UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

[DIV]ISION OF
[INVEST]MENT MANAGEMENT

ACT ICA
SECTION
RULE 2a-7
PUBLIC AVAILABILITY 11/2/92

November 2, 1992

Ms. Amy B. R. Lancellotta
Associate General Counsel
Investment Company Institute
1600 M Street, NW
Washington, DC 20036

re: Paragraph (c)(3)(i) of Rule 2a-7

Dear Ms. Lancellotta:

This responds to your letter of May 5, 1992, in which you requested guidance regarding technical issues arising under rule 2a-7. 1/ Your letter posits a number of situations in which securities are subject to unconditional credit support from banks or other issuers who themselves have outstanding short-term debt. You ask for clarification of how paragraph (c)(3)(i) of the rule would be applied to a variety of combinations of securities and credit support. 2/

We would analyze the cases you present as follows:

Case 1. A fund purchases a short-term note subject to an irrevocable letter of credit ("LOC"). The note is not rated and the issuer of the note does not have outstanding any rated short-term debt obligations. The bank issuing the LOC has rated short-term debt outstanding that is clearly "first tier" under rule 2a-7.

1/ All references are to paragraphs of rule 2a-7.

2/ Paragraph (c)(3)(i) provides that "[a] demand instrument that has an Unconditional Demand Feature may be determined to be an Eligible Security or a First Tier Security based solely on whether the Unconditional Demand Feature is an Eligible Security or First Tier Security, as the case may be."

<u>Conclusion</u>. Because the bank issuing the LOC has a class of short-term debt comparable in priority and security to the LOC, the LOC would be considered to be a first tier security by reference to the bank's short-term debt, and the fund's board would not be required to perform a comparability analysis, which it would if the note were treated as an unrated security.

<u>Analysis</u>. This case raises the question of whether an LOC that is not a demand feature may be used to transform an unrated short-term security into a first tier security. Paragraph (c)(3)(i) permits a money market fund to determine the status of a security based on the status of a credit enhancement. However, paragraph (c)(3)(i) is available only when a security has an "unconditional demand feature." A "demand feature" is defined in paragraph (a)(4) as a put that, among other things, may be exercised at any time on no more than 30 days' notice. Demand features generally are used not only as credit enhancements but also to shorten the maturities of instruments. An LOC for a short-term instrument likely would not be structured to include a demand feature because the maturity of such an instrument would not need to be shortened. Nonetheless, because the key credit enhancement function is served by the LOC, the Division believes that paragraph (c)(3)(i) may be read to treat a short-term instrument subject to an LOC or similar unconditional credit enhancement as a first tier security based solely on the LOC itself being a first tier security. <u>3</u>/

<u>Case 2</u>. A fund purchases a long-term bond subject to an unconditional monthly put provided by a third party (<u>i.e.</u>, an "unconditional demand feature" as defined under the rule). The bond is not rated. The put provider has short-term debt outstanding that is first tier.

<u>3</u>/ As you note in your letter, all fund investments, including those rated by NRSROs, must be determined to present minimal credit risks by the fund's board. In addition, a fund relying on paragraph (c)(3)(i) must carefully analyze the structure of the guarantee when performing its credit risk analysis. The fund must be satisfied that the guarantee is unconditional, enforceable, and structured to ensure that the LOC provider will make principal and interest payments in full when due, even in the event of the issuer's bankruptcy. <u>See</u> "Perspective on Structured Finance: Moody's Approach to Rating Credit-Supported Debt," Public Finance Department, Moody's Investors Service (1990).

<u>Conclusion</u>. The fund may rely on paragraph (c)(3)(i) to treat the bond as a first tier security.

<u>Analysis</u>. The bond would not be considered an unrated security because, under paragraph (c)(3)(i), the fund may look to the ratings of the put provider which, in this case, has short-term debt outstanding that is first tier.

<u>Case 3</u>. Same as Case 1, except the note has a "split rating" (<u>i.e.</u>, a first tier rating from one NRSRO and a second tier rating from another NRSRO). The LOC was in effect at the time the ratings were assigned and, thus, was considered by the NRSROs in determining the note's ratings. The LOC bank's short-term debt has identical ratings from those two NRSROs, but it is also rated by a third NRSRO, which has given it a first tier rating.

<u>Conclusion</u>. The note may be treated as a first tier security under paragraph (c)(3)(i) since the LOC provider has two first tier ratings.

<u>Analysis</u>. A fund that may, under paragraph (c)(3)(i), determine the status of a security based on the status of a demand feature, may take into consideration other ratings of debt of the LOC provider that is comparable in priority and security to the LOC. <u>4</u>/ In this case, the LOC would be considered to have two first tier ratings, and thus the note could be considered a first tier security.

<u>Case 4</u>. Same as Case 3, except in this case the note only has a single first tier rating. The bank is rated by two NRSROs. One (the same one that rated the note) rates it first tier; the other has assigned it a second tier rating.

<u>Conclusion</u>. The money market fund could treat the note as either a second tier or an unrated security.

<u>Analysis</u>. This case raises the question of whether a money market fund is required to determine the status of an LOC-backed note by reference to the LOC. By its terms, paragraph (c)(3)(i) is permissive. Therefore, a money market fund would have two choices in the case you present:

(1) under paragraph (c)(3)(i), it may rely on the ratings of the comparable debt of the LOC provider and classify the note as a second tier security, or

---

<u>4</u>/ <u>See</u> paragraphs (a)(5) and (a)(6).

(2) it may disregard the LOC, in which case it must also disregard any rating premised on the existence of the LOC. 5/

Because the single first tier rating on the note was premised on the existence of the LOC, if the fund elects to disregard the LOC, the security would be an unrated security. In order for the note to be an eligible security, the fund's board of directors or, in the case of a tax exempt fund, the board's delegate, would need to determine that the note, without the LOC, is of comparable quality to a security that has received the NRSRO ratings required to qualify as an eligible security. 6/

Case 5. Same as Case 4, except the note in this case is subject to an unconditional monthly put, rather than an LOC, and it is the put provider, rather than the LOC bank, that has the split-rated debt outstanding.

Conclusion. The money market fund could treat the note as either a second tier or an unrated security.

Analysis. The analysis is the same as in Case 4.

Sincerely,

Robert E. Plaze
Assistant Director

5/ Cf. paragraph (a)(20)(iii) (fund purchasing rated security made subject to an external credit enhancement subsequent to assignment of rating must ignore prior rating and treat security as an unrated security).

6/ In connection with memorializing its minimal credit risk analysis, the fund should indicate that it is disregarding the LOC.

INVESTMENT
COMPANY
INSTITUTE

1600 M Street, NW
Washington, DC 20036
202/293-7700
Fax: 202/659-1519

May 5, 1992

Mr. Robert E. Plaze
Associate Director
Division of Investment Management
Securities and Exchange Commission
Washington, D.C. 20549

Re: Technical Issues
Under Rule 2a-7

Dear Bob:

Several months ago we discussed the possibility of the Institute submitting to the staff a list of technical issues that members have identified under amended Rule 2a-7. At that time, you indicated that a good vehicle for the staff to address those issues would be in the release the staff is preparing concerning tax-exempt money market funds. Since that time, the Institute's money market fund ad hoc committee has met to discuss some of the issues that have arisen. I realize that some time has passed since we spoke about the possibility of addressing these issues in the tax-exempt money market fund release. If the proposal is near completion and therefore would no longer be an appropriate vehicle for this purpose, the Institute would be interested in submitting a request for interpretive guidance. Please advise us accordingly.

At this time, there is one issue on which the Institute's members are in need of guidance from the staff. The issue concerns the analysis required under Rule 2a-7 with respect to securities subject to guarantees or other forms of unconditional credit support provided by issuers that themselves have outstanding short-term debt. While we believe that this is a single issue, it can occur in a variety of scenarios. In some cases, it seems clear what the status of the security will be (e.g., Eligible, First Tier), but not how this determination is arrived at (which can, in turn, have an effect on the involvement required of a fund's board). In other cases, the status of the security itself is not clear. Finally, it is not clear whether the Rule requires the consistent treatment of instruments subject to unconditional credit enhancement (whether in the form of an unconditional put, letter of credit or guarantee) although there would appear to be no good policy reasons for doing otherwise.

The easiest way to describe the issue is to give some specific examples, which are set forth below.

Case 1. A short-term note is issued subject to an irrevocable letter of credit. The note is not rated and the issuer does not have outstanding any rated short-term debt obligations. The bank issuing the letter of credit has rated short-term debt outstanding that is clearly "first tier" under Rule 2a-7.

Case 2. A long-term bond is issued. The bond is subject to an unconditional monthly put provided by a third party (i.e., a "Demand Feature" as defined under the Rule). The bond is not rated. The put provider has short-term debt outstanding that is first tier.

Case 3. Same as Case 1, except the note has a "split rating" (i.e., a first tier rating from one NRSRO and a second tier rating from another NRSRO). The LOC was in effect at the time the ratings were assigned and, thus, was considered by the NRSROs in determining the note's ratings. The LOC bank's short-term debt has identical ratings from those two NRSROs, but it is also rated by a third NRSRO, which has given it a first tier rating.

Case 4. Same as Case 3, except in this case the note only has a single first tier rating. The bank is rated by two NRSROs. One (the same one that rated the note) rates it first tier; the other has assigned it a second tier rating.

Case 5. Same as Case 4, except the note in this case is subject to an unconditional monthly put, rather than an LOC, and it is the put provider, rather than the LOC bank, that has the split-rated debt outstanding.

Discussion

A logical approach to each of these cases would be to allow the fund to determine whether the obligation of the issuer has been fully substituted by the obligation of the provider of the guarantee. This determination would then dictate whether the fund should look to (a) the ratings of the entity providing the guarantee, (b) the quality of the note or its issuer, or (c) if the appropriate entity does not have comparable rated securities, a determination that the note is of comparable quality to rated Eligible and First Tier Securities in determining the status of the security for purposes of the Rule.[1] This seems to be the approach taken in paragraph (c)(3)(i) of the Rule. However, it is not clear that this paragraph applies in each case.

With respect to Case 1, it seems that the security could be considered an "Unrated Security", as it appears to fall within the conditions of subparagraph (a)(20)(i). If so, the money market fund would be able to determine that the security was comparable in quality to a First Tier Security and, thus, would itself be a First Tier Security.

Under Case 2, it seems that a different type of analysis is possible. Subparagraph (c)(3)(i) provides that:

> "a demand instrument that has an unconditional demand feature may be determined to be an eligible security or a first tier security <u>based solely</u> on whether the unconditional demand feature is an eligible security or first tier security, as the case may be."

(Emphasis added.)

This seems to indicate that, under Case 2, there is no need to engage in a comparability analysis and that only a minimal credit risk analysis is required because the issuer of the Unconditional Demand Feature has rated first tier short-term debt outstanding. While the instruments in both Case 1 and Case 2 would be First Tier Securities, the determinations required appear to be different, even though the credit risks would not be. This anomaly would be compounded in the case of taxable instruments, where the Board would have to approve or ratify the purchase in Case 1, but not Case 2. Alternatively, it could be argued that the instrument in Case 2 is still technically an "Unrated Security", although one that automatically satisfies the comparable quality test.[2]

One way to describe the issue set forth above is whether, in the case of a security subject to an unconditional guarantee provided by an issuer with rated short-term debt outstanding, the

---

[1] In each case, the fund would still have to establish the minimal credit risk of the security independently, which, for purposes of this discussion, we assume has been made.

[2] However, we note that the charts prepared by Kenneth J. Berman and Eli A. Nathans of your office, which provide an overview of Rule 2a-7, treat securities subject to an unconditional demand feature as a rated security under the Rule.

ratings assigned to the guarantor are the ones that should be considered in performing the required analysis under Rule 2a-7 (i.e., they "replace" the ratings assigned to, or the unrated status of, the security) or instead if they are simply a factor to be taken under consideration.

In Case 1 and Case 2, since the security itself is unrated, the difference between the two alternatives is largely procedural. However, where the security itself is rated, resolution of this issue could be determinative for purposes of whether the security is eligible or first tier, as the case may be.

Thus, in Case 3 the security's ratings indicate it is a second tier security (i.e., one subject to the 5%/1% limit), even though had the issuer chosen to be rated by the third NRSRO, (or had chosen not to be rated by the "second tier" NRSRO) it would be considered first tier. The opposite is true in Case 4 -- the security's ratings would make it first tier, although the guarantor's would make it second tier.[3]

In both cases it seems that the Rule requires funds to look to the security's ratings, rather than the guarantor's, in performing the analysis. (Of course, the guarantor's ratings would still be relevant for purposes of the required minimal credit risk analysis.) However, in Case 5, subparagraph (c)(3)(i) seems to permit, though not require, use of the additional rating assigned to the guarantor. Again, it is not clear why demand instruments should be treated differently for these purposes.

In our view, whenever a security is purchased on the basis of credit substitution (as is permissible under paragraph (c)(3)(1)), the short-term ratings of the entity providing the credit substitution should be used to determine the security's status under the Rule, whether or not all of the rating agencies that have rated that entity have also rated the security in question. If a fund chooses to purchase a security without reference to a credit enhancement, the fund should document the basis for this determination (e.g., the obligor presents minimal credit risk and is of Eligible Quality without reference to the credit enhancement). Otherwise, it should be assumed that the

---

[3] However, it is our understanding that there are fund complexes that treat these securities differently so that in Case 3 the security is treated as first tier and in Case 4 the security is treated as second tier.

determination was made upon the basis of the quality of the entity providing the credit enhancement.

We appreciate the staff's consideration of this issue and would be pleased to respond to any questions.

Very truly yours,

Amy B.R. Lancellotta

Amy B.R. Lancellotta
Associate General Counsel