holding company) (1988-1994).

Edith E. Holiday (1952) One Franklin Parkway San Mateo, CA 94403-1906	Trustee	Since 1998	135	Hess Corporation (exploration and refining of oil and gas), H.J. Heinz Company (processed foods and allied products) (1994-2013), RTI International Metals, Inc. (manufacture and distribution of titanium), Canadian National Railway (railroad) and White Mountains
				Insurance Group, Ltd. (holding company).

#### Principal Occupation During at Least the Past 5 Years:

Director or Trustee of various companies and trusts; and **formerly**, Assistant to the President of the United States and Secretary of the Cabinet (1990-1993); General Counsel to the United States Treasury Department (1989-1990); and Counselor to the Secretary and Assistant Secretary for Public Affairs and Public Liaison-United States Treasury Department (1988-1989).

J. Michael Luttig (1954)	Trustee	Since 2009	135	<b>Boeing Capital Corporation (aircraft</b>
One Franklin Parkway				financing).
San Mateo, CA 94403-1906				

#### Principal Occupation During at Least the Past 5 Years:

Executive Vice President, General Counsel and member of the Executive Council, The Boeing Company (aerospace company); and **formerly**, Federal Appeals Court Judge, U.S. Court of Appeals for the Fourth Circuit (1991-2006).

Name, Year of Birth and Address	Position	Length of Time Served	Number of Portfolios in Fund Complex Overseen by Board Member¹	Other Directorships Held During at Least the Past 5 Years
Frank A. Olson (1932)	Trustee	Since 2005	135	Hess Corporation (exploration and refining of
One Franklin Parkway				oil and gas).
San Mateo, CA 94403-1906				

#### Principal Occupation During at Least the Past 5 Years:

Chairman Emeritus, The Hertz Corporation (car rental) (since 2000) (Chairman of the Board (1980-2000) and Chief Executive Officer (1977-1999)); and formerly, Chairman of the Board, President and Chief Executive Officer, UAL Corporation (airlines) (until 1987).

Larry D. Thompson (1945) One Franklin Parkway San Mateo, CA 94403-1906	Trustee	Since 2007	135	Cbeyond, Inc. (business communications provider), The Southern Company (energy company) (2010-2012) and The Washington Post Company (education and media
				organization).

#### Principal Occupation During at Least the Past 5 Years:

Executive Vice President - Government Affairs, General Counsel and Corporate Secretary, PepsiCo, Inc. (consumer products) (June 2012); and **formerly**, John A. Sibley Professor of Corporate and Business Law, University of Georgia School of Law (2011-2012); Senior Vice President - Government Affairs, General Counsel and Secretary, PepsiCo, Inc. (2004-2011); Senior Fellow of The Brookings Institution (2003-2004); Visiting Professor, University of Georgia School of Law (2004); and Deputy Attorney General, U.S. Department of Justice (2001-2003).

#### Principal Occupation During at Least the Past 5 Years:

President, Staples Europe (office supplies) (October 2012); President and Founder, Hyannis Port Capital, Inc. (real estate and private equity investing); serves on private and non-profit boards; and **formerly**, Chief Operating Officer and Executive Vice President, Gap, Inc. (retail) (1996-2000); Chief Financial Officer and Executive Vice President — Finance and Strategy, Staples, Inc. (1992-1996); Senior Vice President — Corporate Planning, Northwest Airlines, Inc. (airlines) (1990-1992); and Vice President and Partner, Bain & Company (consulting firm) (1986-1990).

## **Interested Board Members and Officers**

Name, Year of Birth and Address	Position	Length of Time Served	Number of Portfolios in Fund Complex Overseen by Board Member¹	Other Directorships Held During at Least the Past 5 Years
Gregory E. Johnson <sup>2</sup> (1961)	Trustee	Since 2007	145	None
One Franklin Parkway				
San Mateo, CA 94403-1906				

## Principal Occupation During at Least the Past 5 Years:

Chairman of the Board, Member - Office of the Chairman, Director, President and Chief Executive Officer, Franklin Resources, Inc.; officer and/or director or trustee, as the case may be, of some of the other subsidiaries of Franklin Resources, Inc. and of 45 of the investment companies in Franklin Templeton Investments; and Chairman, Investment Company Institute.

Rupert H. Johnson, Jr. <sup>3</sup> (1940)	Chairman of the	Since June 2013	135	None
One Franklin Parkway	<b>Board and Trustee</b>			
San Mateo, CA 94403-1906				

#### Principal Occupation During at Least the Past 5 Years:

Vice Chairman, Member - Office of the Chairman and Director, Franklin Resources, Inc.; Director, Franklin Advisers, Inc.; Senior Vice President, Franklin Advisory Services, LLC; and officer and/or director or trustee, as the case may be, of some of the other subsidiaries of Franklin Resources, Inc. and of 42 of the investment companies in Franklin Templeton Investments.

Name, Year of Birth and Address	Position	Length of Time Served	Number of Portfolios in Fund Complex Overseen by Board Member'	Other Directorships Held During at Least the Past 5 Years
Sheila Amoroso (1959) One Franklin Parkway San Mateo, CA 94403-1906	Vice President	Since 1999	Not Applicable	Not Applicable
<b>Principal Occupation During at Least t</b> l Senior Vice President, Franklin Advi		of the investment compan	ies in Franklin Templeton In	vestments.
Alison E. Baur (1964) One Franklin Parkway San Mateo, CA 94403-1906	Vice President	Since 2012	Not Applicable	Not Applicable
<b>Principal Occupation During at Least t</b> Deputy General Counsel, Franklin Te investment companies in Franklin T	mpleton Investments; and of	ficer of some of the other su	ubsidiaries of Franklin Reso	urces, Inc. and of 47 of the
Rafael R. Costas, Jr. (1965) One Franklin Parkway San Mateo, CA 94403-1906	Vice President	Since 1999	Not Applicable	Not Applicable
<b>Principal Occupation During at Least t</b> l Senior Vice President, Franklin Advi		of the investment compan	ies in Franklin Templeton In	vestments.
Laura F. Fergerson (1962) One Franklin Parkway San Mateo, CA 94403-1906	Chief Executive Officer - Finance and Administration	Since 2009	Not Applicable	Not Applicable
Principal Occupation During at Least th Senior Vice President, Franklin Temp		cer of 47 of the investment	companies in Franklin Temp	oleton Investments.
Gaston Gardey (1967) One Franklin Parkway San Mateo, CA 94403-1906	Treasurer, Chief Financial Officer and Chief Accounting Officer	Since 2009	Not Applicable	Not Applicable
<b>Principal Occupation During at Least t</b> l Director, Fund Accounting, Franklin		officer of 28 of the investme	ent companies in Franklin T	empleton Investments.
Aliya S. Gordon (1973) One Franklin Parkway San Mateo, CA 94403-1906	Vice President	Since 2009	Not Applicable	Not Applicable
Principal Occupation During at Least t Senior Associate General Counsel, F formerly, Litigation Associate, Stee	ranklin Templeton Investmen		tment companies in Frankli	in Templeton Investments; a
Steven J. Gray (1955)	Vice President	Since 2009	Not Applicable	Not Applicable

## San Mateo, CA 94403-1906

One Franklin Parkway

Principal Occupation During at Least the Past 5 Years:
Senior Associate General Counsel, Franklin Templeton Investments; Vice President, Franklin Templeton Distributors, Inc.; and officer of 47 of the investment companies in Franklin Templeton Investments.

Vice President - AML Compliance	Since 2012		
		Not Applicable	Not Applicable
ast 5 Years: and officer of 47 of the i	nvestment companies in Fr	anklin Templeton Investment	S.
President and Chief Executive Officer - Investment Management	Since 2010	Not Applicable	Not Applicable
ranklin Advisers, Inc.; Ex			
Vice President	Since March 2013	Not Applicable	Not Applicable
oleton Investments; Vice			
Chief Compliance Officer	Since March 2013	Not Applicable	Not Applicable
	nd officer of 47 of the invest	ment companies in Franklin	Templeton Investments.
Vice President and Secretary	Since 2006	Not Applicable	Not Applicable
	nts; and officer of 47 of the	investment companies in Fra	nklin Templeton Investments.
Vice President	Since 2005	Not Applicable	Not Applicable
	President and Chief Executive Officer - Investment Management ast 5 Years: ranklin Advisers, Inc.; Ex s, Inc. and of 23 of the in  Vice President  Chief Compliance Officer ast 5 Years: mpleton Investments; ar  Vice President and Secretary  ast 5 Years: mpleton Investments; ar	President and Since 2010 Chief Executive Officer - Investment Management ast 5 Years: ranklin Advisers, Inc.; Executive Vice President, France, Inc. and of 23 of the investment companies in Fra  Vice President Since March 2013  ast 5 Years: oleton Investments; Vice President, Secretary and Trell, LLC; Assistant Secretary, Franklin Resources, Inc  Chief Compliance Since March 2013 Officer  ast 5 Years: mpleton Investments; and officer of 47 of the invest  Vice President Since 2006 and Secretary  ast 5 Years: din Templeton Investments; and officer of 47 of the	Chief Executive Officer - Investment Management  ast 5 Years: ranklin Advisers, Inc.; Executive Vice President, Franklin Templeton Institutional, s, Inc. and of 23 of the investment companies in Franklin Templeton Investments.  Vice President Since March 2013 Not Applicable  ast 5 Years: oleton Investments; Vice President, Secretary and Trust Officer, Fiduciary Trust Intel, LLC; Assistant Secretary, Franklin Resources, Inc.; and officer of 47 of the investment Chief Compliance Officer  ast 5 Years: mpleton Investments; and officer of 47 of the investment companies in Franklin  Vice President Since 2006 Not Applicable and Secretary  ast 5 Years: din Templeton Investments; and officer of 47 of the investment companies in Franklin  Tranklin Templeton Investments; and officer of 47 of the investment companies in Franklin  Since 2006 Not Applicable and Secretary

General Counsel and Executive Vice President, Franklin Resources, Inc.; officer of some of the other subsidiaries of Franklin Resources, Inc. and of 47 of the investment companies in Franklin Templeton Investments; and **formerly**, Partner, Shearman & Sterling, LLP (2004-2005); and General Counsel, Investment Company Institute (ICI) (1997-2004).

Thomas Walsh (1961) Vice President Since 1999 Not Applicable One Franklin Parkway

San Mateo, CA 94403-1906

## Principal Occupation During at Least the Past 5 Years:

Senior Vice President, Franklin Advisers, Inc.; and officer of eight of the investment companies in Franklin Templeton Investments.

Name, Year of Birth and Address	Position	Length of Time Served	Number of Portfolios in Fund Complex Overseen by Board Member¹	Other Directorships Held During at Least the Past 5 Years
Lori A. Weber (1964) 300 S.E. 2nd Street	Vice President	Since 2011	Not Applicable	Not Applicable
Fort Lauderdale, FL 33301-1923				

#### Principal Occupation During at Least the Past 5 Years:

Senior Associate General Counsel, Franklin Templeton Investments; Assistant Secretary, Franklin Resources, Inc.; Vice President and Secretary, Templeton Investment Counsel, LLC; Vice President, Fiduciary Trust International of the South; and officer of 47 of the investment companies in Franklin Templeton Investments.

- Note 1: Rupert H. Johnson, Jr. is the uncle of Gregory E. Johnson.
- Note 2: Officer information is current as of the date of this SAI. It is possible that after this date, information about officers may change.
- Note 3: Effective June 13, 2013, Charles B. Johnson ceased to be a trustee of the Trust.
- 1. We base the number of portfolios on each separate series of the U.S. registered investment companies within the Franklin Templeton Investments fund complex. These portfolios have a common investment manager or affiliated investment managers.
- 2. Gregory E. Johnson is considered to be an interested person of the Fund under the federal securities laws due to his position as an officer and director of Resources.
- 3. Rupert H. Johnson, Jr. is considered to be an interested person of the Fund under the federal securities laws due to his position as officer and director and major shareholder of Franklin Resources, Inc., which is the parent company of the Fund's investment manager and distributor.

The Trust's independent board members constitute the sole independent board members of 27 investment companies in the Franklin Templeton Investments complex for which each independent board member currently is paid a \$247,000 annual retainer fee, together with a \$7,000 per meeting fee for attendance at regularly scheduled board meetings, a portion of which is allocated to the Trust. To the extent held, compensation may also be paid for attendance at specially held board meetings. The Trust's lead independent trustee is paid an annual supplemental retainer of \$25,000 for services to such investment companies, a portion of which is allocated to the Trust. Board members who serve on the Audit Committee of the Trust and such other funds receive a flat fee of \$3,000 per Committee meeting attended in person and \$2,000 per telephonic meeting, a portion of which is allocated to the Trust. John B. Wilson, who serves as chairman of the Audit Committee of the Trust and such other funds receives an additional fee of \$50,000 per year, a portion of which is allocated to the Trust. Members of the Committee are not separately compensated for any committee meeting held on the day of a regularly scheduled board meeting. The following table provides the total fees paid to independent board members by the Trust and by other funds in Franklin Templeton Investments.

Name	Total Fees Received from the Trust (\$)'	Total Fees Received from Franklin Templeton Investments (\$)²	Number of Boards in Franklin Templeton Investments on which Each Serves <sup>3</sup>
Harris J. Ashton	21,456	493,000	42
Sam Ginn	21,458	303,000	28
Edith E. Holiday	24,261	538,000	42
J. Michael Luttig	24,260	515,000	42
Frank A. Olson	24,260	515,000	42
Larry D. Thompson	21,458	660,000	42
John B. Wilson	34,558	400,000	28

- 1. For the fiscal year ended February 28, 2013.
- 2. For the calendar year ended December 31, 2012.
- 3. We base the number of boards on the number of U.S. registered investment companies in Franklin Templeton Investments. This number does not include the total number of series or portfolios within each investment company for which the board members are responsible.

Independent board members are reimbursed for expenses incurred in connection with attending board meetings and are paid pro rata by each fund in Franklin Templeton Investments for which they serve as director or trustee. No officer or board member received any other compensation, including pension or retirement benefits, directly or indirectly from the Trust or other funds in Franklin Templeton Investments. Certain officers or board members who are shareholders of Franklin Resources, Inc. (Resources) may be deemed to receive indirect remuneration by virtue of their participation, if any, in the fees paid to its subsidiaries.

Board members historically have followed a policy of having substantial investments in one or more of the Franklin Templeton funds, as is consistent with their individual financial goals. In February 1998, this policy was formalized through the adoption of a requirement that each board member invest one-third of fees received for serving as a director or trustee of a Templeton fund (excluding committee fees) in shares of one or more Templeton funds and one-third of fees received for serving as a director or trustee of a Franklin fund (excluding committee fees) in shares of one or more Franklin funds until the value of such investments equals or exceeds five times the annual retainer and regular board meeting fees paid to such board member. Investments in the name of family members or entities controlled by a board member constitute fund holdings of such board member for purposes of this policy, and a three-year phase-in period applies to such investment requirements for newly elected board members. In implementing such policy, a board member's fund holdings

Number of

existing on February 27, 1998, are valued as of such date with subsequent investments valued at cost.

The following tables provide the dollar range of equity securities beneficially owned by the board members of the Fund on December 31, 2012.

#### **Independent Board Members**

Name of Board Member	Dollar Range of Equity Securities in the Fund	Aggregate Dollar Range of Equity Securities in All Funds Overseen by the Board Member in the Franklin Templeton Fund Complex
Harris J. Ashton	None	Over \$100,000
Sam Ginn	None	Over \$100,000
Edith E. Holiday	None	Over \$100,000
J. Michael Luttig	None	Over \$100,000
Frank A. Olson	None	Over \$100,000
Larry D. Thompson	None	Over \$100,000
John B. Wilson	None	Over \$100,000

#### **Interested Board Members**

Name of Board Member	Dollar Range of Equity Securities in the Fund	Aggregate Dollar Range of Equity Securities in All Funds Overseen by the Board Member in the Franklin Templeton Fund Complex
Gregory E. Johnson	None	Over \$100,000
Rupert H. Johnson, Jr.	None	Over \$100,000

Board committees The board maintains two standing committees: the Audit Committee and the Nominating Committee. The Audit Committee is generally responsible for recommending the selection of the Trust's independent registered public accounting firm (auditors), including evaluating their independence and meeting with such auditors to consider and review matters relating to the Trust's financial reports and internal controls. The Audit Committee is comprised of the following independent trustees of the Trust: Edith E. Holiday, J. Michael Luttig, Frank A. Olson and John B. Wilson. The Nominating Committee is comprised of the following independent trustees of the Trust: Harris J. Ashton, Sam Ginn, Edith E. Holiday, J. Michael Luttig, Frank A. Olson, Larry D. Thompson and John B. Wilson.

The Nominating Committee is responsible for selecting candidates to serve as board members and recommending such candidates (a) for selection and nomination as independent board members by the incumbent independent board member and the full board; and (b) for selection and nomination as interested board members by the full board.

When the board has or expects to have a vacancy, the Nominating Committee receives and reviews information on individuals qualified to be recommended to the full board as nominees for election as board members, including any recommendations by "Qualifying Fund Shareholders" (as defined below). To date, the Nominating Committee has been able to identify, and expects to continue to be able to identify, from its own resources an ample number of qualified candidates. The Nominating Committee, however, will review recommendations from Qualifying Fund Shareholders to fill vacancies on the board if these recommendations are submitted in writing and addressed to the Nominating Committee at the Trust's offices at One Franklin Parkway, San Mateo, CA 94403-1906 and are presented with appropriate background material concerning the candidate that demonstrates his or her ability to serve as a board member, including as an independent board member, of the Trust. A Qualifying Fund Shareholder is a shareholder who (i) has continuously owned of record, or beneficially through a financial intermediary, shares of the Fund having a net asset value of not less than two hundred and fifty thousand dollars (\$250,000) during the 24-month period prior to submitting the recommendation; and (ii) provides a written notice to the Nominating Committee containing the following information: (a) the name and address of the Qualifying Fund Shareholder making the recommendation; (b) the number of shares of the Fund which are owned of record and beneficially by such Qualifying Fund Shareholder and the length of time that such shares have been so owned by the Qualifying Fund Shareholder; (c) a description of all arrangements and understandings between such Qualifying Fund Shareholder and any other person or persons (naming such person or persons) pursuant to which the recommendation is being made; (d) the name, age, date of birth, business address and residence address of the person or persons being recommended; (e) such other information regarding each person recommended by such Qualifying Fund Shareholder as would be required to be included in a proxy statement filed pursuant to the proxy rules of the SEC had the nominee been nominated by the board; (f) whether the shareholder making the recommendation believes the person recommended would or would not be an "interested person" of the Trust, as defined in the Investment Company Act of 1940, as amended (1940 Act); and (g) the written consent of each person recommended to serve as a board member of the Trust if so nominated and elected/appointed.

The Nominating Committee may amend these procedures from time to time, including the procedures relating to the evaluation of nominees and the process for submitting recommendations to the Nominating Committee.

During the fiscal year ended February 28, 2013, the Audit Committee met three times; the Nominating Committee met twice.

Board role in risk oversight The board, as a whole, considers risk management issues as part of its general oversight responsibilities throughout the year at regular board meetings, through regular reports that have been developed by management, in consultation with the board and its counsel. These reports address certain investment, valuation and compliance matters. The board also may receive special written

reports or presentations on a variety of risk issues, either upon the board's request or upon the investment manager's initiative. In addition, the Audit Committee of the board meets regularly with the investment manager's internal audit group to review reports on their examinations of functions and processes within Franklin Templeton Investments that affect the Fund.

With respect to investment risk, the board receives regular written reports describing and analyzing the investment performance of the Fund. In addition, the portfolio managers of the Fund meet regularly with the boards to discuss portfolio performance, including investment risk. To the extent that the Fund changes a particular investment strategy that could have a material impact on the Fund's risk profile, the board generally is consulted with respect to such change. To the extent that the Fund invests in certain complex securities, including derivatives, the board receives periodic reports containing information about exposure of the Fund to such instruments. In addition, the investment manager's investment risk personnel meet regularly with the board to discuss a variety of issues, including the impact on the Fund of the investment in particular securities or instruments, such as derivatives.

With respect to valuation, the Fund's administrator provides regular written reports to the board that enable the board to monitor the number of fair valued securities in a particular portfolio, the reasons for the fair valuation and the methodology used to arrive at the fair value. Such reports also include information concerning illiquid securities within the Fund's portfolio. The board also reviews dispositional analysis information on the sale of securities that require special valuation considerations such as illiquid or fair valued securities. In addition, the Fund's Audit Committee reviews valuation procedures and results with the Fund's auditors in connection with such Committee's review of the results of the audit of the Fund's year end financial statements.

With respect to compliance risks, the board receives regular compliance reports prepared by the investment manager's compliance group and meets regularly with the Fund's Chief Compliance Officer (CCO) to discuss compliance issues, including compliance risks. In accordance with SEC requirements, the independent board members meet regularly in executive session with the CCO, and the Fund's CCO prepares and presents an annual written compliance report to the board. The Fund's board adopts compliance policies and procedures for the Fund and approves such procedures for the Fund's service providers. The compliance policies and procedures are specifically designed to detect and prevent violations of the federal securities laws.

The investment manager periodically provides an enterprise risk management presentation to the board to describe the way in which risk is managed on a complex-wide level. Such presentation covers such areas as investment risk, reputational risk, personnel risk, and business continuity risk.

**Board structure** Seventy-five percent or more of board members consist of independent board members who are not deemed to

be "interested persons" by reason of their relationship with the Fund's management or otherwise as provided under the 1940 Act. While the Chairman of the Board is an interested person, the board is also served by a lead independent board member. The lead independent board member, together with independent counsel, reviews proposed agendas for board meetings and generally acts as a liaison with management with respect to questions and issues raised by the independent board members. The lead independent board member also presides at separate meetings of independent board members held in advance of each scheduled board meeting where various matters, including those being considered at such board meeting are discussed. It is believed such structure and activities assure that proper consideration is given at board meetings to matters deemed important to the Fund and its shareholders.

Trustee qualifications Information on the Fund's officers and trustees appears above including information on the business activities of trustees during the past five years and beyond. In addition to personal qualities, such as integrity, the role of an effective Fund trustee inherently requires the ability to comprehend, discuss and critically analyze materials and issues presented in exercising judgments and reaching informed conclusions relevant to his or her duties and fiduciary obligations. The board believes that the specific background of each trustee evidences such ability and is appropriate to his or her serving on the Fund's board of trustees. As indicated, Harris J. Ashton, Frank A. Olson and Sam Ginn have each served as chief executive officers of New York Stock Exchange listed public corporations: Larry D. Thompson and Edith E. Holiday have legal backgrounds, including high level legal positions with departments of the U.S. government; John B. Wilson has served as chief operating officer of a New York Stock Exchange listed public corporation, as well as chief financial officer of a NASDAQ listed public corporation; J. Michael Luttig has fifteen years of judicial experience as a Federal Appeals Court Judge; and Gregory E. Johnson and Rupert H. Johnson are both high ranking executive officers of Franklin Templeton Investments.

## **Fair Valuation and Liquidity**

The Fund's board of trustees has delegated to the investment manager the task of ensuring that regulatory guidelines governing the fair valuation for securities are applied to the Fund and that the required level of liquidity is maintained. The investment manager has formed a Valuation & Liquidity Oversight Committee (VLOC) to oversee these obligations. The VLOC oversees and administers the policies and procedures governing fair valuation and liquidity determination of securities. The VLOC meets monthly to review and approve fair value and liquidity reports and conduct other business, and meets whenever necessary to review potential significant market events and take appropriate steps to adjust valuations in accordance with established policies. The VLOC provides regular reports that document its activities to the board

of trustees for its review and approval of pricing determinations at scheduled meetings.

The Fund's policies and procedures governing fair valuation and liquidity determination of securities have been initially reviewed and approved by the board of trustees and any material amendments will also be reviewed and approved by the board. The investment manager's compliance staff conducts periodic reviews of compliance with the policies and provides at least annually a report to the board of trustees regarding the operation of the policies and any material changes recommended as a result of such review.

## **Management and Other Services**

Investment manager and services provided The Fund's investment manager is Franklin Advisers, Inc. The investment manager is a wholly owned subsidiary of Resources, a publicly owned company engaged in the financial services industry through its subsidiaries. Charles B. Johnson and Rupert H. Johnson, Jr. are the principal shareholders of Resources.

The investment manager provides investment research and portfolio management services, and selects the securities for the Fund to buy, hold or sell. The investment manager's extensive research activities include, as appropriate, traveling to meet with issuers and to review project sites. The investment manager also selects the brokers who execute the Fund's portfolio transactions. The investment manager provides periodic reports to the board, which reviews and supervises the investment manager's investment activities. To protect the Fund, the investment manager and its officers, directors and employees are covered by fidelity insurance.

The investment manager and its affiliates manage numerous other investment companies and accounts. The investment manager may give advice and take action with respect to any of the other funds it manages, or for its own account, that may differ from action taken by the investment manager on behalf of the Fund. Similarly, with respect to the Fund, the investment manager is not obligated to recommend, buy or sell, or to refrain from recommending, buying or selling any security that the investment manager and access persons, as defined by applicable federal securities laws, may buy or sell for its or their own account or for the accounts of any other fund. The investment manager is not obligated to refrain from investing in securities held by the Fund or other funds it manages. Because the investment manager is a subsidiary of a financial holding company (FHC) under the Gramm-Leach-Bliley Act of 1999, federal regulations applicable to FHCs may limit or restrict the Fund's ability to acquire or hold a position in a given security when it might otherwise be advantageous for the Fund to acquire or hold that security.

The Fund, its investment manager and principal underwriter have each adopted a code of ethics, as required by federal securities laws. Under the code of ethics, employees who are designated as access persons may engage in personal securities transactions, including transactions involving securities that are being considered for the Fund or that are currently held by the Fund, subject to certain general restrictions and procedures. The personal securities transactions of access persons of the Fund, its investment manager and principal underwriter will be governed by the code of ethics. The code of ethics is on file with, and available from, the SEC.

**Management fees** The Fund pays the investment manager a fee equal to an annual rate of:

- 0.625% of the value of net assets up to and including \$100 million;
- 0.500% of the value of net assets over \$100 million and not over \$250 million;
- 0.450% of the value of net assets over \$250 million and not over \$7.5 billion;
- 0.440% of the value of net assets over \$7.5 billion and not over \$10 billion;
- 0.430% of the value of net assets over \$10 billion and not over \$12.5 billion;
- 0.420% of the value of net assets over \$12.5 billion and not over \$15 billion;
- 0.400% of the value of net assets over \$15 billion and not over \$17.5 billion;
- 0.380% of the value of net assets over \$17.5 billion and not over \$20 billion; and
- 0.360% of the value of net assets in excess of \$20 billion.

The fee is calculated daily and paid monthly according to the terms of the management agreement. Each class of the Fund's shares pays its proportionate share of the fee.

For the last three fiscal years ended February 28, 2013, February 29, 2012 and February 28, 2011, the Fund paid the following management fees:

	Management Fees Paid (\$)		
	2013	2012	2011
Alabama Fund	1,714,577	1,546,277	1,586,367
Florida Fund	5,471,654	5,301,527	5,870,160
Georgia Fund	2,992,343	2,481,506	2,457,881
Kentucky Fund	1,163,425	1,027,279	1,091,870
Louisiana Fund	2,504,009	2,111,611	2,109,296
Maryland Fund	3,499,661	3,106,397	3,277,626
Missouri Fund	6,511,609	5,362,864	5,141,312
North Carolina Fund	7,045,805	5,935,152	5,845,667
Virginia Fund	4,520,171	3,935,273	4,031,201

Portfolio managers This section reflects information about the portfolio managers as of February 28, 2013.

The following table shows the number of other accounts managed by the portfolio managers and the total assets in the accounts managed within each category:

Name	Number of Other Registered Investment Companies Managed¹	Assets of Other Registered Investment Companies Managed (x \$1 million)¹	Number of Other Pooled Investment Vehicles Managed	Assets of Other Pooled Investment Vehicles Managed (x \$1 million)	Number of Other Accounts Managed <sup>2</sup>	Assets of Other Accounts Managed (x \$1 million) <sup>2</sup>
John Bonelli	2	1,580.2	0	N/A	0	N/A
James Conn	10	21,255.8	0	N/A	0	N/A
Michael Conn	1	93.4	0	N/A	0	N/A
Carrie Higgins	9	20,160.7	0	N/A	0	N/A
John Pomeroy	9	21,162.4	0	N/A	0	N/A
Francisco Rivera	4	24,277.0	0	N/A	0	N/A
Stella Wong	5	5,559.1	0	N/A	0	N/A
Daniel Workman	2	10,486.7	0	N/A	0	N/A

- 1. These figures represent registered investment companies other than the Funds that are included in this SAI.
- 2. The various pooled investment vehicles and accounts listed are managed by a team of investment professionals. Accordingly, the portfolio manager listed would not be solely responsible for managing such listed amounts.

Portfolio managers that provide investment services to the Fund may also provide services to a variety of other investment products, including other funds, institutional accounts and private accounts. The advisory fees for some of such other products and accounts may be different than that charged to the Fund but does not include performance based compensation. This may result in fees that are higher (or lower) than the advisory fees paid by the Fund. As a matter of policy, each fund or account is managed solely for the benefit of the beneficial owners thereof. As discussed below, the separation of the trading execution function from the portfolio management function and the application of objectively based trade allocation procedures help to mitigate potential conflicts of interest that may arise as a result of the portfolio managers managing accounts with different advisory fees.

Conflicts. The management of multiple funds, including the Fund, and accounts may also give rise to potential conflicts of interest if the funds and other accounts have different objectives, benchmarks, time horizons, and fees as the portfolio manager must allocate his or her time and investment ideas across multiple funds and accounts. The investment manager seeks to manage such competing interests for the time and attention of portfolio managers by having portfolio managers focus on a particular investment discipline. Most other accounts managed by a portfolio manager are managed using the same investment strategies that are used in connection with the management of the Fund. Accordingly, portfolio holdings, position sizes, and industry and sector exposures tend to be similar across similar portfolios, which may minimize the potential for conflicts of interest. As noted above, the separate management of the trade execution and valuation functions from the portfolio management process also helps to reduce potential conflicts of interest. However, securities selected for funds or accounts other than the Fund may outperform the securities selected for the Fund. Moreover, if a portfolio manager identifies a limited investment opportunity that may be suitable for more than one fund or other

account, the Fund may not be able to take full advantage of that opportunity due to an allocation of that opportunity across all eligible funds and other accounts. The investment manager seeks to manage such potential conflicts by using procedures intended to provide a fair allocation of buy and sell opportunities among funds and other accounts.

The structure of a portfolio manager's compensation may give rise to potential conflicts of interest. A portfolio manager's base pay and bonus tend to increase with additional and more complex responsibilities that include increased assets under management. As such, there may be an indirect relationship between a portfolio manager's marketing or sales efforts and his or her bonus.

Finally, the management of personal accounts by a portfolio manager may give rise to potential conflicts of interest. While the funds and the investment manager have adopted a code of ethics which they believe contains provisions reasonably necessary to prevent a wide range of prohibited activities by portfolio managers and others with respect to their personal trading activities, there can be no assurance that the code of ethics addresses all individual conduct that could result in conflicts of interest.

The investment manager and the Fund have adopted certain compliance procedures that are designed to address these, and other, types of conflicts. However, there is no guarantee that such procedures will detect each and every situation where a conflict arises.

Compensation. The investment manager seeks to maintain a compensation program that is competitively positioned to attract, retain and motivate top-quality investment professionals. Portfolio managers receive a base salary, a cash incentive bonus opportunity, an equity compensation opportunity, and a benefits package. Portfolio manager compensation is reviewed annually and the level of compensation is based on individual performance, the salary range for a portfolio manager's level of responsibility and Franklin Templeton guidelines. Portfolio managers are provided no financial incentive to favor one fund or account over

another. Each portfolio manager's compensation consists of the following three elements:

Base salary Each portfolio manager is paid a base salary.

**Annual bonus** Annual bonuses are structured to align the interests of the portfolio manager with those of the Fund's shareholders. Each portfolio manager is eligible to receive an annual bonus. Bonuses generally are split between cash (50% to 65%) and restricted shares of Resources stock (17.5% to 25%) and mutual fund shares (17.5% to 25%). The deferred equity-based compensation is intended to build a vested interest of the portfolio manager in the financial performance of both Resources and mutual funds advised by the investment manager. The bonus plan is intended to provide a competitive level of annual bonus compensation that is tied to the portfolio manager achieving consistently strong investment performance, which aligns the financial incentives of the portfolio manager and Fund shareholders. The Chief Investment Officer of the investment manager and/or other officers of the investment manager, with responsibility for the Fund, have discretion in the granting of annual bonuses to portfolio managers in accordance with Franklin Templeton guidelines. The following factors are generally used in determining bonuses under the plan:

- Investment performance. Primary consideration is given
  to the historic investment performance of all accounts
  managed by the portfolio manager over the 1, 3 and
  5 preceding years measured against risk benchmarks
  developed by the fixed income management team. The pretax performance of each fund managed is measured relative
  to a relevant peer group and/or applicable benchmark as
  appropriate.
- Non-investment performance. The more qualitative contributions of the portfolio manager to the investment manager's business and the investment management team, including business knowledge, productivity, customer service, creativity, and contribution to team goals, are evaluated in determining the amount of any bonus award.
- Responsibilities. The characteristics and complexity of funds managed by the portfolio manager are factored in the investment manager's appraisal.

Additional long-term equity-based compensation Portfolio managers may also be awarded restricted shares or units of Resources stock or restricted shares or units of one or more mutual funds. Awards of such deferred equity-based compensation typically vest over time, so as to create incentives to retain key talent.

Portfolio managers also participate in benefit plans and programs available generally to all employees of the investment manager.

Ownership of Fund shares. The investment manager has a policy of encouraging portfolio managers to invest in the funds they manage. Exceptions arise when, for example, a fund is closed to new investors or when tax considerations or jurisdictional

constraints cause such an investment to be inappropriate for the portfolio manager. The following is the dollar range of Fund shares beneficially owned by the portfolio manager (such amounts may change from time to time):

Portfolio Manager	Dollar Range of Fund Shares Beneficially Owned
John Bonelli	None
James Conn	None
Michael Conn	None
Carrie Higgins	None
John Pomeroy	None
Francisco Rivera	None
Stella Wong	None
Daniel Workman	None

Administrator and services provided Franklin Templeton Services, LLC (FT Services) has an agreement with the investment manager to provide certain administrative services and facilities for the Fund. FT Services is an indirect, wholly owned subsidiary of Resources and is an affiliate of the Fund's investment manager and principal underwriter.

The administrative services FT Services provides include preparing and maintaining books, records, and tax and financial reports, and monitoring compliance with regulatory requirements.

**Administration fees** The investment manager pays FT Services a monthly fee equal to an annual rate of:

- 0.150% of the Fund's average daily net assets up to \$200 million:
- 0.135% of average daily net assets over \$200 million up to \$700 million;
- 0.100% of average daily net assets over \$700 million up to \$1.2 billion; and
- 0.075% of average daily net assets over \$1.2 billion.

For the last three fiscal years ended February 28, 2013, February 29, 2012 and February 28, 2011, the investment manager paid FT Services the following administration fees:

	Administration Fees Paid (\$)		
	2013	2012	2011
Alabama Fund	469,373	418,881	430,910
Florida Fund	1,435,367	1,397,561	1,509,195
Georgia Fund	852,703	699,452	692,364
Kentucky Fund	310,194	270,683	289,925
Louisiana Fund	706,203	588,483	587,791
Maryland Fund	996,401	886,921	937,373
Missouri Fund	1,618,600	1,408,876	1,361,956
North Carolina Fund	1,707,636	1,521,587	1,506,561
Virginia Fund	1,223,928	1,093,949	1,115,269

Shareholder servicing and transfer agent Franklin Templeton Investor Services, LLC (Investor Services) is the Fund's shareholder servicing agent and acts as the Fund's transfer agent and dividend-paying agent. Investor Services is located at 3344 Quality Drive, Rancho Cordova, CA 95670-7313. Please send all correspondence to Investor Services at P.O. Box 997151, Sacramento, CA 95899-7151.

Investor Services receives a fee for servicing Fund shareholder accounts. The Fund also will reimburse Investor Services for certain out-of-pocket expenses necessarily incurred in servicing the shareholder accounts in accordance with the terms of its servicing contract with the Fund.

Investor Services may also pay servicing fees, that will be reimbursed by the Fund, in varying amounts to certain financial institutions (primarily to help offset their costs associated with client account maintenance support, statement preparation and transaction processing) that (i) maintain omnibus accounts with the Fund in the institution's name on behalf of numerous beneficial owners of Fund shares who are either direct clients of the institution or are participants in an IRS-recognized taxdeferred savings plan (including Employer Sponsored Retirement Plans and Section 529 Plans) for which the institution, or its affiliate, provides participant level recordkeeping services (called "Beneficial Owners"); or (ii) provide support for Fund shareholder accounts by sharing account data with Investor Services through the National Securities Clearing Corporation (NSCC) networking system. In addition to servicing fees received from the Fund, these financial institutions also may charge a fee for their services directly to their clients. Investor Services will also receive a fee from the Fund for services provided in support of Beneficial Owners and NSCC networking system accounts.

**Custodian** The Bank of New York Mellon, Mutual Funds Division, 100 Church Street, New York, NY 10286, acts as custodian of the Fund's securities and other assets.

# **Independent Registered Public Accounting**

**Firm** PricewaterhouseCoopers LLP, Three Embarcadero Center, San Francisco, CA 94111-4004, is the Fund's independent registered public accounting firm. The independent registered public accounting firm audits the financial statements included in the Trust's Annual Report to shareholders.

# **Portfolio Transactions**

Since most purchases by the Fund are principal transactions at net prices, the Fund incurs little or no brokerage costs. The Fund deals directly with the selling or buying principal or market maker without incurring charges for the services of a broker on its behalf, unless it is determined that a better price or execution may be obtained by using the services of a broker. Purchases of portfolio securities from underwriters will include a commission or concession paid to the underwriter, and purchases from dealers will include a spread between the bid and ask price. The Fund seeks to obtain prompt execution of orders at the most favorable net price. Transactions may be directed to dealers in return for research and statistical information, as well as for special services provided by the dealers in the execution of orders.

It is not possible to place an accurate dollar value on the special execution or on the research services the investment manager receives from dealers effecting transactions in portfolio securities. The allocation of transactions to obtain additional research

services allows the investment manager to supplement its own research and analysis activities and to receive the views and information of individuals and research staffs from many securities firms. The receipt of these products and services does not reduce the investment manager's research activities in providing investment advice to the Fund.

As long as it is lawful and appropriate to do so, the investment manager and its affiliates may use this research and data in their investment advisory capacities with other clients.

If purchases or sales of securities of the Fund and one or more other investment companies or clients supervised by the investment manager are considered at or about the same time, transactions in these securities will be allocated among the several investment companies and clients in a manner deemed equitable to all by the investment manager, taking into account the respective sizes of the accounts and the amount of securities to be purchased or sold. In some cases this procedure could have a detrimental effect on the price or volume of the security so far as the Fund is concerned. In other cases it is possible that the ability to participate in volume transactions may improve execution and reduce transaction costs to the Fund.

For the last three fiscal years ended February 28, 2013, February 29, 2012 and February 28, 2011, the Fund did not pay any brokerage commissions.

As of February 28, 2013, the Fund did not own securities of their regular broker-dealers.

# **Distributions and Taxes**

# The discussion below pertains to all Funds, unless otherwise noted.

References to "the Code" and other references to the U.S. Federal income tax law, refer to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder.

**Multiclass distributions** The Fund calculates income dividends and capital gain distributions the same way for each class. The amount of any income dividends per share will differ, however, generally due to any differences in the distribution and service (Rule 12b-1) fees applicable to the classes.

**Distributions** The Fund intends to declare income dividends from its net investment income each day that its net asset value is calculated and pay them monthly. Capital gains, if any, may be paid at least annually. The Fund may distribute income dividends and capital gains more frequently, if necessary or appropriate in the Board's discretion. The amount of any distribution will vary, and there is no guarantee the Fund will pay either income dividends or capital gain distributions. Your income dividends and capital gain distributions will be automatically reinvested in additional shares at net asset value unless you elect to receive them in cash. Distributions declared in December to shareholders of record in such month and paid in January are treated as if they were paid in December.

Distributions of net investment income. The Fund receives income generally in the form of interest on its investments. This income, less expenses incurred in the operation of the Fund, constitutes the Fund's net investment income from which dividends may be paid to you. This net investment income may either be tax-exempt or taxable when distributed to you.

Exempt-interest dividends. By meeting certain requirements of the Internal Revenue Code (Code), the Fund qualifies to pay exempt-interest dividends to you. These dividends are derived from interest income exempt from regular federal income tax, and are not subject to regular federal income tax when they are paid to you.

In addition, to the extent that exempt-interest dividends are derived from interest on obligations of any state or its political subdivisions, or from interest on qualifying U.S. territorial obligations (including qualifying obligations of Puerto Rico, the U.S. Virgin Islands or Guam), they also may be exempt from that state's personal income tax. Income from municipal securities of other states generally does not qualify as tax-free. Because of these tax exemptions, the Fund may not be a suitable investment for retirement plans and other tax-exempt investors, or for residents of states other than the state in which a state-specific Fund primarily invests.

Corporate shareholders should be advised that these personal income tax rules may not apply to them and that these exemptinterest dividends may be taxable for state franchise or income tax reporting. They should consult with their tax advisor concerning the application of these rules to their state tax reporting.

Taxable income dividends. The Fund may earn taxable income from many sources, including temporary investments, the discount on stripped obligations or their coupons, income from securities loans or other taxable transactions, and ordinary income on the sale of market discount bonds. If you are a taxable investor, any income dividends the Fund pays from this income are taxable to you as ordinary income. Because the Fund invests primarily in tax-exempt debt securities, it does not anticipate that any of its dividends will be treated as qualified dividends subject to reduced rates of federal taxation for individuals.

*Distributions of capital gains.* The Fund may realize capital gains and losses on the sale of its portfolio securities.

Distributions of short-term capital gains are taxable to you as ordinary income. Distributions of long-term capital gains are taxable to you as long-term capital gains, regardless of how long you have owned your shares in the Fund. Any net capital gains realized by the Fund (in excess of any available capital loss carryovers) generally are distributed once each year, and may be distributed more frequently, if necessary, to reduce or eliminate excise or income taxes on the Fund.

Capital gain dividends and any net long-term capital gains you realize from the sale of Fund shares are taxable at the reduced long-term capital gains rates. For individuals in the 10% and

15% tax brackets, the long-term capital gains tax rate is 0%. For individuals in higher tax brackets, the long-term capital gains rate is 15% (20% for certain high income taxpayers).

Returns of capital. If the Fund's distributions exceed its earnings and profits (i.e., its taxable income and realized capital gains) for a taxable year, all or a portion of the distributions made in that taxable year may be characterized as a return of capital to you. A return of capital distribution will generally not be taxable, but will reduce the cost basis in your Fund shares and will result in a higher capital gain or in a lower capital loss when you sell your shares. Any return of capital in excess of the basis in your Fund shares, however, will be taxable as a capital gain. In the case of a non-calendar year fund, earnings and profits are first allocated to distributions made on or before December 31 of its taxable year and then to distributions made thereafter. The effect of this provision is to "push" returns of capital into the next calendar year.

# Information on the amount and tax character of

distributions The Fund will inform you of the amount of your income dividends and capital gain distributions at the time they are paid, and will advise you of their tax status for federal income tax purposes shortly after the close of each calendar year. This information will include the portion of the distributions that on average are comprised of taxable or tax-exempt income, or interest income that is a tax preference item when determining your federal alternative minimum tax. If you have not owned your Fund shares for a full year, the Fund may report to shareholders and distribute to you, as taxable, tax-exempt or tax preference income, a percentage of income that may not be equal to the actual amount of each type of income earned during the period of your investment in the Fund.

Avoid "buying a dividend" At the time you purchase your Fund shares, the Fund's net asset value may reflect undistributed taxable income, undistributed capital gains, or net unrealized appreciation in the value of the portfolio securities held by the Fund. For taxable investors, a subsequent distribution to you of such amounts, although constituting a return of your investment, would be taxable. This tax treatment is required even if you reinvest your distributions in additional Fund shares. Buying shares in the Fund just before it declares a distribution of taxable income or capital gains is sometimes known as "buying a dividend." For example, if you buy 500 shares in a fund on December 10th at the fund's net asset value (NAV) of \$10 per share, and the fund makes a capital gain distribution on December 15th of \$1 per share, your shares will then have an NAV of \$9 per share (disregarding any change in the fund's market value), and you will have to pay a tax on what is essentially a return of your investment of \$1 per share.

**Election to be taxed as a regulated investment company** The Fund has elected to be treated as a regulated investment company under Subchapter M of the Internal Revenue Code (Code). It has qualified as a regulated investment company for its most recent fiscal year, and intends to continue to qualify

during the current fiscal year. As a regulated investment company, the Fund generally pays no federal income tax on the income and gains it distributes to you. In order to qualify for treatment as a regulated investment company, the Fund must satisfy the requirements described below.

Distribution requirement. The Fund must distribute an amount equal to the sum of at least 90% of its net tax-exempt income and 90% of its investment company taxable income, if any, for the tax year (including, for purposes of satisfying this distribution requirement, certain distributions made by the Fund after the close of its taxable year that are treated as made during such taxable year).

Income requirement. The Fund must derive at least 90% of its gross income from interest, certain payments with respect to securities loans, and gains from the sale or other disposition of securities, or other income derived from its business of investing in such securities.

Asset diversification test. The Fund must satisfy the following asset diversification test at the close of each quarter of the Fund's tax year: (1) at least 50% of the value of the Fund's assets must consist of cash and cash items, U.S. government securities, securities of other regulated investment companies, and securities of other issuers (as to which the Fund has not invested more than 5% of the value of the Fund's total assets in securities of an issuer and as to which the Fund does not hold more than 10% of the outstanding voting securities of the issuer); and (2) no more than 25% of the value of the Fund's total assets may be invested in the securities of any one issuer (other than U.S. government securities and securities of other regulated investment companies) or of two or more issuers which the Fund controls and which are engaged in the same or similar trades or businesses.

If for any taxable year the Fund does not qualify as a regulated investment company, all of its taxable income (including its net capital gain) would be subject to tax at regular corporate rates without any deduction for dividends paid to shareholders, and the dividends would be taxable to the shareholders as ordinary income (or possibly as qualified dividend income) to the extent of the Fund's current and accumulated earnings and profits. Failure to qualify as a regulated investment company, subject to savings provisions for certain qualification failures, which, in general, are limited to those due to reasonable cause and not willful neglect, would thus have a negative impact on the Fund's income and performance. In that case, the Fund would be liable for federal, and possibly state, corporate taxes on its taxable income and gains, and distributions to you would be taxed as dividend income to the extent of the Fund's earnings and profits. Even if such savings provisions apply, the Fund may be subject to a monetary sanction of \$50,000 or more. Moreover, the board reserves the right not to maintain the qualification of the Fund as a regulated investment company if it determines such a course of action to be beneficial to shareholders.

**Capital loss carryovers** The capital losses of the Fund, if any, do not flow through to shareholders. Rather, the Fund may use its capital losses, subject to applicable limitations, to offset its capital gains without being required to pay taxes on or distribute to shareholders such gains that are offset by the losses. If the Fund has a "net capital loss" (that is, capital losses in excess of capital gains) for a taxable year beginning after December 22, 2010, the excess (if any) of the Fund's net short-term capital losses over its net long-term capital gains is treated as a short-term capital loss arising on the first day of the Fund's next taxable year, and the excess (if any) of the Fund's net long-term capital losses over its net short-term capital gains is treated as a long-term capital loss arising on the first day of the Fund's next taxable year. Any such net capital losses of the Fund that are not used to offset capital gains may be carried forward indefinitely to reduce any future capital gains realized by the Fund in succeeding taxable years. However, for any net capital losses realized in taxable years of the Fund beginning on or before December 22, 2010, the Fund is only permitted to carry forward such capital losses for eight years as a short-term capital loss. Under a transition rule, capital losses arising in a taxable year beginning after December 22, 2010 must be used before capital losses realized in a prior taxable year.

**Excise tax distribution requirements** To avoid federal excise taxes, the Code requires the Fund to distribute to you by December 31 of each year, at a minimum, the following amounts:

- 98% of its taxable ordinary income earned during the calendar year;
- 98.2% of its capital gain net income earned during the 12-month period ending October 31; and
- 100% of any undistributed amounts of these categories of income or gain from the prior year.

The Fund intends to declare and pay these distributions in December (or to pay them in January, in which case you must treat them as received in December), but can give no assurances that its distributions will be sufficient to eliminate all taxes.

Tax reporting for income and excise tax years. Because the periods for measuring a regulated investment company's income are different for income (determined on a fiscal year basis) and excise tax years (determined as noted above), special rules are required to calculate the amount of income earned in each period, and the amount of earnings and profits needed to support that income. For example, if the Fund uses the excise tax period ending on October 31 as the measuring period for calculating and paying out capital gain net income and realizes a net capital loss between November 1 and the end of the Fund's fiscal year, it will likely have insufficient earnings and profits for its taxable year to support its required excise tax distribution. The Fund may elect to treat part or all of any "qualified late year loss" as if it had been incurred in the succeeding taxable year in determining the Fund's taxable income, net capital gain, net short-term capital gain, and earnings and profits. The effect of this election is to treat any

such "qualified late year loss" as if it had been incurred in the succeeding taxable year, which may change the timing, amount, or characterization of Fund distributions.

A "qualified late year loss" includes: (i) any net capital loss, net long-term capital loss, or net short-term capital loss incurred after October 31 of the current taxable year (post-October losses). and (ii) the excess, if any, of (1) the sum of (a) specified losses incurred after October 31 of the current taxable year, and (b) other ordinary losses incurred after December 31 of the current taxable year, over (2) the sum of (a) specified gains incurred after October 31 of the current taxable year, and (b) other ordinary gains incurred after December 31 of the current taxable year. The terms "specified losses" and "specified gains" mean ordinary losses and gains from the sale, exchange, or other disposition of property (including the termination of a position with respect to such property). The terms "ordinary losses" and "ordinary gains" mean other ordinary losses and gains that are not described in the preceding sentence. Special rules apply to a Fund with a fiscal year ending in November or December that elects to use its taxable year for determining its capital gain net income for excise tax purposes. The Fund may only elect to treat any post-October loss incurred after October 31 as if it had been incurred in the succeeding year in determining its taxable income for the current year.

Because these rules are not entirely clear, the Fund may be required to interpret the "qualified late-year loss" and other rules relating to these different year-ends to determine its taxable income and capital gains. The Fund's reporting of income and its allocation between different taxable and excise tax years may be challenged by the Internal Revenue Service (IRS), possibly resulting in adjustments in the income reported by the Fund on its tax returns and/or by the Fund to you on your year-end tax statements.

Medicare tax The recently enacted Patient Protection and Affordable Care Act of 2010, as amended by the Health Care and Education Affordability Reconciliation Act of 2010, will impose a 3.8% Medicare tax on net investment income earned by certain individuals, estates and trusts for taxable years beginning after December 31, 2012. "Net investment income," for these purposes, means investment income, including ordinary dividends and capital gain distributions received from the Fund and net gains from redemptions or other taxable dispositions of Fund shares, reduced by the deductions properly allocable to such income. Investment income does not include exempt interest dividends. In the case of an individual, the tax will be imposed on the lesser of (1) the shareholder's net investment income or (2) the amount by which the shareholder's modified adjusted gross income exceeds \$250,000 (if the shareholder is married and filing jointly or a surviving spouse), \$125,000 (if the shareholder is married and filing separately) or \$200,000 (in any other case). Any liability for this additional Medicare tax will be reported on, and paid with, your federal income tax return.

Sales of Fund shares Sales and exchanges of Fund shares are generally taxable transactions for federal and state income tax purposes. If you sell your Fund shares, or exchange them for shares of a different Franklin Templeton fund, you are required to report any gain or loss on your sale or exchange. If you owned your shares as a capital asset, any gain or loss that you realize is a capital gain or loss, and is long-term or short-term, depending on how long you owned your shares. Under current law, shares held one year or less are short-term and shares held more than one year are long-term. The conversion of shares of one class into another class of the same fund is not taxable for federal income tax purposes.

Sales at a loss within six months of purchase. If you sell or exchange Fund shares that you owned for six months or less:

- any loss incurred is disallowed to the extent of any exemptinterest dividends paid to you on your shares, and
- any remaining loss is treated as a long-term capital loss to the extent of any long-term capital gains distributed to you by the Fund.

However, the loss disallowance rule for exempt-interest dividends will not apply to any loss incurred on a redemption or exchange of shares of a fund that declares dividends daily and distributes them at least monthly for which your holding period begins after December 22, 2010.

Wash sales. All or a portion of any loss that you realize on the sale of your Fund shares is disallowed to the extent that you buy other shares in the Fund within 30 days before or after your sale. Any loss disallowed under these rules is added to your tax basis in the new shares.

Deferral of basis. In reporting gain or loss on the sale of your Fund shares, you may be required to adjust your basis in the shares you sell under the following circumstances:

IF:

- In your original purchase of Fund shares, you paid a sales charge and received a reinvestment right (the right to reinvest your sales proceeds at a reduced or with no sales charge), and
- You sell some or all of your original shares within 90 days of their purchase, and
- You reinvest the sales proceeds in the Fund or in another Franklin Templeton fund by January 31 of the calendar year following the calendar year in which the disposition of the original shares occurred, and the sales charge that would otherwise apply is reduced or eliminated;

THEN: In reporting any gain or loss on your sale, all or a portion of the sales charge that you paid for your original shares is excluded from your tax basis in the shares sold and added to your tax basis in the new shares.

**Cost basis reporting** Beginning in calendar year 2012, the Fund is required to report the cost basis of Fund shares sold or exchanged to you and the Internal Revenue Service (IRS) annually.

The cost basis of Fund shares acquired by purchase will generally be based on the amount paid for the shares, including any front-end sales charges, and then may be subsequently adjusted for other applicable transactions as required by the Code. The difference between the selling price and the cost basis of Fund shares generally determines the amount of the capital gain or loss realized on the sale or exchange of Fund shares. Capital gains and losses on the sale or exchange of Fund shares are generally taxable transactions for federal and state income tax purposes.

Shares acquired on or after January 1, 2012. Cost basis reporting is generally required for Fund shares that are acquired by purchase, gift, inheritance or other transfer on or after January 1, 2012 (referred to as "covered shares"), and sold or exchanged on or after that date. Cost basis reporting does not apply to sales or exchanges of shares acquired before January 1, 2012, or to shares held in money market funds and tax-deferred accounts, such as individual retirement accounts and qualified retirement plans.

Cost basis methods. Treasury regulations permit the use of several methods to determine the cost basis of mutual fund shares. The method used will determine which specific shares are treated as sold or exchanged when there are multiple purchases at different prices and the entire position is not sold at one time.

The Fund's default method is the average cost method. Under the average cost method, the cost basis of your Fund shares will be determined by averaging the cost basis of all outstanding shares. The holding period for determining whether gains and losses are short-term or long-term is based on the first-in-first-out method (FIFO) which treats the earliest shares acquired as those first sold or exchanged.

If you wish to select a different cost basis method, or choose to specifically identify your shares at the time of each sale or exchange, you must contact the Fund. However, once a shareholder has sold or exchanged covered shares from the shareholder's account, a change by the shareholder from the average cost method to another permitted method will only apply prospectively to shares acquired after the date of the method change.

Under the specific identification method, Treasury regulations require that you adequately identify the tax lots of Fund shares to be sold, exchanged or transferred at the time of each transaction. An adequate identification is made by providing the dates that the shares were originally acquired and the number of shares to be sold, exchanged or transferred from each applicable tax lot. Alternatively, an adequate identification of shares may be made with a standing order of instruction on your account. If you do not provide an adequate identification the Fund is required to use the FIFO method with any shares with an unknown acquisition date treated as sold or exchanged first.

The Fund does not recommend any particular cost basis method and the use of other methods may result in more favorable tax consequences for some shareholders. It is important that you consult with your tax or financial advisor to determine which

method is best for you and then notify the Fund if you intend to use a method other than average cost.

If your account is held by your financial advisor or other brokerdealer, that firm may select a different cost basis default method. In these cases, please contact the firm to obtain information with respect to the available methods and elections for your account.

Shares acquired before January 1, 2012. Cost basis reporting is not generally required for Fund shares that were acquired by purchase, gift, inheritance or other transfer prior to January 1, 2012 (referred to as "noncovered shares"), regardless of when they are sold or exchanged. As a service to shareholders, the Fund presently intends to continue to provide shareholders cost basis information for eligible accounts for shares acquired prior to January 1, 2012. Consistent with prior years, this information will not be reported to the IRS or any state taxing authority.

Shareholders that use the average cost method for shares acquired before January 1, 2012 must make the election to use the average cost method for these shares on their federal income tax returns in accordance with Treasury regulations. This election cannot be made by notifying the Fund.

Important limitations regarding cost basis information. The Fund will report the cost basis of your Fund shares by taking into account all of the applicable adjustments required by the Code for purposes of reporting cost basis information to shareholders and the IRS annually. However the Fund is not required, and in many cases the Fund does not possess the information, to take all possible basis, holding period or other adjustments into account in reporting cost basis information to you. Therefore shareholders should carefully review the cost basis information provided by the Fund, whether this information is provided with respect to covered or noncovered shares, and make any additional basis, holding period or other adjustments that are required by the Code when reporting these amounts on their federal and state income tax returns. Shareholders remain solely responsible for complying with all federal and state income tax laws when filing their income tax returns.

Additional information about cost basis reporting. For additional information about cost basis reporting, including the methods and elections available to you, please contact Franklin Templeton Investments at (800) DIAL BEN/342-5236. Additional information is also available on franklintempleton.com/costbasis.

**Tax certification and backup withholding** Tax laws require that you certify your tax information when you become an investor in the Fund. For U.S. citizens and resident aliens, this certification is made on IRS Form W-9. Under these laws, the Fund must withhold a portion of your distributions and sales proceeds unless you:

- provide your correct Social Security or taxpayer identification number,
- certify that this number is correct,
- certify that you are not subject to backup withholding, and

 certify that you are a U.S. person (including a U.S. resident alien).

If you fail to meet any of these certification requirements, you will be subject to federal backup withholding at a rate of 28% on any reportable payments that you receive from the Fund, including any exempt-interest dividends (even though this income is not subject to regular federal income tax), taxable ordinary and capital gain dividends, and any redemption proceeds on the sale of your Fund shares. State backup withholding may also apply.

The Fund must also withhold if the IRS instructs it to do so. When withholding is required, the amount will be 28% of any reportable payments that you receive from the Fund.

Reclassification risk The Internal Revenue Service (IRS) has announced that holders of tax-exempt bonds have risks that their tax-exempt income may be reclassified as taxable if the bonds that they own were issued in an abusive transaction or become taxable by reason of refinancing irregularities or the misuse of proceeds from the bond offering. While the Fund endeavors to purchase only bona fide tax-exempt securities, there is a risk that a bond issued as tax-exempt may be reclassified by the IRS as taxable, creating taxable rather than tax-exempt income for the Fund. In this case, the Fund might be required to send to you and file with the IRS information returns for the current or prior calendar years classifying (or reclassifying) some of its exemptinterest dividends as taxable dividends. On prior year dividends, you might need to file amended income tax returns and pay additional tax and interest to avoid additional penalties and to limit interest charges on these taxable dividends

**Dividends-received deduction for corporations** For corporate shareholders, a portion of the dividends paid by a fund may qualify for the dividends-received deduction. This deduction generally is available to corporations for dividends paid by a fund out of income earned on its investments in domestic corporations. Because the Fund's income primarily is derived from investments earning interest rather than dividend income, generally none of its income dividends will be eligible for the corporate dividends-received deduction.

**Qualified dividend income for individuals** For the same reason, none of its distributions are expected to be qualified dividends eligible for federal taxation of individuals at long-term capital gain rates.

**Investment in complex securities** The Fund may invest in complex securities that could require it to adjust the amount, timing or tax character (ordinary or capital) of the income, gains and losses it recognizes on these investments. This, in turn, could affect the amount, timing and tax character of the Fund's income and gains distributed to you.

In general. Gain or loss recognized by the Fund on the sale or other disposition of municipal bonds and other portfolio investments will generally be capital gain or loss. Such capital gain and loss may be long-term or short-term depending, in general, upon the length of time a particular investment

position is maintained and, in some cases, upon the nature of the transaction. Portfolio investments held for more than one year generally will be eligible for long-term capital gain or loss treatment.

Debt obligations purchased at a discount. Gain recognized on the disposition of a debt obligation purchased by the Fund with market discount (generally, at a price less than its principal amount) will be treated as ordinary income to the extent of the portion of the market discount that accrued during the period of time the Fund held the debt obligation, unless the Fund made an election to accrue market discount into income currently. Fund distributions of accrued market discount on municipal bonds, including any current inclusions, are taxable to shareholders as ordinary income to the extent of the Fund's earnings and profits.

Debt obligations issued at a discount. If the Fund purchases a debt obligation (such as a zero coupon security or pay-in-kind security) that was originally issued at a discount, the Fund generally is required to include in gross income each year the portion of the original issue discount that accrues during such year. Fund distributions from accruals of original issue discount on municipal bonds are generally taxable to shareholders as exempt-interest dividends to the extent of the Fund's earnings and profits. The Fund's investment in such securities issued at a discount may cause the Fund to recognize income and make distributions to shareholders before it receives any cash payments on the securities. To generate cash to satisfy those distribution requirements, the Fund may have to sell portfolio securities that it otherwise might have continued to hold or to use cash flows from other sources such as the sale of Fund shares.

Investments in debt obligations that are at risk of or in default. The Fund may also hold obligations that are at risk of or in default. Tax rules are not entirely clear about issues such as whether and to what extent the Fund should recognize market discount on such a debt obligation, when the Fund may cease to accrue interest, original issue discount or market discount, when and to what extent the Fund may take deductions for bad debts or worthless securities and how the Fund should allocate payments received on obligations in default between principal and income. These and other related issues will be addressed by the Fund in order to ensure that it distributes sufficient income to preserve its status as a regulated investment company.

**Treatment of private activity bond interest** Interest on certain private activity bonds, while exempt from regular federal income tax, is a tax preference item for taxpayers when determining their alternative minimum tax under the Code. Private activity bond interest could subject you to or increase your liability under the federal alternative minimum tax, depending on your personal or corporate tax position. Persons defined in the Code as substantial users (or persons related to such users) of facilities financed by private activity bonds should consult their tax advisors before buying Fund shares.

Prior to the American Recovery and Reinvestment Act of 2009 ("Recovery Act"), interest on all tax-exempt private activity bonds

(other than certain tax-exempt housing bonds issued after July 30, 2008) was considered an item of tax preference, and a portion of the interest earned on tax-exempt obligations was includable in the alternative minimum taxable income of corporations. Under the Recovery Act, for bonds issued between December 31, 2008 and January 1, 2011 (i) the interest on tax-exempt private activity bonds is not an item of tax preference, and (ii) the interest on any tax-exempt bonds is not included in adjusted gross earnings in determining the alternative minimum taxable income of corporations.

Effect on taxation of social security benefits; denial of interest deduction. Exempt-interest dividends must be taken into account in computing the portion, if any, of social security or railroad retirement benefits that must be included in an individual shareholder's gross income subject to federal income tax. Further, a shareholder of the Fund is denied a deduction for interest on indebtedness incurred or continued to purchase or carry shares of the Fund.

State income taxes Some state tax codes adopt the Internal Revenue Code (IRC) through a certain date. As a result, such conforming states may not have adopted the version of the IRC that contains either the Regulated Investment Company Modernization Act of 2010, or other federal tax laws enacted after the applicable conformity date. Other states may have adopted an income or other basis of tax that differs from the IRC. The California Revenue and Taxation Code currently conforms, with certain modifications, to the IRC as of January 1, 2009, and to the Regulated Investment Company Modernization Act of 2010.

The information furnished by the Fund to shareholders and the Internal Revenue Service (IRS) annually with respect to the amount and character of dividends paid, cost basis information with respect to shares redeemed or exchanged, and records maintained by the Fund with respect to the cost basis of Fund shares, will be prepared on the basis of current federal income tax law to comply with the information reporting requirements of the Code, and not on the basis of the law of any state in which a shareholder is resident or otherwise subject to tax. Under the current California Revenue and Taxation Code, certain funds are required to report federal tax information to the California Franchise Tax Board annually.

Accordingly, the amount and character of income, gain or loss realized by a shareholder with respect to his or her investment in Fund shares for state income tax purposes may differ from that for federal income tax purposes. Franklin Templeton Investments provides tax information on franklintempleton.com (under the Tax Center) regarding tax-exempt income by jurisdiction and U.S. government interest to assist shareholders with the preparation of their state income tax returns. Shareholders are solely responsible for determining the amount and character of income, gain or loss to report on their federal, state and local income tax returns each year as a result of their purchase, holding and sale of Fund shares.

**Non-U.S. investors** Non-U.S. investors may be subject to U.S. withholding and estate tax, and are subject to special U.S. tax certification requirements.

*In general.* The United States imposes a flat 30% withholding tax (or a tax at a lower treaty rate) on U.S. source dividends. An exemption from this withholding tax is provided for exemptinterest dividends and capital gain dividends paid by the Fund from its net long-term capital gains. An exemption from withholding is also provided for short-term capital gain dividends and interest-related dividends as described below, to the extent that these gains and dividends are paid with respect to taxable years of the Fund beginning before January 1, 2014. However, notwithstanding such exemptions from U.S. withholding at the source, any distributions of exempt-interest dividends, capital gain dividends, short-term capital gain dividends, interestrelated dividends, and other taxable ordinary income, and, the proceeds from the sale of your Fund shares, will be subject to backup withholding at a rate of 28% if you fail to properly certify that you are not a U.S. person. The exemptions for interest-related and short-term capital gain dividends will sunset unless extended or made permanent. If these exemptions sunset, the Fund's interest-related and short-term capital gain dividends will be subject to taxation as ordinary income.

Capital gain distributions and short-term capital gain dividends. Dividends reported by the Fund to shareholders as either (i) a distribution from net long-term capital gains (a capital gain dividend), or (ii) a distribution from net short-term capital gains (a short-term capital gain dividend) paid out of income earned within the Fund prior to the sunset date described above are not subject to U.S. withholding tax unless you are a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the calendar year.

Interest-related dividends. Interest-related dividends reported by the Fund to shareholders as paid from qualified net interest income earned prior to the sunset date described above are not subject to U.S. withholding tax. The Fund's qualified net interest income equals its qualified interest income less allocable expenses. "Qualified interest income" includes, in general, the sum of the Fund's U.S. source: i) bank deposit interest, ii) shortterm original issue discount, iii) portfolio interest, and iv) any interest-related dividend passed through from another regulated investment company. On any payment date, the amount of an income dividend that is reported by the Fund as an interestrelated dividend may be more or less than the amount that is so qualified. This is because the amount reported is based on an estimate of the Fund's qualified interest income for its entire fiscal year, which can only be determined with exactness at fiscal year end. As a consequence, the Fund may over withhold a small amount of U.S. tax from a dividend payment. In this case, the non-U.S. investor's only recourse may be to either forgo recovery of the excess withholding, or to file a United States nonresident income tax return to recover the excess withholding.

Limitations on tax reporting for interest-related dividends and short-term capital gains dividends for non-U.S. investors. It may not be practical in every case for the Fund to report to shareholders, and the Fund reserves the right in these cases to not report, small amounts of interest-related or short-term capital gain dividends. Additionally, the Fund's reporting of interest-related or short-term capital gain dividends may not, in turn, be passed through to shareholders by intermediaries who have assumed tax reporting responsibilities for this income in managed or omnibus accounts due to systems limitations or operational constraints. When the Fund has reported interestrelated or short-term capital gain dividends, this information will be available online at franklintempleton.com, under the Fund's Tax Information, or through a Customer Service Representative at Franklin Templeton Investments at (800) DIAL BEN/342-5236. If you are a shareholder of an institutional fund, you may obtain this information by calling Institutional Services at (800) 321-8563, or through a Customer Service Representative at Franklin Templeton Investments at (800) DIAL BEN/342-5236.

Effectively connected income. Taxable ordinary income dividends paid by the Fund to non-U.S. investors on portfolio investments are generally subject to U.S. withholding tax at 30% or a lower treaty rate. However, if you hold your Fund shares in connection with a U.S. trade or business, your income and gains may be considered effectively connected income and taxed in the U.S. on a net basis at graduated income tax rates in which case you may be required to file a nonresident U.S. income tax return.

U.S. estate tax. An individual who is a non-U.S. investor will be subject to U.S. federal estate tax on all or a portion of the value of Fund shares owned at the time of death, unless a treaty exemption applies between the country of residence of the non-U.S. investor and the U.S. Even if a treaty exemption is available, a decedent's estate may nevertheless be required to file a U.S. estate tax return to claim the exemption, as well as to obtain a U.S. federal transfer certificate. The transfer certificate will identify the property (i.e., Fund shares) on which a U.S. federal tax lien has been released. and is required before the Fund can release a nonresident alien decedent's investment in the Fund to his or her estate. For estates with U.S. situs assets of not more than \$60,000 (there is a statutory estate tax credit for this amount of property), the Fund may accept, in lieu of a federal transfer certificate, an affidavit from the executor of the estate or other authorized individual evidencing that the U.S. situs assets (excluding any exempt assets as noted below) are at or below this threshold amount. Transfers by gift of shares of the Fund by a non-U.S. investor who is a nonresident alien individual will not be subject to U.S. federal gift tax. The tax consequences to a non-U.S. investor entitled to claim the benefits of a treaty between the country of residence of the non-U.S. investor and the U.S. may be different from the consequences described above. Non-U.S. investors should consult with their tax advisors on the estate tax consequences of an investment in the Fund.

Sunsetting of provisions. The provisions dealing with interest-related dividends and short-term capital gain dividends that are discussed above are scheduled to sunset with respect to taxable years of the Fund ending on December 31, 2013 (calendar year Funds) or in 2014 (fiscal year Funds). Unless these rules are extended, or made permanent, non-U.S. investors will again be subject to nonresident withholding taxes on any ordinary dividends (including short-term capital gain dividends) that they receive.

Tax certification and backup withholding as applied to non-U.S. investors. Non-U.S. investors have special U.S. tax certification requirements to avoid backup withholding at a rate of 28% and, if applicable, to obtain the benefit of any income tax treaty between the non-U.S. investor's country of residence and the United States. To claim these tax benefits, the non-U.S. investor must provide a properly completed Form W-8BEN (or other Form W-8, where applicable, or their substitute forms) to establish his or her status as a non-U.S. investor, to claim beneficial ownership over the assets in the account, and to claim, if applicable, a reduced rate of or exemption from withholding tax under the applicable treaty. A Form W-8BEN provided without a U.S. taxpayer identification number remains in effect for a period of three years beginning on the date that it is signed and ending on the last day of the third succeeding calendar year. However, non-U.S. investors must advise the Fund of any changes of circumstances that would render the information given on the form incorrect, and must then provide a new W-8BEN to avoid the prospective application of backup withholding, Forms W-8BEN with U.S. taxpayer identification numbers remain valid indefinitely, or until the investor has a change of circumstances that renders the form incorrect and necessitates a new form and tax certification.

Foreign Account Tax Compliance Act Under the Foreign Account Tax Compliance Act (or "FATCA"), the Fund may be required to withhold U.S. tax at 30% on (a) dividend distributions paid by the Fund after December 31, 2013, and (b) capital gain distributions (distributions of the Fund's net realized long-term capital gains) and the proceeds from the sale or exchange of Fund shares (including redemptions), paid after December 31, 2016, when such amounts are paid to certain foreign financial institutions and non-financial foreign entities. These requirements are different from, and in addition to, the U.S. withholding tax and account certification rules described above under the section titled Non-U.S. investors.

The rules implementing FATCA have not been finalized and are subject to change and future interpretation. Shareholders should consult their own tax advisors regarding the application of these requirements to their individual situations.

Foreign financial institutions. The Fund is required to withhold 30% U.S. tax on payments made to a foreign financial institution (FFI), unless such FFI provides documentation to the Fund indicating that it is exempt from withholding as a participating FFI, deemed-compliant FFI, exempt beneficial owner, or is otherwise exempt from withholding under Chapter 4 of the

Internal Revenue Code (Code). In some cases, the Fund may be required to verify the U.S. tax status of the FFI with the IRS prior to making payment in order to determine whether the payment is subject to 30% U.S. withholding tax.

The term FFI includes non-U.S. financial institutions such as certain banks, custodians, broker-dealers, investment vehicles and insurance companies. A participating FFI is a non-U.S. financial institution that has entered into a U.S. tax compliance agreement with the U.S. Internal Revenue Service (IRS) under section 1471(b) of the Code (referred to as an "FFI agreement"). Under the terms of the U.S. tax compliance agreement, the FFI will be required to perform certain due diligence procedures with respect to its accounts, including the identification and annual reporting of U.S. persons to the IRS, and the withholding and reporting of U.S. tax on payments to certain accounts where the accountholders do not comply with the requirements of these rules. A non-participating FFI is an FFI that does not enter into a U.S. tax compliance agreement or fails to provide the documentation indicating its status as a participating FFI under these rules.

In order to avoid 30% U.S. withholding tax as described above, a shareholder that is an FFI is strongly encouraged to seek professional tax and legal assistance in determining whether it will enter into a U.S. tax compliance agreement with the IRS and become a participating FFI, or otherwise can be classified as a deemed-compliant FFI, exempt beneficial owner, or other exempt entity.

Non-financial foreign entities. The Fund is also required to withhold 30% U.S. tax on payments made to a non-financial foreign entity (NFFE) that is the beneficial owner of the payment, unless (a) the NFFE is exempt from withholding as an excepted NFFE or exempt beneficial owner, or (b) such entity certifies that it does not have any substantial U.S. owners or provides the name, address and taxpayer identification number of each substantial U.S. owner of the NFFE to the Fund. Substantial U.S. owners are certain U.S. persons, including U.S. citizens and resident aliens, owning more than 10% of the ownership interests in such NFFE. Once identified, the Fund is required to report such information regarding the substantial U.S. owners to the IRS. The term NFFE refers to any non-U.S. entity that is not classified as an FFI.

Shareholders that fail to provide the required documentation to the Fund under these rules will be subject to 30% U.S. withholding tax as described above and shareholders should be aware that refunds of such withholding may only be granted by the IRS under certain circumstances.

Intergovernmental agreements — alternative approach. The U.S. Treasury is in discussion with a number of foreign governments with respect to one or more alternative approaches to implement FATCA. Under one form of a proposed model agreement, FFIs located in a foreign country that enters into such an intergovernmental agreement with the U.S. Treasury would be required to report U.S.-owned account information directly to their

local tax authority, rather than to the IRS. The local tax authority would then automatically share that information with the IRS.

Other Tax Information This discussion of "Distributions and Taxes" is not written to provide you with tax advice, and does not purport to deal with all of the tax consequences that may be applicable to your investment in the Fund. You should consult your tax advisor regarding your particular circumstances before making an investment in the Fund, or about the federal, state, local and foreign tax consequences of your investment in the Fund.

# Organization, Voting Rights and Principal Holders

The Fund is a diversified series of Franklin Tax-Free Trust, an open-end management investment company, commonly called a mutual fund. The Trust was initially organized as a Massachusetts business trust in September 1984, was converted to a Delaware statutory trust effective July 1, 2007 and is registered with the SEC.

The Kentucky Fund currently offers only one share class. Shares of the Fund are considered Class A shares for redemption, exchange and other purposes. The Alabama, Florida, Georgia and Louisiana Funds currently offer two classes of shares, Class A and Class C. The Maryland, Missouri, North Carolina and Virginia Funds currently offer three classes of shares, Class A, Class C and Advisor Class. The Fund may offer additional classes of shares in the future. The full title of each class is:

- Franklin Alabama Tax-Free Income Fund Class A
- Franklin Alabama Tax-Free Income Fund Class C
- Franklin Florida Tax-Free Income Fund Class A
- Franklin Florida Tax-Free Income Fund Class C
- Franklin Georgia Tax-Free Income Fund Class A
- Franklin Georgia Tax-Free Income Fund Class C
- Franklin Kentucky Tax-Free Income Fund
- Franklin Louisiana Tax-Free Income Fund Class A
- Franklin Louisiana Tax-Free Income Fund Class C
- Franklin Maryland Tax-Free Income Fund Class A
- Franklin Maryland Tax-Free Income Fund Class C
- Franklin Maryland Tax-Free Income Fund Advisor Class
- Franklin Missouri Tax-Free Income Fund Class A
- Franklin Missouri Tax-Free Income Fund Class C
- Franklin Missouri Tax-Free Income Fund Advisor Class
- Franklin North Carolina Tax-Free Income Fund Class A
- Franklin North Carolina Tax-Free Income Fund Class C
- Franklin North Carolina Tax-Free Income Fund Advisor Class
- Franklin Virginia Tax-Free Income Fund Class A
- Franklin Virginia Tax-Free Income Fund Class C

• Franklin Virginia Tax-Free Income Fund - Advisor Class

Shares of each class represent proportionate interests in the Fund's assets. On matters that affect the Fund as a whole, each class has the same voting and other rights and preferences as any other class. On matters that affect only one class, only shareholders of that class may vote. Each class votes separately on matters affecting only that class, or matters expressly required to be voted on separately by state or federal law. Shares of each class of a series have the same voting and other rights and preferences as the other classes and series of the Trust for matters that affect the Trust as a whole. Additional series may be offered in the future.

The Trust has noncumulative voting rights. For board member elections, this gives holders of more than 50% of the shares voting the ability to elect all of the members of the board. If this happens, holders of the remaining shares voting will not be able to elect anyone to the board.

The Trust does not intend to hold annual shareholder meetings. The Trust or a series of the Trust may hold special meetings, however, for matters requiring shareholder approval.

From time to time, the number of Fund shares held in the "street name" accounts of various securities dealers for the benefit of their clients or in centralized securities depositories may exceed 5% of the total shares outstanding. To the best knowledge of the Fund, no other person holds beneficially or of record more than 5% of the outstanding shares of any class.

As of June 3, 2013, the officers and board members, as a group, owned of record and beneficially less than 1% of the outstanding shares of each Fund and class. The board members may own shares in other funds in Franklin Templeton Investments.

# **Buying and Selling Shares**

The Fund continuously offers its shares through securities dealers who have an agreement with Franklin Templeton Distributors, Inc. (Distributors). A securities dealer includes any financial institution that, either directly or through affiliates, has an agreement with Distributors to handle customer orders and accounts with the Fund. This reference is for convenience only and does not indicate a legal conclusion of capacity. Banks and financial institutions that sell shares of the Fund may be required by state law to register as securities dealers. If you buy or sell shares through your securities dealer, you may be charged a transaction processing fee by your securities dealer. Your securities dealer will provide you with specific information about any transaction processing fees you will be charged.

For investors outside the U.S., the offering of Fund shares may be limited in many jurisdictions. An investor who wishes to buy shares of the Fund should determine, or have a broker-dealer determine, the applicable laws and regulations of the relevant jurisdiction. Investors are responsible for compliance with tax, currency exchange or other regulations applicable to redemption

and purchase transactions in any jurisdiction to which they may be subject. Investors should consult appropriate tax and legal advisors to obtain information on the rules applicable to these transactions.

All checks, drafts, wires and other payment mediums used to buy or sell shares of the Fund must be denominated in U.S. dollars. We may, in our sole discretion, either (a) reject any order to buy or sell shares denominated in any other currency or (b) honor the transaction or make adjustments to your account for the transaction as of a date and with a foreign currency exchange factor determined by the drawee bank. We may deduct any applicable banking charges imposed by the bank from your account.

When you buy shares, if you submit a check or a draft that is returned unpaid to the Fund we may impose a \$10 charge against your account for each returned item.

## Investment by asset allocators and large

shareholders Particularly during times of overall market turmoil or price volatility, the Fund may experience adverse effects when certain large shareholders such as other funds, institutional investors (including those trading by use of non-discretionary mathematical formulas) and asset allocators (who make investment decisions on behalf of underlying clients), purchase or redeem large amounts of shares of the Fund. Such large shareholder redemptions may cause the Fund to sell portfolio securities at times when it would not otherwise do so. Similarly, large Fund share purchases may adversely affect the Fund's performance to the extent that the Fund is delayed in investing new cash and is required to maintain a larger cash position than it ordinarily would.

These transactions may also accelerate the realization of taxable income to shareholders if such sales of investments resulted in gains, and may also increase transaction costs. In addition, a large redemption could result in the Fund's current expenses being allocated over a smaller asset base, leading to an increase in the Fund's expense ratio.

When experiencing such purchases and redemptions by large shareholders, the Fund may restrict or reject trading activity in accordance with the Frequent Trading Policy of the Fund as set forth in the Fund's Prospectus.

**Initial sales charges** The maximum initial sales charge is 4.25% for Class A. There is no initial sales charge for Class C and Advisor Class.

The initial sales charge for Class A shares may be reduced for certain large purchases, as described in the prospectus. We offer several ways for you to combine your purchases in Franklin Templeton funds to take advantage of the lower sales charges for large purchases.

Letter of intent (LOI). You may buy Class A shares at a reduced sales charge by completing the LOI section of your account application. An LOI is a commitment by you to invest a specified dollar amount during a 13-month period. The amount you agree

to invest determines the sales charge you pay. By completing the LOI section of the application, you acknowledge and agree to the following:

- You authorize Distributors to reserve approximately 5% of your total intended purchase in Class A shares registered in your name until you fulfill your LOI. Your periodic statements will include the reserved shares in the total shares you own, and we will pay or reinvest dividend and capital gain distributions on the reserved shares according to the distribution option you have chosen.
- You give Distributors a security interest in the reserved shares and appoint Distributors as attorney-in-fact.
- Distributors may sell any or all of the reserved shares to cover any additional sales charge if you do not fulfill the terms of the LOI.
- Although you may exchange your shares, you may not sell reserved shares until you complete the LOI or pay the higher sales charge.

After you file your LOI with the Fund, you may buy Class A shares at the sales charge applicable to the amount specified in your LOI. Sales charge reductions based on purchases in more than one Franklin Templeton fund will be effective only after notification to Distributors that the investment qualifies for a discount. If you file your LOI with the Fund before a change in the Fund's sales charge, you may complete the LOI at the lower of the new sales charge or the sales charge in effect when the LOI was filed.

Your holdings in Franklin Templeton funds acquired before you filed your LOI will be counted towards the completion of the LOI.

If the terms of your LOI are met, the reserved shares will be deposited to an account in your name or delivered to you or as you direct.

If the amount of your total purchases is less than the amount specified in your LOI, the sales charge will be adjusted upward, depending on the actual amount purchased during the period. You will need to send Distributors an amount equal to the difference in the actual dollar amount of sales charge paid and the amount of sales charge that would have applied to the total purchases if the total of the purchases had been made at one time. Upon payment of this amount, the reserved shares held for your account will be deposited to an account in your name or delivered to you or as you direct. If within 20 days after written request the difference in sales charge is not paid, we will redeem an appropriate number of reserved shares to realize the difference. If you redeem the total amount in your account before you fulfill your LOI, we will deduct the additional sales charge due from the sale proceeds and forward the balance to you.

**Dealer and financial intermediary compensation** Securities dealers may at times receive the entire sales charge. A securities dealer who receives 90% or more of the sales charge may be deemed an underwriter under the Securities Act of 1933, as amended. Financial institutions or their affiliated brokers may

receive an agency transaction fee in the percentages indicated in the dealer compensation table in the Fund's prospectus.

Distributors may pay the following commissions to securities dealers who initiate and are responsible for purchases of Class A shares of \$1 million or more: 1% (for funds with a maximum initial sales charge of 5.75%) and 0.75% (for funds with a maximum initial sales charge less than 5.75%) on sales of \$1 million or more but less than \$4 million, plus 0.50% on sales of \$4 million or more but less than \$50 million, plus 0.25% on sales of \$50 million or more. Consistent with the provisions and limitations set forth in its Class A Rule 12b-1 distribution plan, the Fund may reimburse Distributors for the cost of these commission payments.

These payments may be made in the form of contingent advance payments, which may be recovered from the securities dealer or set off against other payments due to the dealer if shares are sold within 18 months of the calendar month of purchase. Other conditions may apply. Other terms and conditions may be imposed by an agreement between Distributors, or one of its affiliates, and the securities dealer.

In addition to the sales charge payments described above and the distribution and service (12b-1) fees described below under "The Underwriter - Distribution and service (12b-1) fees," Distributors and/or its non-fund affiliates may make the following additional payments to securities dealers that sell shares of Franklin Templeton funds:

*Marketing support payments.* Distributors may make payments to certain dealers who are holders or dealers of record for accounts in one or more of the Franklin Templeton funds. A dealer's marketing support services may include business planning assistance, advertising, educating dealer personnel about the Franklin Templeton funds and shareholder financial planning needs, placement on the dealer's list of offered funds, and access to sales meetings, sales representatives and management representatives of the dealer. Distributors compensates dealers differently depending upon, among other factors, sales and assets levels, redemption rates and the level and/or type of marketing and educational activities provided by the dealer. Such compensation may include financial assistance to dealers that enable Distributors to participate in and/or present at conferences or seminars, sales or training programs for invited registered representatives and other employees, client and investor events and other dealer-sponsored events. These payments may vary depending upon the nature of the event. Distributors will, on an annual basis, determine whether to continue such payments. In the case of any one dealer, marketing support payments will not exceed the sum of 0.08% of that dealer's current year's total sales of Franklin Templeton mutual funds and 0.05% (or 0.03%) of the total assets respectively, of equity or fixed income funds attributable to that dealer, on an annual basis.

Distributors may also make marketing support payments to financial intermediaries in connection with their activities that are intended to assist in the sale of shares of Franklin Templeton funds, directly or indirectly, to certain Employer Sponsored Retirement Plans that have retained such financial intermediaries as plan service providers. Payments may be made on account of activities that may include, but are not limited to, one or more of the following: business planning assistance for financial intermediary personnel, educating financial intermediary personnel about the Franklin Templeton funds, access to sales meetings, sales representatives, wholesalers, and management representatives of the financial intermediary, and detailed sales reporting. A financial intermediary may perform the services itself or may arrange with a third party to perform the services. In the case of any one financial intermediary, such payments will not exceed 0.10% of the total assets of Franklin Templeton equity or fixed income mutual funds held, directly or indirectly, by such Employer Sponsored Retirement Plans, on an annual basis. Distributors will, on an annual basis, determine whether to continue such payments. Any current year sales to, or assets held on behalf of, Employer Sponsored Retirement Plans for which payment is made to a financial intermediary pursuant to this paragraph will be excluded from the calculation of marketing support payments pursuant to the preceding paragraph.

Consistent with the provisions and limitations set forth in its Rule 12b-1 distribution plans, the Fund may reimburse Distributors for the cost of a portion of these marketing support payments.

Marketing support payments may be in addition to any servicing and other fees paid by Investor Services, as described further below and under "Management and Other Services - Shareholder servicing and transfer agent" above.

As noted below, Distributors may provide additional compensation to dealers and financial intermediaries, including dealers and financial intermediaries not listed below, related to transaction support and various dealer-sponsored events intended to educate financial advisers and their clients about the Franklin Templeton funds.

The following list includes FINRA member firms (or, in some instances, their respective affiliates) that Distributors anticipates will receive marketing support payments as of March 31, 2013. In addition to member firms of FINRA, Distributors also makes marketing support payments, and Distributors' non-fund affiliates may make administrative services payments, to certain other financial intermediaries, such as banks, insurance companies, and plan administrators, that sell fund shares or provide services to Franklin Templeton funds and shareholders. These firms may not be included in this list. You should ask your financial intermediary if it receives such payments.

ADP Retirement Services, American Portfolios Financial Services, Inc., American United Life Insurance Company, Ameriprise Financial Services, Inc., Ascensus, Inc., AXA Advisors, LLC, BBVA Compass Investment Solutions, Inc., Benjamin F. Edwards & Company, Inc., Cadaret Grant & Co., Inc., Cambridge Investment Research, Inc., Cetera Advisors LLC, Cetera Advisor Networks LLC, Cetera Financial Specialists LLC, Cetera Investment Services LLC, CCO Investment Services Corp., Citigroup Global Markets Inc.,

Commonwealth Financial Network, CPI Qualified Plan Consultants, Inc., CUNA Brokerage Services, Inc., CUSO Financial Services, L.P., Daily Access Corporation, Diversified Investment Advisors, Edward Jones, ePlan Services, Inc., ExpertPlan, Inc., Fidelity Investments Institutional Services Company, Inc., Fifth Third Securities, Inc., First Command Financial Planning, Inc., FSC Securities Corporation, Goldman, Sachs & Co., Great-West Retirement Services, Hartford, IFC Holdings Inc. D/B/A INVEST Financial Corporation, ING Financial Partners, Inc., ING Institutional Plan Services LLP, Investment Centers of America, Inc., J.J.B. Hilliard, W.L. Lyons LLC, J.P. Morgan Securities LLC, Janney Montgomery Scott LLC, John Hancock Distributors LLC, Legend Equities Corporation, Lincoln Financial Advisors Corporation, Lincoln Financial Securities Corporation, Lincoln Investment Planning, Inc., Lincoln Retirement Services Company LLC, LPL Financial Corporation, M&T Securities, Inc., Massachusetts Mutual Life Insurance Company, Merrill Lynch, Pierce, Fenner & Smith, Inc., Morgan Stanley Smith Barney LLC, National Planning Corporation, Nationwide Financial Services, Inc., New York Life Retirement Plan Services, Newport Retirement Services, Inc., Northwestern Mutual Investment Services, LLC, PFS Investments Inc., PNC Investments LLC, Principal Financial Group, Putnam Investor Services, Inc., Raymond James & Associates, Inc., Raymond James Financial Services, Inc., RBC Capital Markets LLC, Richard D. Schubert, Inc., Robert W. Baird & Co., Inc., Royal Alliance Associates, Inc., SagePoint Financial, Inc., Securities America, Inc., Signator Investors, Inc., SII Investments, Inc., Sorrento Pacific Financial, LLC, Stifel, Nicolaus & Company, Incorporated, SunTrust Banks Inc., SunTrust Investment Services, Inc., TD Ameritrade Trust Company, TFS Securities, Inc., The Huntington Investment Company, The Investment Center, Inc., TIAA-CREF Individual & Institutional Services, LLC, Transamerica Advisors Life Insurance Company, UBS Financial Services, Inc., UBS Global Asset Management (US) Inc., UnionBanc Investment Services, LLC, U.S. Bancorp Investments, Inc., USI Consulting Group and Wells Fargo Advisors, LLC.

Marketing support payments made to organizations located outside the U.S., with respect to investments in the Fund by non-U.S. persons, may exceed the above-stated limitation.

Transaction support payments. The types of payments that Distributors may make under this category include, among others, payment of ticket charges of up to \$20 per purchase or exchange order placed by a dealer or one-time payments for ancillary services such as setting up funds on a dealer's mutual fund trading system.

Other payments. From time to time, Distributors, at its expense, may make additional payments to dealers that sell or arrange for the sale of shares of the Fund. Such compensation may include financial assistance to dealers that enable Distributors to participate in and/or present at conferences or seminars, sales or training programs for invited registered representatives and other employees, client and investor events, co-operative advertising, newsletters, and other dealer-sponsored events.

These payments may vary depending upon the nature of the event, and can include travel expenses, such as lodging incurred by registered representatives and other employees in connection with training and educational meetings, client prospecting and due diligence trips.

Distributors routinely sponsors due diligence meetings for registered representatives during which they receive updates on various Franklin Templeton funds and are afforded the opportunity to speak with portfolio managers. Invitation to these meetings is not conditioned on selling a specific number of shares. Those who have shown an interest in Franklin Templeton funds, however, are more likely to be considered. To the extent permitted by their firm's policies and procedures, registered representatives' expenses in attending these meetings may be covered by Distributors.

Other compensation may be offered to the extent not prohibited by federal or state laws or any self-regulatory agency, such as FINRA. Distributors makes payments for events it deems appropriate, subject to Distributors' guidelines and applicable law.

You should ask your dealer for information about any payments it receives from Distributors and any services provided.

In addition, Investor Services may make payments to financial intermediaries that provide administrative services to defined benefit plans. Investor Services does not seek reimbursement by the Fund for such payments.

Contingent deferred sales charge (CDSC) - Class A and C If you invest any amount in Class C shares or \$1 million or more in Class A shares, either as a lump sum or through our cumulative quantity discount or letter of intent programs, a CDSC may apply on any Class A shares you sell within 18 months and any Class C shares you sell within 12 months of purchase. The CDSC is 1% for Class C and 0.75% for Class A of the value of the shares sold or the net asset value at the time of purchase, whichever is less.

CDSC waivers. The CDSC for any share class will be waived for:

- Assets held in accounts managed by a state or federally regulated trust company or bank (Trust Company) either as discretionary trustee of an inter vivos or testamentary trust or as investment manager under an advisory agreement (including sub-advisory) or other agreement that grants the Trust Company investment discretion over those assets (Trust Company Managed Assets) if (i) the aggregate value of Trust Company Managed Assets invested in Franklin Templeton funds at the time of purchase equals at least \$1 million; and (ii) the purchased shares are registered directly to the Trust Company in its corporate capacity (not as trustee of an individual trust) and held solely as Trust Company Managed Assets.
- · Account fees
- Redemptions by the Fund when an account falls below the minimum required account size
- Redemptions following the death of the shareholder or beneficial owner

- Redemptions through a systematic withdrawal plan set up before February 1, 1995
- Redemptions through a systematic withdrawal plan set up on or after February 1, 1995, up to 1% monthly, 3% quarterly, 6% semiannually or 12% annually of your account's net asset value depending on the frequency of your plan

**Exchange privilege** If you request the exchange of the total value of your account, accrued but unpaid income dividends and capital gain distributions will be reinvested in the Fund at net asset value on the date of the exchange, and then the entire share balance will be exchanged into the new fund. Backup withholding and information reporting may apply.

If a substantial number of shareholders should, within a short period, sell their Fund shares under the exchange privilege, the Fund might have to sell portfolio securities it might otherwise hold and incur the additional costs related to such transactions. On the other hand, increased use of the exchange privilege may result in periodic large inflows of money. If this occurs, it is the Fund's general policy to initially invest this money in short-term, tax-exempt municipal securities, unless it is believed that attractive investment opportunities consistent with the Fund's investment goals exist immediately. This money will then be withdrawn from the short-term, tax-exempt municipal securities and invested in portfolio securities in as orderly a manner as is possible when attractive investment opportunities arise.

The proceeds from the sale of shares of an investment company generally are not available until the seventh day following the sale. The funds you are seeking to exchange into may delay issuing shares pursuant to an exchange until that seventh day. The sale of Fund shares to complete an exchange will be effected at net asset value at the close of business on the day the request for exchange is received in proper form.

In certain comprehensive fee or advisory programs that hold Class A shares, at the discretion of the financial intermediary, you may exchange to Advisor Class shares or Class Z shares (if offered by the fund).

Class C shares of a Fund may be exchanged for Advisor Class or Class Z shares of the same Fund, if offered by the Fund, provided you meet the Fund's eligibility requirements for purchasing Advisor Class or Class Z shares. The Class C shares that you wish to exchange must not currently be subject to any CDSC.

**Systematic withdrawal plan** Our systematic withdrawal plan allows you to sell your shares and receive regular payments from your account on a monthly, quarterly, semiannual or annual basis. The value of your account must be at least \$5,000 and the minimum payment amount for each withdrawal must be at least \$50. There are no service charges for establishing or maintaining a systematic withdrawal plan.

Each month in which a payment is scheduled, we will redeem an equivalent amount of shares in your account on the day of the month you have indicated on your account application or, if no day is indicated, on the 20th day of the month. If that day falls

on a weekend or holiday, we will process the redemption on the next business day. For plans set up before June 1, 2000, we will continue to process redemptions on the 25th day of the month (or the next business day) unless you instruct us to change the processing date. Available processing dates currently are the 1st, 5th, 10th, 15th, 20th and 25th days of the month. When you sell your shares under a systematic withdrawal plan, it is a taxable transaction.

To avoid paying sales charges on money you plan to withdraw within a short period of time, you may not want to set up a systematic withdrawal plan if you plan to buy shares on a regular basis. Shares sold under the plan also may be subject to a CDSC.

Redeeming shares through a systematic withdrawal plan may reduce or exhaust the shares in your account if payments exceed distributions received from the Fund. This is especially likely to occur if there is a market decline. If a withdrawal amount exceeds the value of your account, your account will be closed and the remaining balance in your account will be sent to you. Because the amount withdrawn under the plan may be more than your actual yield or income, part of the payment may be a return of your investment.

To discontinue a systematic withdrawal plan, change the amount and schedule of withdrawal payments, or suspend one payment, we must receive instructions from you at least three business days before a scheduled payment. The Fund may discontinue a systematic withdrawal plan by notifying you in writing and will discontinue a systematic withdrawal plan automatically if all shares in your account are withdrawn, if the Fund receives notification of the shareholder's death or incapacity, or if mail is returned to the Fund marked "unable to forward" by the postal service.

**Redemptions in kind** The Fund has committed itself to pay in cash (by check) all requests for redemption by any shareholder of record, limited in amount, however, during any 90-day period to the lesser of \$250,000 or 1% of the value of the Fund's net assets at the beginning of the 90-day period. This commitment is irrevocable without the prior approval of the SEC. In the case of redemption requests in excess of these amounts, the board reserves the right to make payments in whole or in part in securities or other assets of the Fund, in case of an emergency, or if the payment of such a redemption in cash would be detrimental to the existing shareholders of the Fund. In these circumstances, the securities distributed would be valued at the price used to compute the Fund's net assets and you may incur brokerage fees in converting the securities to cash. The Fund does not intend to redeem illiquid securities in kind. If this happens, however, you may not be able to recover your investment in a timely manner.

Share certificates We will credit your shares to your Fund account. We do not issue share certificates unless you specifically request them. This eliminates the costly problem of replacing lost, stolen or destroyed certificates. If a certificate is lost, stolen or destroyed, you may have to pay an insurance premium of up to 2% of the value of the certificate to replace it.

Any outstanding share certificates must be returned to the Fund if you want to sell or exchange those shares or if you would like to start a systematic withdrawal plan. The certificates should be properly endorsed. You can do this either by signing the back of the certificate or by completing a share assignment form. For your protection, you may prefer to complete a share assignment form and to send the certificate and assignment form in separate envelopes.

**General information** If dividend checks are returned to the Fund marked "unable to forward" by the postal service, we will consider this a request by you to change your dividend option to reinvest all distributions. The proceeds will be reinvested in additional shares at net asset value until we receive new instructions.

Distribution or redemption checks sent to you do not earn interest or any other income during the time the checks remain uncashed. Neither the Fund nor its affiliates will be liable for any loss caused by your failure to cash such checks. The Fund is not responsible for tracking down uncashed checks, unless a check is returned as undeliverable.

In most cases, if mail is returned as undeliverable we are required to take certain steps to try to find you free of charge. If these attempts are unsuccessful, however, we may deduct the costs of any additional efforts to find you from your account. These costs may include a percentage of the account when a search company charges a percentage fee in exchange for its location services.

Sending redemption proceeds by wire or electronic funds transfer (ACH) is a special service that we make available whenever possible. By offering this service to you, the Fund is not bound to meet any redemption request in less than the seven-day period prescribed by law. Neither the Fund nor its agents shall be liable to you or any other person if, for any reason, a redemption request by wire or ACH is not processed as described in the prospectus.

There are special procedures for banks and other institutions that wish to open multiple accounts. An institution may open a single master account by filing one application form with the Fund, signed by personnel authorized to act for the institution. Individual sub-accounts may be opened when the master account is opened by listing them on the application, or by providing instructions to the Fund at a later date. These sub-accounts may be registered either by name or number. The Fund's investment minimums apply to each sub-account. The Fund will send confirmation and account statements for the sub-accounts to the institution.

If you buy or sell shares through your securities dealer, we use the net asset value next calculated after your securities dealer receives your request, which is promptly transmitted to the Fund. If you sell shares through your securities dealer, it is your dealer's responsibility to transmit the order to the Fund in a timely fashion. Your redemption proceeds will not earn interest between the time we receive the order from your dealer and the time we receive any required documents. Any loss to you resulting from your dealer's

failure to transmit your redemption order to the Fund in a timely fashion must be settled between you and your securities dealer.

Certain shareholder servicing agents may be authorized to accept your transaction request.

For institutional and bank trust accounts, there may be additional methods of buying or selling Fund shares than those described in this SAI or in the prospectus. Institutional and bank trust accounts include accounts opened by or in the name of a person (includes a legal entity or an individual) that has signed an Institutional Account Application or Bank Trust Account Application accepted by Franklin Templeton Institutional, LLC or entered into a selling agreement and/or servicing agreement with Distributors or Investor Services. For example, the Fund permits the owner of an institutional account to make a same day wire purchase if a good order purchase request is received (a) before the close of the New York Stock Exchange (NYSE) or (b) through the National Securities Clearing Corporation's automated system for processing purchase orders (Fund/SERV), even though funds are delivered by wire after the close of the NYSE. If funds to be wired are not received as scheduled, the purchase order may be cancelled or reversed and the institutional account owner could be liable for any losses or fees the Fund, Distributors and/or Investor Services may incur.

In the event of disputes involving conflicting claims of ownership or authority to control your shares, the Fund has the right (but has no obligation) to: (i) restrict the shares and require the written agreement of all persons deemed by the Fund to have a potential interest in the shares before executing instructions regarding the shares; or (ii) interplead disputed shares or the proceeds from the court-ordered sale thereof with a court of competent jurisdiction.

Should the Fund be required to defend against joint or multiple shareholders in any action relating to an ownership dispute, you expressly grant the Fund the right to obtain reimbursement for costs and expenses including, but not limited to, attorneys' fees and court costs, by unilaterally redeeming shares from your account.

The Fund may be required (i) pursuant to a validly issued levy, to turn your shares over to a levying officer who may, in turn, sell your shares at a public sale; or (ii) pursuant to a final order of forfeiture to sell your shares and remit the proceeds to the U.S. or state government as directed.

Using good faith efforts, the investment manager attempts to identify class action litigation settlements and regulatory or governmental recovery funds involving securities presently or formerly held by the Fund or issuers of such securities or related parties (Claims) in which the Fund may be eligible to participate. When such Claims are identified, the investment manager will cause the Fund to file proofs of claim. Currently, such Claim opportunities predominate in the U.S. and in Canada; the investment manager's efforts are therefore focused on Claim opportunities in those jurisdictions. The investment manager may learn of such class action lawsuit or victim fund recovery opportunities in jurisdictions outside of North America (Foreign

Actions), in which case the investment manager has complete discretion to determine, on a case-by-case basis, whether to cause the Fund to file proofs of claim in such Foreign Actions. In addition, the investment manager may participate in bankruptcy proceedings relating to securities held by the Fund and join creditors' committees on behalf of the Fund.

Further, the investment manager may on occasion initiate and/or recommend, and the board of trustees of the Fund may approve, pursuit of separate litigation against an issuer or related parties in connection with securities presently or formerly held by the Fund (whether by opting out of an existing class action lawsuit or otherwise).

Clients of financial advisors whose firms have a Selling Agreement with Distributors and who are eligible for the Financial Advisor Service Team (FAST) may be eligible for Franklin Templeton VIP Services® which offers enhanced service and transaction capabilities. Please contact Shareholder Services at (800) 632-2301 for additional information on this program.

## The Underwriter

Franklin Templeton Distributors, Inc. (Distributors) acts as the principal underwriter in the continuous public offering of the Fund's shares. Distributors is located at One Franklin Parkway, San Mateo, CA 94403-1906.

Distributors does not receive compensation from the Fund for acting as underwriter of the Fund's Advisor Class shares.

The table below shows the aggregate underwriting commissions Distributors received in connection with the offering of the Fund's Class A, B, and C shares, the net underwriting discounts and commissions Distributors retained after allowances to dealers, and the amounts Distributors received in connection with redemptions or repurchases of shares for the fiscal years ended February 28, 2013, February 29, 2012 and February 28, 2011:

	Total Commissions Received (\$)	Amount Retained by Distributors (\$)	Amount Received in Connection with Redemptions and Repurchases (\$)
2013			
Alabama Fund	772,408	109,251	7,810
Florida Fund	1,418,116	216,300	13,080
Georgia Fund	1,822,844	246,009	25,539
Kentucky Fund	1,033,768	129,672	3,483
Louisiana Fund	2,099,365	288,340	21,378
Maryland Fund	1,238,480	188,046	16,798
Missouri Fund	4,735,261	647,201	33,762
North Carolina Fund	4,209,471	600,593	24,169
Virginia Fund	2,267,806	341,155	20,132

	Total Commissions Received (\$)	Amount Retained by Distributors (\$)	Received in Connection with Redemptions and Repurchases (\$)
2012	(Ψ)	(ψ)	(ψ)
Alabama Fund	E70 ECE	02 722	15 072
Florida Fund	578,565	83,722	15,072
	895,294	136,735	11,604
Georgia Fund	948,611	126,597	11,618 38
Kentucky Fund	611,785	81,390	
Louisiana Fund	1,282,598	172,260	17,871
Maryland Fund	724,169	105,806	18,312
Missouri Fund	3,716,969	504,496	24,176
North Carolina Fund	3,185,455	444,166	32,927
Virginia Fund	1,398,488	205,627	35,618
2011			
Alabama Fund	589,871	85,544	14,958
Florida Fund	1,152,081	167,559	32,303
Georgia Fund	1,229,556	163,809	39,729
Kentucky Fund	655,603	93,250	0
Louisiana Fund	1,374,430	190,102	35,050
Maryland Fund	1,229,439	172,258	74,288
Missouri Fund	4,744,653	656,668	46,545
North Carolina Fund	3,704,263	517,415	70,366
Virginia Fund	2,142,876	312,010	71,579

**Amount** 

Distributors may be entitled to payments from the Fund under the Rule 12b-1 plans, as discussed below. Except as noted, Distributors received no other compensation from the Fund for acting as underwriter.

Distribution and service (12b-1) fees - Class A and C The board has adopted a separate plan pursuant to Rule 12b-1 for each class. Although the plans differ in some ways for each class, each plan is designed to benefit the Fund and its shareholders. The plans are expected to, among other things, increase advertising of the Fund, encourage purchases of Fund shares and service to its shareholders, and increase or maintain assets of the Fund so that certain fixed expenses may be spread over a broader asset base, with a positive impact on per share expense ratios. In addition, a positive cash flow into the Fund is useful in managing the Fund because the investment manager has more flexibility in taking advantage of new investment opportunities and handling shareholder redemptions.

Under each plan, the Fund pays Distributors or others for the expenses of activities that are primarily intended to sell shares of the class. These expenses also may include service fees paid to securities dealers or others who have executed a servicing agreement with the Fund, Distributors or its affiliates and who provide service or account maintenance to shareholders (service fees); and the expenses of printing prospectuses and reports used for sales purposes, of marketing support and of preparing and distributing sales literature and advertisements. Together, these expenses, including the service fees, are "eligible expenses." The 12b-1 fees charged to each class are based only on the fees attributable to that particular class.

The Class A, B and C plans. The Fund may pay up to 0.10% per year of Class A's average daily net assets.

The Fund pays Distributors up to 0.65% per year of Class C's average daily net assets, out of which 0.15% may be paid for services to the shareholders (service fees). The Class C plan also may be used to pay Distributors for advancing commissions to securities dealers with respect to the initial sale of Class C shares

In implementing the Class A plan, the board has determined that the annual fees payable under the plan will be equal to the sum of: (i) the amount obtained by multiplying 0.10% by the average daily net assets represented by the Fund's Class A shares that were acquired by investors on or after May 1, 1994, the effective date of the plan (new assets), and (ii) the amount obtained by multiplying 0.05% by the average daily net assets represented by the Fund's Class A shares that were acquired before May 1, 1994 (old assets). These fees will be paid to the current securities dealer of record on the account. In addition, until such time as the maximum payment of 0.10% is reached on a yearly basis, up to an additional 0.02% will be paid to Distributors under the plan. When the Fund reaches \$4 billion in assets, the amount to be paid to Distributors will be reduced from 0.02% to 0.01%. The payments made to Distributors will be used by Distributors to defray other marketing expenses that have been incurred in accordance with the plan, such as advertising.

The fee is a Class A expense. This means that all Class A shareholders, regardless of when they purchased their shares, will bear Rule 12b-1 expenses at the same rate. The initial rate will be at least 0.07% (0.05% plus 0.02%) of the average daily net assets of Class A and, as Class A shares are sold on or after May 1, 1994, will increase over time. Thus, as the proportion of Class A shares purchased on or after May 1, 1994, increases in relation to outstanding Class A shares, the expenses attributable to payments under the plan also will increase (but will not exceed 0.10% of average daily net assets). While this is the currently anticipated calculation for fees payable under the Class A plan, the plan permits the board to allow the Fund to pay a full 0.10% on all assets at any time. The approval of the board would be required to change the calculation of the payments to be made under the Class A plan.

The Class A plan is a reimbursement plan. It allows the Fund to reimburse Distributors for eligible expenses that Distributors has shown it has incurred. The Fund will not reimburse more than the maximum amount allowed under the plan. Any unreimbursed expenses from one year may not be carried over to or reimbursed in later years.

The Class C plan is a compensation plan. It allows the Fund to pay a fee to Distributors that may be more than the eligible expenses Distributors has incurred at the time of the payment. Distributors must, however, demonstrate to the board that it has spent or has near-term plans to spend the amount received on eligible expenses. The Fund will not pay more than the maximum amount allowed under the plan.

Under the Class A plan, the amounts paid by the Fund pursuant to the plan for the fiscal year ended February 28, 2013, were:

	Alabama Fund (\$)	l Florida Fund (\$)	Georgia Fund (\$)
Advertising	15,121	84,479	16,272
Printing and mailing prospectuses other than to current shareholders	359	1,319	211
Payments to underwriters	2,768	12,957	4,307
Payments to broker- dealers	244,515	933,487	432,960
Other		<del>_</del>	
Total	262,763	1,032,242	453,750
	Kentucky Fund (\$)	d Louisiana Fund (\$)	Maryland Fund (\$)
Advertising	7,909	16,922	21,478
Printing and mailing prospectuses other than to current shareholders	284	265	293
Payments to underwriters	2,409	4,740	3,999
Payments to broker- dealers	196,616	382,708	497,779
Other			
Total	207,218	404,635	523,549
	Missouri Fund (\$)	North Carolina Fund (\$)	Virginia Fund (\$)
Advertising	36,927	33,701	32,680
Printing and mailing prospectuses other than to current shareholders	367	296	464
Payments to underwriters	9,180	7,120	8,017
Payments to broker-dealers Other	1,044,888	1,062,542	701,436
Total	1,091,362	1,103,659	742,597

Class B is currently closed to all investors. For shareholders that held accounts in Class B during the Fund's previous fiscal year, the amounts paid by the Fund under its plan were primarily to pay for ongoing shareholder servicing and to pay Distributors in connection with the advancing of commissions to securities broker-dealers who sold Class B shares. Under the Class B plan, the amounts paid by the Fund pursuant to the plan for the fiscal year ended February 28, 2013, were:

	Florida Fund (\$)
Advertising	<u> </u>
Printing and mailing prospectuses other than to current shareholders	_
Payments to underwriters	_
Payments to broker-dealers	3,407
Other	12,544
Total	15,951

Under the Class C plan, the amounts paid by the Fund pursuant to the plan for the fiscal year ended February 28, 2013 were:

	Alabama Fund (\$)	Florida Fund (\$)	Georgia Fund (\$)
Advertising	7,854	14,772	28,124
Printing and mailing prospectuses other than to current shareholders	162	145	284
Payments to underwriters	2,579	3,935	7,295
Payments to broker- dealers	375,161	789,635	893,846
Other			
Total	385,756	808,487	929,549
	Louisiana Fund (\$)	Maryland Fund (\$)	Missouri Fund (\$)
Advertising	11,310	25,684	42,730
Printing and mailing prospectuses other than to current shareholders	189	310	308
Payments to underwriters	4,896	6,414	12,800
Payments to broker-dealers	554,740	1,043,643	1,214,881
Other	_		
Total	571,135	1,076,051	1,270,719
	Nort	h Carolina Fund (\$)	Virginia Fund (\$)
Advertising	,	55,160	23,886
Printing and mailing prosper other than to current share		402	261
Payments to underwriters		14,605	7,576
Payments to broker-dealers Other		1,924,652	988,726
Total		1,994,819	1,020,449

In addition to the payments that Distributors or others are entitled to under each plan, each plan also provides that to the extent the Fund, the investment manager or Distributors or other parties on behalf of the Fund, the investment manager or Distributors make payments that are deemed to be for the financing of any activity primarily intended to result in the sale of Fund shares within the context of Rule 12b-1 under the 1940 Act, then such payments shall be deemed to have been made pursuant to the plan.

To the extent fees are for distribution or marketing functions, as distinguished from administrative servicing or agency transactions, certain banks may not participate in the plans because of applicable federal law prohibiting certain banks from engaging in the distribution of mutual fund shares. These banks, however, are allowed to receive fees under the plans for administrative servicing or for agency transactions.

Distributors must provide written reports to the board at least quarterly on the amounts and purpose of any payment made under the plans and any related agreements, and furnish the board with such other information as the board may reasonably request to enable it to make an informed determination of whether the plans should be continued.

Each plan has been approved according to the provisions of Rule 12b-1. The terms and provisions of each plan also are consistent with Rule 12b-1.

## **Performance**

Performance quotations are subject to SEC rules. These rules require the use of standardized performance quotations or, alternatively, that every non-standardized performance quotation furnished by the Fund be accompanied by certain standardized performance information computed as required by the SEC. Average annual total return before taxes, average annual total return after taxes on distributions, average annual total return after taxes on distributions and sale of shares and current yield quotations used by the Fund are based on the standardized methods of computing performance mandated by the SEC. An explanation of these and other methods used by the Fund to compute or express performance follows. Regardless of the method used, past performance does not guarantee future results, and is an indication of the return to shareholders only for the limited historical period used.

Average annual total return before taxes Average annual total return before taxes is determined by finding the average annual rates of return over certain periods that would equate an initial hypothetical \$1,000 investment to its ending redeemable value. The calculation assumes that the maximum initial sales charge, if applicable, is deducted from the initial \$1,000 purchase, and income dividends and capital gain distributions are reinvested at net asset value. The quotation assumes the account was completely redeemed at the end of each period and the deduction of all applicable charges and fees. If a change is made to the sales charge structure, historical performance information will be restated to reflect the maximum initial sales charge currently in effect.

When considering the average annual total return before taxes quotations for Class A shares, you should keep in mind that the maximum initial sales charge reflected in each quotation is a one-time fee charged on all direct purchases, which will have its greatest impact during the early stages of your investment. This charge will affect actual performance less the longer you retain your investment in the Fund.

The following SEC formula is used to calculate these figures:

$$P(1+T)^n = ERV$$

where:

P = a hypothetical initial payment of \$1,000

T = average annual total return

 $n \ = \ number \, of \, years$ 

ERV = ending redeemable value of a hypothetical \$1,000 payment made at the beginning of each period at the end of each period

Average annual total return after taxes on distributions Average annual total return after taxes on distributions is determined by finding the average annual rates of return over certain periods that would equate an initial hypothetical \$1,000 investment to its ending redeemable value, after taxes on distributions. The calculation assumes that the maximum initial sales charge, if applicable, is deducted from the initial \$1,000 purchase, and income dividends and capital gain distributions, less the taxes due on such distributions, are reinvested at net asset value. The quotation assumes the account was completely redeemed at the end of each period and the deduction of all applicable charges and fees, but assumes that the redemption itself had no tax consequences. If a change is made to the sales charge structure, historical performance information will be restated to reflect the maximum initial sales charge currently in effect.

Taxes due on distributions are calculated by applying the highest individual marginal federal income tax rates in effect on the reinvestment date, using the rates that correspond to the tax character of each component of the distributions (e.g., the ordinary income rate for distributions of ordinary income and net short-term capital gains, and the long-term capital gain rate for distributions of net long-term capital gains). The taxable amount and tax character of a distribution may be adjusted to reflect any recharacterization of the distribution since its original date. Distributions are adjusted to reflect the federal tax impact the distribution would have on an individual taxpayer on the reinvestment date; for example, no taxes are assumed to be due on the portion of any distribution that would not result in federal income tax on an individual (e.g., tax-exempt interest or nontaxable returns of capital). The effect of applicable tax credits, such as the foreign tax credit, is taken into account in accordance with federal tax law. Any potential tax liabilities other than federal tax liabilities (e.g., state and local taxes) are disregarded, as are the effects of phaseouts of certain exemptions, deductions, and credits at various income levels, and the impact of the federal alternative minimum tax. Any redemptions of shares required to pay recurring fees charged to shareholder accounts are assumed to result in no additional taxes or tax credits.

The Fund's sales literature and advertising commonly refer to this calculation as the Fund's after-tax average annual total return (pre-liquidation). When considering the average annual total return after taxes on distributions quotations for Class A shares, you should keep in mind that the maximum initial sales charge reflected in each quotation is a one-time fee charged on all direct purchases, which will have its greatest impact during the early stages of your investment. This charge will affect actual performance less the longer you retain your investment in the Fund.

The following SEC formula is used to calculate these figures:

$$P(1+T)^n = ATV_D$$

where:

P = a hypothetical initial payment of \$1,000

T = average annual total return (after taxes on distributions)

n = number of years

ATVb = ending value of a hypothetical \$1,000 payment made at the beginning of each period at the end of each period, after taxes on fund distributions but not after taxes on redemption

Average annual total return after taxes on distributions and sale of fund shares Average annual total return after taxes on distributions and sale of fund shares is determined by finding the average annual rates of return over certain periods that would equate an initial hypothetical \$1,000 investment to its ending redeemable value, after taxes on distributions and sale of fund shares. The calculation assumes that the maximum initial sales charge, if applicable, is deducted from the initial \$1,000 purchase, and income dividends and capital gain distributions are reinvested at net asset value. The quotation assumes the account was completely redeemed at the end of each period and the deduction of all applicable charges and fees, including taxes upon sale of fund shares. If a change is made to the sales charge structure, historical performance information will be restated to reflect the maximum initial sales charge currently in effect.

Taxes due on distributions are calculated by applying the highest individual marginal federal income tax rates in effect on the reinvestment date, using the rates that correspond to the tax character of each component of the distributions (e.g., the ordinary income rate for distributions of ordinary income and net short-term capital gains, and the long-term capital gain rate for distributions of net long-term capital gains). The taxable amount and tax character of a distribution may be adjusted to reflect any recharacterization of the distribution since its original date. Distributions are adjusted to reflect the federal tax impact the distribution would have on an individual taxpaver on the reinvestment date; for example, no taxes are assumed to be due on the portion of any distribution that would not result in federal income tax on an individual (e.g., tax-exempt interest or nontaxable returns of capital). The effect of applicable tax credits, such as the foreign tax credit, is taken into account in accordance with federal tax law. Any potential tax liabilities other than federal tax liabilities (e.g., state and local taxes) are disregarded, as are the effects of phaseouts of certain exemptions, deductions, and credits at various income levels, and the impact of the federal alternative minimum tax. Any redemptions of shares required to pay recurring fees charged to shareholder accounts are assumed to result in no additional taxes or tax credits.

The capital gain or loss upon redemption is calculated by subtracting the tax basis from the redemption proceeds, after deducting any nonrecurring charges assessed at the end of the period, subtracting capital gains taxes resulting from the redemption, or adding the tax benefit from capital losses resulting from the redemption. In determining the basis for a reinvested distribution, the distribution is included net of taxes assumed paid from the distribution, but not net of any sales

loads imposed upon reinvestment. Tax basis is adjusted for any distributions representing returns of capital and any other tax basis adjustments that would apply to an individual taxpayer, as permitted by applicable federal law. The amount and character (e.g., short-term or long-term) of capital gain or loss upon redemption are separately determined for shares acquired through the initial investment and each subsequent purchase through reinvested distributions. Shares acquired through reinvestment of distributions are not assumed to have the same holding period as the initial investment. The tax character of such reinvestments is determined by the length of the period between reinvestment and the end of the measurement period in the case of reinvested distributions. Capital gains taxes (or the benefit resulting from tax losses) are calculated using the highest federal individual capital gains tax rate for gains of the appropriate character in effect on the redemption date and in accordance with federal law applicable on the redemption date. Shareholders are assumed to have sufficient capital gains of the same character from other investments to offset any capital losses from the redemption, so that the taxpayer may deduct the capital losses in full.

The Fund's sales literature and advertising commonly refer to this calculation as the Fund's after-tax average annual total return (post-liquidation). When considering the average annual total return after taxes on distributions quotations for Class A shares, you should keep in mind that the maximum initial sales charge reflected in each quotation is a one-time fee charged on all direct purchases, which will have its greatest impact during the early stages of your investment. This charge will affect actual performance less the longer you retain your investment in the Fund.

The following SEC formula is used to calculate these figures:

$$P(1+T)^n = ATV_{DR}$$

where:

P = a hypothetical initial payment of \$1,000

T = average annual total return (after taxes on distributions and redemptions)

n = number of years

ATVDR = ending value of a hypothetical \$1,000 payment made at the beginning of each period at the end of each period, after taxes on fund distributions and redemption

**Cumulative total return** Like average annual total return, cumulative total return assumes that the maximum initial sales charge, if applicable, is deducted from the initial \$1,000 purchase, income dividends and capital gain distributions are reinvested at net asset value, the account was completely redeemed at the end of each period and the deduction of all applicable charges and fees. Cumulative total return, however, is based on the actual return for a specified period rather than on the average return.

**Current yield** Current yield shows the income per share earned by the Fund. It is calculated by dividing the net investment income per share earned during a 30-day base period by the applicable maximum offering price per share on the last day of the period and annualizing the result. Expenses accrued for the period include any fees charged to all shareholders of the class during the base period.

This SEC standardized yield reflects an estimated yield to maturity for each obligation held by the Fund which takes into account the current market value of the obligation and may reflect some judgments as to the ultimate realizable value of the obligation. This SEC standardized yield should be regarded as an estimate of the Fund's current rate of investment income, and it may not equal the Fund's actual income dividend distribution rate, the income paid to a shareholder's account or the income reported in the Fund's financial statements.

The following SEC formula is used to calculate these figures:

$$Yield = 2\left[\left(\frac{a-b}{cd} + 1\right)^6 - 1\right]$$

where:

a = dividends and interest earned during the period

b = expenses accrued for the period (net of reimbursements)

c = the average daily number of shares outstanding during the period that were entitled to receive dividends

d = the maximum offering price per share on the last day of the period

**Taxable-equivalent yield** The Fund also may quote a taxable-equivalent yield that shows the before-tax yield that would have to be earned from a taxable investment to equal the yield. Taxable-equivalent yield is computed by dividing the portion of the yield that is tax-exempt by one minus the highest applicable combined federal and state income tax rate and adding the product to the portion of the yield that is not tax-exempt, if any.

From time to time, as any changes to the rates become effective, taxable-equivalent yield quotations advertised by the Fund will be updated to reflect these changes. The Fund expects updates may be necessary as tax rates are changed by federal and state governments. The advantage of tax-free investments, like the Fund, will be enhanced by any tax rate increases. Therefore, the details of specific tax increases may be used in sales material for the Fund.

**Current distribution rate** Current yield and taxable-equivalent yield, which are calculated according to a formula prescribed by the SEC, are not indicative of the amounts that were or will be paid to shareholders. Amounts paid to shareholders are reflected in the quoted current distribution rate or taxable-equivalent distribution rate. The current distribution rate is usually computed by annualizing the dividends paid per share by a class during a certain period and dividing that amount by the current maximum offering price. The current distribution rate differs from the

current yield computation because it may include distributions to shareholders from sources other than interest, if any, and is calculated over a different period of time.

A taxable-equivalent distribution rate shows the taxable distribution rate equivalent to the current distribution rate. The advertised taxable-equivalent distribution rate will reflect the most current federal and state tax rates available to the Fund.

**Volatility** Occasionally statistics may be used to show the Fund's volatility or risk. Measures of volatility or risk are generally used to compare the Fund's net asset value or performance to a market index. One measure of volatility is beta. Beta is the volatility of a fund relative to the total market, as represented by an index considered representative of the types of securities in which the fund invests. A beta of more than 1.00 indicates volatility greater than the market and a beta of less than 1.00 indicates volatility less than the market. Another measure of volatility or risk is standard deviation. Standard deviation is used to measure variability of net asset value or total return around an average over a specified period of time. The idea is that greater volatility means greater risk undertaken in achieving performance.

Other performance quotations The Fund also may quote the performance of Class A shares without a sales charge. Sales literature and advertising may quote a cumulative total return, average annual total return and other measures of performance with the substitution of net asset value for the public offering price.

The Fund may include in its advertising or sales material information relating to investment goals and performance results of funds belonging to Franklin Templeton Investments. Resources is the parent company of the advisors and underwriter of Franklin Templeton funds.

## **Miscellaneous Information**

The Fund may help you achieve various investment goals such as accumulating money for retirement, saving for a down payment on a home, college costs and other long-term goals. The Franklin College Savings Planner may help you in determining how much money must be invested on a monthly basis to have a projected amount available in the future to fund a child's college education. (Projected college cost estimates are based upon current costs published by the College Board.) The Franklin Retirement Savings Planner leads you through the steps to start a retirement savings program. Of course, an investment in the Fund cannot guarantee that these goals will be met.

The Fund is a member of Franklin Templeton Investments, one of the largest mutual fund organizations in the U.S., and may be considered in a program for diversification of assets. Founded in 1947, Franklin is one of the oldest mutual fund organizations and now services more than 2 million shareholder accounts. In 1992, Franklin, a leader in managing fixed-income mutual funds and an innovator in creating domestic equity funds, joined forces with Templeton, a pioneer in international investing. The Mutual

Series team, known for its value-driven approach to domestic equity investing, became part of the organization four years later. In 2001, the Fiduciary Trust team, known for providing global investment management to institutions and high net worth clients worldwide, joined the organization. Together, Franklin Templeton Investments has, as of May 31, 2013, over \$846 billion in assets under management for more than 3 million U.S. based mutual fund shareholder and other accounts. Franklin Templeton Investments offers 111 U.S. based open-end investment companies to the public. The Fund may identify itself by its NASDAQ symbol or CUSIP number.

Under current federal and state income tax laws, municipal securities remain one of the few investments offering the potential for tax-free income. In 2013, the tax cost of a fully taxable investment could reach \$50.36 on every \$100 of investment earnings. This is based on the highest federal personal income tax rate of 43.4% and the highest combined state and local personal income tax rate of 12.3%. The combined tax rate of 50.36% assumes a federal income tax deduction for the full amount of the state and local income taxes. Federal and state income tax rates are as of January 8, 2013, and are subject to change as federal and state legislatures search for new revenue to meet expected budget shortfalls. Franklin tax-free funds, however, offer tax relief through a professionally managed portfolio of tax-free securities selected based on their yield, quality and maturity. An investment in a Franklin tax-free fund may provide you with the potential to earn income free from regular federal income tax and, depending on the fund and your state of residence, state and local tax as well, while supporting state and local public projects. A portion, or a small portion, of the tax-free funds' income dividends may be subject to the federal alternative minimum tax. Franklin tax-free funds may also provide tax-free compounding when tax-free income is reinvested. An investment in Franklin's tax-free funds can grow more rapidly than similar taxable investments. Shareholders should also be aware that many states are experiencing budget shortfalls in their annual budgets and these states may raise taxes on investment income to generate additional revenue to cover these shortfalls. Tax-free compounding may create one more reason why investors should consider an investment in a tax-free fund as an investment opportunity at this time.

Municipal securities are generally considered to be creditworthy, second in quality only to securities issued or guaranteed by the U.S. government and its agencies. The market price of municipal securities, however, may fluctuate. This fluctuation will have a direct impact on the net asset value of the Fund's shares.

Currently, there are more mutual funds than there are stocks listed on the NYSE. While many of them have similar investment goals, no two are exactly alike. Shares of the Fund are generally sold through securities dealers, whose investment representatives are experienced professionals who can offer advice on the type of investments suitable to your unique goals and needs, as well as the risks associated with such investments.

# **Description of Ratings**

## **Municipal Bond Ratings**

# Moody's

Municipal Ratings are the opinions of the investment quality of issuers and issues in the U.S. municipal and tax-exempt markets. As such, these ratings incorporate Moody's assessment of the default probability and loss severity of these issuers and issues. The default and loss content for Moody's municipal long-term rating scale differs from Moody's general long-term rating scale. It is important that users of Moody's ratings understand these differences when making rating comparisons between the Municipal and Global Scales.

Municipal Ratings are based upon the analysis of five primary factors related to municipal finance: market position, financial position, debt levels, finances, governance and covenants. Each of the factors is evaluated individually and for its effect on the other factors in the context of the municipality's ability to repay its debt.

#### INVESTMENT GRADE

Aaa: Issues or issuers rated Aaa demonstrate the strongest creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

Aa: Issues or issuers rated Aa demonstrate very strong creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

A: Issues or issuers rated A present above-average creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

Baa: Issues or issuers rated Baa represent average creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

# BELOW INVESTMENT GRADE

Ba: Issues or issuers rated Ba demonstrate below-average creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

B: Issues or issuers rated B demonstrate weak creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

Caa: Issues or issuers rated Caa demonstrate very weak creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

Ca: Issues or issuers rated Ca demonstrate extremely weak creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

C: Issues or issuers demonstrate the weakest creditworthiness relative to other U.S. municipal or tax-exempt issues or issuers.

Con.(\*): Municipal bonds for which the security depends upon the completion of some act or the fulfillment of some condition are rated conditionally. These are bonds secured by (a) earnings of projects under construction, (b) earnings of projects unseasoned in operation experience, (c) rentals that begin when facilities are completed, or (d) payments to which some other limiting condition attaches. Parenthetical rating denotes probable credit stature upon the completion of construction or the elimination of the basis of the condition.

Note: Moody's appends numerical modifiers 1, 2 and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the issue or issuer ranks in the higher end of its generic rating category; modifier 2 indicates a mid-range ranking; and modifier 3 indicates that the issue or issuer ranks in the lower end of its generic rating category.

## S&P®

S&P's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program (including ratings on medium-term note programs and commercial paper programs). It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated. The opinion evaluates the obligor's capacity and willingness to meet its financial commitments as they come due, and may assess terms, such as collateral security and subordination, which could affect ultimate payment in the event of default. The issue credit rating is not a statement of fact or recommendation to purchase, sell, or hold a financial obligation or make any investment decisions. Nor is it a comment regarding an issue's market price or suitability for a particular investor.

Issue credit ratings are based on current information furnished by the obligors or obtained by S&P from other sources it considers reliable. S&P does not perform an audit in connection with any credit rating and may, on occasion, rely on unaudited financial information. Credit ratings may be changed, suspended, or withdrawn as a result of changes in, or unavailability of, such information, or based on other circumstances.

## INVESTMENT GRADE

AAA: An obligation rated AAA has the highest rating assigned by S&P. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

AA: An obligation rated AA differs from AAA issues only in a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

A: An obligation rated A is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than an obligation in the higher rating categories. However, the obligor's capacity to meet its financial commitment is considered still strong.

BBB: An obligation rated BBB normally exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

#### **BELOW INVESTMENT GRADE**

- BB, B, CCC, CC, C: Obligations rated BB, B, CCC, CC and C are regarded as having significant speculative characteristics. BB indicates the least degree of speculation and C the highest degree of speculation. While these obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.
- BB: An obligation rated BB is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
- B: An obligation rated B is more vulnerable to nonpayment than obligations rated BB, but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.
- CCC: An obligation rated CCC is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.
- CC: An obligation rated CC is currently highly vulnerable to nonpayment.
- C: A C rating is assigned to obligations that are currently highly vulnerable to nonpayment, obligations that have payment arrearages allowed by the terms of the documents, or obligations of an issuer that is the subject of a bankruptcy petition or similar action which have not experienced a payment default.
- D: An obligation rated D is in payment default. The D rating category is used when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless S&P believes that such payments will be made during such grace period. The D rating is also used upon the filing of a bankruptcy petition or the taking of a similar action if payments on the obligation are jeopardized.

Plus (+) or minus (-): The ratings from "AA" to "CCC" may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

pr: The designation "pr" indicates that the rating is provisional. Such a rating assumes the successful completion of the project financed by the debt being rated and also indicates that payment of the debt service is largely or entirely dependent upon the successful and timely completion of the project. This rating addresses credit quality subsequent to the completion of the project, but makes no comment on the likelihood of or the risk of default upon failure of such completion.

# **Municipal Note Ratings**

#### Moody's

Moody's ratings for municipal short-term investment grade obligations are designated Municipal Investment Grade (MIG) and are divided into three levels — MIG 1 through MIG 3. In addition, those short-term obligations that are of speculative quality are designated SG, or speculative grade. MIG ratings expire at the maturity of the obligation. Symbols used will be as follows:

#### INVESTMENT GRADE

- MIG 1: This designation denotes superior credit quality. Excellent protection is afforded by established cash flows, highly reliable liquidity support, or demonstrated broad-based access to the market for refinancing.
- MIG 2: This designation denotes strong credit quality. Margins of protection are ample, although not so large as in the preceding group.
- MIG 3: This designation denotes acceptable credit quality. Liquidity and cash-flow protection may be narrow, and market access for refinancing is likely to be less well established.

## **BELOW INVESTMENT GRADE**

SG: This designation denotes speculative-grade credit quality. Debt instruments in this category may lack sufficient margins of protection.

## S&P®

New municipal note issues due in three years or less, will usually be assigned the ratings below. Notes maturing beyond three years will most likely receive a bond rating of the type recited above.

- SP-1: Issues carrying this designation have a strong capacity to pay principal and interest. Issues determined to possess a very strong capacity to pay debt service are given a "plus" (+) designation.
- SP-2: Issues carrying this designation have a satisfactory capacity to pay principal and interest, with some vulnerability to adverse financial and economic changes over the terms of the notes.
- SP-3: Issues carrying this designation have a speculative capacity to pay principal and interest.

## **Short-Term Debt Ratings**

#### Moody's

Moody's short-term debt ratings are opinions of the ability of issuers to honor short-term financial obligations. Ratings may be assigned to issuers, short-term programs and to individual short-term debt instruments. These obligations generally have an original maturity not exceeding 13 months, unless explicitly noted. Moody's employs the following designations to indicate the relative repayment capacity of rated issuers:

P-1 (Prime-1): Issuers (or supporting institutions) so rated have a superior ability to repay short-term debt obligations.

- P-2 (Prime-2): Issuers (or supporting institutions) so rated have a strong ability to repay short-term debt obligations.
- P-3 (Prime-3): Issuers (or supporting institutions) so rated have an acceptable ability to repay short-term debt obligations.
- NP: Issuers (or supporting institutions) rated Not Prime do not fall within any of the Prime rating categories.

#### S&P®

S&P's ratings are a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program. Short-term ratings are generally assigned to those obligations considered short-term in the relevant market. In the U.S., for example, that means obligations with an original maturity of no more than 365 days — including commercial paper. Short-term ratings are also used to indicate the creditworthiness of an obligor with respect to put features on long-term obligations. The result is a dual rating, in which the short-term rating addresses the put feature, in addition to the usual long-term rating.

- A-1: This designation indicates that the obligor's capacity to meet its financial commitment on the obligation is strong. Within this category, certain obligations are designated with a plus sign (+). This indicates that the obligor's capacity to meet its financial commitment on these obligations is extremely strong.
- A-2: Issues carrying this designation are somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations carrying the higher designations. However, the obligor's capacity to meet its financial commitments on the obligation is satisfactory.
- A-3: Issues carrying this designation exhibit adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
- B: Issues carrying this designation are regarded as having significant speculative characteristics. The obligor currently has the capacity to meet its financial commitment on the obligation. However, it faces major ongoing uncertainties which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
- C: Issues carrying this designation are currently vulnerable to nonpayment and are dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation.
- D: Issues carrying this designation are in payment default. The D rating category is used when payments on an obligation are not made on the due date even if the applicable grace period has not expired, unless S&P believes that such payments will be made during such grace period. The D rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized.

# State Tax Treatment

The following information on the state income tax treatment of dividends from the Fund is based upon correspondence and sources believed to be reliable. Except where otherwise noted, the information pertains to individual state income taxation only. You may be subject to local taxes on dividends or the value of your shares. Corporations, trusts, estates and other entities may be subject to income and/or other taxes and should consult with their tax advisors or their state department of revenue. For some investors, a portion of the dividend income may be subject to the federal and/or state alternative minimum tax.

**Alabama** Under Section 40-18-14(3)f of the Alabama Code. interest on obligations of the state of Alabama and any of its counties, municipalities or other political subdivisions is exempt from personal income tax. Section 40-18-14(3)d provides similar tax-exempt treatment for interest on exempt obligations of the U.S. government or its possessions. In addition, the position of the Alabama Department of Revenue, as reflected in the instructions to Form 40, Alabama Individual Income Tax Return, is that dividends derived from interest on United States obligations and/or Alabama municipal obligations that are received from a regulated investment company, such as the Alabama Fund, are exempt from the Alabama individual income tax. Tax-exempt treatment generally is not available for distributions attributable to income earned on indirect U.S. government obligations or obligations of other states and their political subdivisions. To the extent such investments are made by the Fund, distributions from those investments generally will be taxable. Any distributions of capital gains earned by the Fund are included in an individual shareholder's Alabama taxable income.

**Georgia** Under Section 48-7-27(b)(1)(A) of the Georgia Code, interest on obligations of the state of Georgia and its political subdivisions, which is excluded from federal adjusted gross income, is exempt from the state's individual income tax. Likewise, under Section 48-7-27(b)(2) interest on exempt obligations of the U.S. government, its territories and possessions (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands), or of any authority, commission, or instrumentality of the U.S. government also is exempt from the state's individual income tax. According to the instructions to Georgia's personal income tax return, distributions from a regulated investment company (such as the Georgia Fund) attributable to interest on obligations of the state of Georgia and its political subdivisions and, apparently, to interest on obligations of the U.S. government, its territories and possessions, will be excluded from the Georgia individual income tax. Tax-exempt treatment generally is not available for distributions attributable to income earned on indirect U.S. government obligations (Ginnie Maes, Fannie Maes, etc.) or for obligations of other states and their political subdivisions. To the extent such investments are made by the Fund, such as for temporary or defensive purposes, such distributions generally will be taxable. Any distributions of capital gains earned by the

Fund are included in an individual shareholder's Georgia taxable income.

**Kentucky** Pursuant to Kentucky Revised Statute 141.010(10) (a), income that is exempt from state taxation under the Kentucky Constitution and the Constitution and statutory laws of the United States and Kentucky is excluded from the Kentucky individual income tax base. This should include interest earned on obligations issued by the Commonwealth of Kentucky or its political subdivisions ("Kentucky Obligations") and direct obligations of the U.S. government, its agencies and instrumentalities, or its territories (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands). Pursuant to Kentucky Revenue Cabinet Tax Policy No. 42P161 (as revised December 1, 1990), income distributed to resident shareholders of a regulated investment company (such as the Kentucky Fund) retains the same character in the hands of the shareholder as it had in the hands of the regulated investment company. Therefore, dividends from such regulated investment companies, such as the Kentucky Fund, which are derived from Kentucky Obligations or direct obligations of the U.S. government, its agencies and instrumentalities, or its territories (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands), will be exempt from the Kentucky individual income tax. Tax-exempt treatment generally is not available for distributions attributable to income earned on indirect U.S. government obligations (Ginnie Maes, Fannie Maes, etc.) or for obligations of other states and their political subdivisions. To the extent such investments are made by the Fund, such as for temporary or defensive purposes. such distributions generally will be taxable. Any distributions of net short-term and net long-term capital gains earned by the Kentucky Fund are generally includable in an individual shareholder's Kentucky net income.

Louisiana Under Section 47:293(9)(b) of Louisiana's individual income tax law, interest earned on exempt obligations of the state of Louisiana or its political subdivisions, is exempt from the Louisiana individual income tax. The instructions to the Louisiana individual income tax return (Form IT-540) and Section 47:293(9)(a)(iii) of the Louisiana individual income tax law provide that interest from U.S. government obligations is also exempt. Distributions from a regulated investment company, such as the Louisiana Fund, will also be exempt from the Louisiana individual income tax to the extent that they are derived from interest earned on such exempt obligations. Tax-exempt treatment generally is not available for distributions attributable to income earned on indirect U.S. government obligations (Ginnie Maes, Fannie Maes, etc.) or for obligations of other states and their political subdivisions. To the extent such investments are made by the Fund, such as for temporary or defensive purposes, such distributions generally will be taxable. Any distributions of net short-term and net long-term capital gains earned by the Fund are included in an individual shareholder's Louisiana taxable income.

**Maryland** Under Section 10-204(b) of the Maryland Code Ann. — Tax Gen. ("Maryland Tax Code") interest on obligations of the state of Maryland and its political subdivisions is excluded from the Maryland personal income tax. Maryland Administrative Release No. 5 clarifies that this exemption applies to distributions from a regulated investment company, such as the Maryland Fund. In addition, under Section 10-207(c) of the Maryland Tax Code, interest attributable to direct obligations of the U.S. government and any authority, commission, instrumentality, possession or territory of the U.S. (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands) also is exempt from Maryland's personal income tax. Under Section 10-207(c-1), this exemption is extended to distributions from a regulated investment company, such as the Maryland Fund. Tax-exempt treatment generally is not available for distributions attributable to income earned on indirect U.S. government obligations (Ginnie Maes, Fannie Maes, etc.) or on obligations of other states and their political subdivisions. To the extent such investments are made by the Fund, such as for temporary or defensive purposes, such distributions generally will be taxable.

Under Section 10-207(i) of the Maryland Tax Code, profit realized from the sale or exchange of bonds issued by the state of Maryland or a political subdivision thereof is excluded from the Maryland personal income tax. Maryland Administrative Release No. 5 clarifies that this exemption applies to distributions from a regulated investment company, such as the Maryland Fund. Distributions of capital gains attributable to non-Maryland obligations and gains from the sale of shares of the Maryland Fund are included in an individual shareholder's Maryland adjusted gross income.

Missouri Under Section 143.121 of the Revised Statutes of Missouri, interest attributable to obligations of the state of Missouri and its political subdivisions or authorities ("Missouri Obligations") are exempt from Missouri personal income tax. In addition, interest attributable to direct obligations of the U.S. government, its authorities, commissions, instrumentalities, possessions or territories (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands), are exempt from the Missouri personal income tax. Pursuant to the Missouri income tax regulations (Title 12, Section 10-2.155), a regulated investment company such as the Missouri Fund may pass the tax-exempt character of interest from Missouri Obligations and direct obligations of the U.S. government, its authorities, commissions, instrumentalities, possessions or territories (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands) through to its shareholders (a copy of the year end statement received from the regulated investment company identifying all United States Obligations by issuer or a summary document indicating the percentage of dividends attributable to interest on United States Obligations must be attached to the Missouri income tax return when filed). Distributions attributable to income earned on indirect U.S. government obligations (Ginnie Maes, Fannie Maes, etc.) or from obligations of other states and their

political subdivisions is not exempt from taxation. To the extent such investments are made by the Fund, such as for temporary or defensive purposes, such distributions generally will be taxable. Any distributions of net short-term and net long-term capital gains earned by the Fund are included in an individual shareholder's Missouri taxable income.

North Carolina Section 105-134.6(b)(1) of the North Carolina General Statutes provides that interest on obligations of the state of North Carolina or its political subdivisions ("North Carolina Obligations") and direct obligations of the United States or its possessions, (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands) are exempt from the North Carolina individual income tax. Pursuant to N.C. Admin Code Section 6B.4102 and North Carolina Department of Revenue Individual Income Tax Technical Bulletin No. X, dated December 30, 2009, distributions received from a regulated investment company, such as the North Carolina Fund, that are attributable to interest on North Carolina Obligations, direct obligations of the United States and qualifying obligations of certain U.S. possessions, are exempt from the North Carolina individual income tax. Tax-exempt treatment generally is not available for distributions attributable to income earned on indirect U.S. government obligations (Ginnie Maes, Fannie Maes, etc.) or for obligations of other states and their political subdivisions. To the extent such investments are made by the Fund, such as for temporary or defensive purposes, such distributions generally will be taxable.

Any distributions of capital gains earned by the Fund are included in an individual shareholder's North Carolina taxable income (except that distributions of capital gains from the sale of certain North Carolina obligations issued before July 1, 1995 may be exempt from taxation for the Fund's individual shareholders).

**Virginia** Sections 58.1-322 of the Code of Virginia provides that interest and gains on obligations of the state of Virginia, its political subdivisions, and instrumentalities ("Virginia Obligations") and income and gains derived from direct obligations of the U.S. government or its authorities, commission, instrumentalities or territories (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands) is exempt from state income tax. Under Title 23, Virginia Administrative Code 10-110-141 and 10-110-142, distributions from a regulated investment company, such as the Virginia Fund, also will be exempt from state income tax to the extent attributable to interest received by the Virginia Fund from Virginia Obligations or from direct obligations of the U.S. government or its authorities, commission, instrumentalities or territories (including qualifying obligations of Puerto Rico, Guam and the Virgin Islands). Tax-exempt treatment generally is not available for distributions attributable to income earned on indirect U.S. government obligations (Ginnie Maes, Fannie Maes, etc.) or from obligations of other states and their political subdivisions. To the extent such investments are made by the Fund, such as for temporary or defensive purposes, such distributions generally will be taxable.

This page intentionally left blank

This page intentionally left blank