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RULE 3a-7
PUBLIC AVAILABILITY July 8, 1997

**RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT**

Our Ref. No. 97-75
Federated Investors, Inc.
File No. 811-699

Your letter of July 7, 1997 requests our assurance that we would not recommend enforcement action to the Commission if an issuer that does not register under the Investment Company Act of 1940 ("Investment Company Act") in reliance on the exception from the definition of investment company provided by Rule 3a-7 under that Act, purchases and holds in its "pre-funded account" shares of money market funds in the manner described in your letter.

Facts

You state that a "pre-funded account" is an account, established by an issuer of asset-backed securities, that holds highly rated, liquid, short-term investments under the control of an indenture trustee pending the purchase by the issuer of additional receivables, the cash flow of which would fund the asset-backed securities (the "pre-funding period").¹ You state that pre-funded accounts, which are prevalent in transactions in which the issuer securitizes receivables that are created on a regular and predictable basis, such as automobile loans and credit card receivables, allow sponsors to lock in financing and take advantage of market opportunities without waiting for all of the underlying receivables to be created.

You explain that in a pre-funded transaction, the issuer raises more cash from the sale of asset-backed securities than is needed to pay for the receivables that it purchases from the sponsor on the date that the securities are issued (the "closing date"). You state that the excess cash is deposited in a pre-funded account, and that the ratio of the amount deposited compared with the total offering proceeds varies depending on the size of the offering, the amount of receivables available to be purchased by the issuer on the closing date, interest rate expectations, and market demand for the securities. You state that the assets in the pre-funded account are used to purchase additional receivables that are substantially similar to those receivables purchased by the issuer on the closing date,² and that the sponsor determines the frequency of

¹You state that, as a general matter, these investments are not actively managed.

²You state that, when rating an asset-backed transaction with a pre-funded component, the rating agency considers the nature of the receivables being securitized, the sponsor's ability to generate the receivables on a timely basis, the sponsor, and the criteria of the underlying documents regarding the additional receivables to be purchased by the issuer during the pre-funding period. In addition, the rating agency, along with the underwriter and credit support provider (if any), examines the receivables acquired during the pre-funding period to ensure that the characteristics of these receivables are substantially similar to the characteristics of the receivables transferred on the closing date.

these purchases.³ Any assets remaining in the pre-funded account at the end of the pre-funding period will be paid to security holders as principal prepayments. You represent that pre-funded accounts generally are terminated no later than six months after the asset-backed securities are issued, although issuers that are structured as grantor trusts must terminate these accounts no later than 90 days after issuance in order to preserve their status as a trust for tax purposes.

You state that an indenture trustee selects appropriate investments for the pre-funded account from a list, previously approved by the rating agency rating the transaction, that is set forth in the issuer's governing documents.⁴ You further state that assets in pre-funded accounts typically are invested in money market instruments such as commercial paper. You maintain that permitting pre-funded accounts to invest in shares of money market funds would enhance investor protection by enabling the account to hold (1) a more diversified pool of assets, and (2) assets that are highly liquid and under continuous professional management.

Analysis

Rule 3a-7 excepts from the definition of investment company any issuer "who is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets and who does not issue redeemable securities (and in activities related or incidental thereto)," provided that certain conditions are met. Paragraph (b)(1) of the rule defines "eligible assets" as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders." Money market fund shares held in a pre-funded account are not eligible assets because (1) money market fund shares are common stock and thus do not convert into cash within a finite time period, and (2) such shares are held in a pre-funded account pending the purchase of additional receivables and are not designed to assure the servicing or timely distribution of cash flow from the receivables to security holders.

³You state that if interest rates decrease after the closing date, resulting in the origination of receivables with an interest rate lower than those receivables already purchased by the issuer, the sponsor would sell these receivables to the issuer at a discount and more receivables would be purchased by the issuer in order to support the interest rate on the asset-backed securities. However, if interest rates drop so dramatically that the sponsor is unable to provide sufficient receivables at the requisite interest rates, you state that security holders would be repaid their principal from the assets held in the pre-funded account.

⁴You state that the investments are selected in a manner designed to ensure that the investment return is both secure and sufficient to help fund the asset-backed securities' interest rate until additional receivables are purchased. You also state that typically in a pre-funded account, the sponsor will self-fund a capitalized interest account that would be used to help support the securities' interest rate, because the returns of the permitted investments by themselves are usually insufficient.

Any issuer relying on Rule 3a-7 must be engaged solely in the business of purchasing, or otherwise acquiring, and holding eligible assets and in activities related or incidental thereto.⁵ The "related or incidental" activities permitted by Rule 3a-7 include only those activities that support or further, and therefore are secondary to, the entity's business of purchasing, or otherwise acquiring, and holding eligible assets.⁶

You maintain that holding money market fund shares in a pre-funded account may be viewed as a secondary activity that supports the issuer's business of acquiring eligible assets (*i.e.*, the receivables), and thus such an activity meets the standard of "related or incidental thereto" for purposes of Rule 3a-7. You contend that any issuer that purchases and holds in its pre-funded account shares of money market funds may rely on Rule 3a-7 if the issuer obtains an opinion of counsel concluding that it may rely on Rule 3a-7 because the issuer is engaged solely in the business of acquiring and holding eligible assets.

Based on all the facts and representations contained in your letter, we agree that, under certain circumstances, holding assets in a pre-funded account could be viewed as a related or incidental activity for purposes of Rule 3a-7, provided that such an activity will support or further, and therefore be secondary to, the issuer's business of acquiring and holding eligible assets. In reaching this determination, factors to be considered include the length of the pre-funding period, the maturity date of the asset-backed securities issued, and the cash amount deposited in the pre-funded account compared with the total offering proceeds. This analysis would be the same regardless of whether the pre-funded account held money market fund shares or any other instrument that is not an eligible asset.⁷ Because of the factual nature of this determination, the staff will not express an opinion with respect to whether a particular issuer that holds assets that are not eligible assets in a pre-funded account is engaged in a related or incidental activity for purposes of Rule 3a-7.



Rochelle Kauffman Plesset
Senior Counsel

⁵See Investment Company Act Release No. 19105 (Nov. 19, 1992) (adopting Rule 3a-7); Investment Company Act Release No. 18736 (May 29, 1992) (proposing Rule 3a-7).

⁶Citicorp Securities, Inc. (pub. avail. Aug. 4, 1995) (no-action relief granted to an issuer that obtained an opinion of counsel that concluded that the issuer may rely on Rule 3a-7 because (1) the issuer will be engaged solely in the business of acquiring and holding eligible assets, and (2) the issuer's holding of assets that are not eligible assets is an activity related or incidental to that business).

⁷Determining whether assets held in a pre-funded account would constitute a related or incidental activity is necessary only when the assets are not eligible assets. Issuers with pre-funded accounts that hold only eligible assets meet the literal terms of Rule 3a-7.

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1940 Act
Section 3(a)
Rule 3a-7

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July 7, 1997

Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Attention: Office of Chief Counsel

Federated Investors, Inc.
1940 Act Section 3(a); Rule 3a-7

Ladies and Gentlemen:

On behalf of Federated Investors, Inc., we are writing in regard to issuers of asset-backed securities which do not register under the Investment Company Act of 1940 (the "1940 Act") in reliance on Rule 3a-7 thereunder. We hereby request that the Staff of the Division of Investment Management (the "Staff") confirm that under Rule 3a-7 such issuers may purchase and hold for their "pre-funded accounts" shares of registered investment companies which qualify as "money market funds" ("MMFs") under Rule 2a-7 under the circumstances described more fully below.

PRE-FUNDED ACCOUNTS

The Commission adopted Rule 3a-7 in 1992 to exclude structured financings meeting the rule's conditions from the definition of "investment company" under Section 3(a) of the 1940 Act. See Release No. IC-19105, 52 SEC Docket 2573 (November 19, 1992) (the "Issuing Release").

The adoption of the rule implemented the recommendation made in Chapter 1, "The Treatment of Structured Finance Under the Investment Company Act," of the Division of Investment Management's 1992 report, Protecting Investors: A Half Century of Investment Company Regulation (the "Report").

An important new development in the structured finance market is "pre-funding". In a pre-funded transaction, the issuer raises more cash in the offering than is needed to purchase the receivables it intends to purchase immediately. The remaining cash is placed in a "pre-funded account" under the control of the indenture trustee and is invested in highly rated, liquid short term investments pending the subsequent purchase by the issuer of other receivables during a limited pre-funding period. The additional assets must be of the same character as the initial assets and meet specific eligibility requirements.

Pre-funding is especially prevalent in the case of issuers which hold assets which are created on a regular and predictable basis, such as automobile loans and credit card receivables. The following is a more comprehensive discussion of pre-funding.

1. The Mechanics of the Pre-funded Account.

The sponsor and/or depositor ("sponsor") or one of its affiliates determines the total dollar amount of certificates which are to be issued by the issuer and the amount of receivables to be transferred to the issuer based on several variable factors. Such factors include: (a) the availability, on the date the securities are issued (the "Closing Date"), of receivables satisfying the characteristics required by the rating agencies, the underwriters and the insurers (or other credit support providers); (b) interest rate expectations; and (c) market demand.

On the Closing Date the sponsor transfers the receivables to the issuer in exchange for the securities. The securities are then sold to an underwriter for cash or to the securityholders directly if the securities are sold through a placement agent. The cash received by the sponsor from the securityholders (or the underwriter) from the sale of the securities issued by the issuer in excess of the purchase price for the receivables constitutes the cash to be deposited in the pre-funded account. Such funds are accounted for separately and are not part of the assets of the sponsor.

Generally, the receivables are transferred at par value, unless the interest rate payable by the receivables is not sufficient to service both the interest rates to be paid on the securities and the transaction fees (*i.e.*, servicing fees, trustee fees and fees to credit support providers). In such cases, the receivables are sold to the issuer at a discount, based on a formula agreed upon in advance by the parties. For example, if the securities issued by the issuer bear interest at ten percent (10%), and assuming no transaction fees, a \$100 receivable that is paying eight percent (8%) would be sold to the issuer at \$80 in order to achieve the required 10% pass-through rate. Alternatively, if there are a large number of such lower interest-paying receivables, the

receivables could be sold to the issuer each at par (\$100) and the securityholders would receive payments from one security representing \$80 of principal paying 10% interest, and the extra \$20 of principal would be offered by the issuer as a "principal only" strip security. The rating agencies do not generally require any particular formula for establishing the purchase price of the receivables, provided that the parties can demonstrate that the purchase price of the receivables can support the pass-through rate to be paid to the securityholders. The proceeds payable to the sponsor from the sale of the receivables transferred to the issuer may also be reduced to the extent they are used to pay transaction costs (which typically include underwriting or placement agent fees and legal and accounting fees). In addition, the sponsor may, in certain cases, be required by the rating agencies to set up trust reserve accounts to protect the securityholders against credit losses.

The pre-funded account is invested in certain permitted investments (as defined in the governing documents). The time period during which an issuer might invest pre-funded accounts in MMFs is usually restricted by economic and tax factors and by the underlying documents. As a practical matter, the rating agencies require that the pre-funding period end after no more than six months, and the underlying documents usually require that the pre-funded account end after six months.¹

¹ It is our understanding that most structured financings (other than credit card receivable transactions) which meet the terms of Rule 3a-7 have qualified as grantor trusts for purposes of federal taxation. Grantor trusts are trusts organized under state law which qualify for pass-through taxation pursuant to Internal Revenue Code Section 671. Under Internal Revenue Service regulations set forth at 26 C.F.R. 301.7701-4(c) and rulings issued thereunder, a trust generally cannot make new investments after 90 days have elapsed since the inception of the trust without losing its status as a trust for tax purposes and the accompanying exemption from tax at the entity level. Such an event would be catastrophic for an asset-backed trust. Therefore, the documentation for a grantor trust with a pre-funded account provides that the balance of the account must be either securitized or returned to the security holders on a pro rata basis within this 90-day period. Accordingly, the pre-funded account of a grantor trust exists for a maximum period of 90 days.

Structured financings backed by credit card receivables generally are also organized as trusts under state law but are not trusts for tax purposes. Due to the "revolving" rather than "term" nature of credit debt, individual credit card holders are constantly repaying and reborrowing. Since purchasers of asset-backed securities require a reasonably predictable amortization schedule, the issuer must be able to acquire additional receivables (which meet defined criteria) to minimize pre-payments of the asset-backed securities. This limited power to vary prevents grantor trust status. Such issuers generally qualify for pass-through taxation as partnerships under subchapter K of the Internal Revenue Code. For a general discussion of these issues, see Peaslee, "Investment Trusts in the Age of Financial Derivatives", Tax Law Review,

During the pre-funding period, the sponsor determines how frequently the receivables are to be sold to the issuer for cash. Usually the transfers are made on a periodic basis as sufficient numbers of receivables become available to make it administratively convenient to transfer them. Any amounts paid out of the pre-funded account are used solely to purchase receivables and to support the pass-through rate (as explained above). However, in the event that, after all of the requisite receivables have been transferred to the issuer, any funds remain in the pre-funded account, such funds will be paid to the certificateholders as principal repayments.

2. Percentage of Pre-Funding.

The percentage or ratio of the amount allocated to the pre-funded account, as compared to the total offering proceeds, of issuers has usually varied from 10% to 40%, with 25% typically used. The pre-funding percentage is a function of both the size of the offering desired and the assets which are available at the time of the offering. In addition, predictions as to the rise or fall of interest rates can affect the decision as to what ratio of pre-funding is to be utilized. An expectation of higher interest rates encourages the use of pre-funding because the parties will want to issue as many certificates as possible at the current rate, rather than issue higher rate certificates in the future. Also, a high market demand encourages pre-funding in order to effectuate the transactions. There is no optimal percentage. However, the advantages for the sponsor of pre-funding must be weighed against the cost to such sponsor of funding a capitalized interest account to subsidize the interest rate on the expected gap between the pass-through rate on the securities and the return on the receivables transferred to the issuer on the Closing Date. This is a cost factor for the sponsor because the permitted investments for funds in the pre-funded account and capitalized interest account produce a lower rate of return than interest accruing on the securities.

Spring, 1994, p. 419.

In recognition of the practical difficulties posed by the grantor trust and partnership formats, Congress established a new type of tax pass-through vehicle, a "Financial Asset Securitization Investment Trust," or FASIT in the Small Business Job Protection Act passed on August 2, 1996. If an issuer satisfies the structural and operational tests provided by new Internal Revenue Code section 860L, then the issuer is not subject to income taxation, and items of income, deduction, loss and tax credit flow through to the investors pursuant to new Internal Revenue Code section 860H. One of the operational tests in the definition of a FASIT is that the issuer must invest substantially all of its assets in "permitted assets" as of the close of the third month after the day of its formation and at all times thereafter. One of the types of asset included in the definition of permitted assets is "cash equivalents," which includes MMFs. Internal Revenue Code Section 860L(c)(1)(A). Therefore, in contrast to grantor trusts, there are no tax considerations which limit the time FASITs can maintain pre-funded accounts if the account is invested in cash equivalents.

3. Changes in Interest Rates During Pre-Funding Period.

A dramatic change in interest rates which adversely affected the rates of return on the receivables held by an issuer using a pre-funded account with a ninety-day pre-funded period would be handled as follows. If the receivables had already been originated prior to the closing date, no action would be required as the fluctuations in market interest rates would not affect the receivables transferred to the issuer after the closing date. In contrast, if interest rates fall after the closing date, receivables originated after the closing date will tend to be originated at lower rates, with the possible result that the receivables will not support the pass-through rate. In such situations, the sponsor would sell the receivables to the issuer at a discount (as described in Item (1) above) and more receivables will be used to fund the issuer in order to support the pass-through rate. In a situation where interest rates drop dramatically and the sponsor is unable to provide sufficient receivables at the requisite interest rates, the pool would be closed. In this latter event, under the terms of the pooling and servicing agreement, the securityholders would get a repayment of principal from the unused cash held in the pre-funded account. In transactions where the pass-through rates are variable or adjustable, the effects of market interest rate fluctuations are mitigated. In no event will fluctuations in interest rates payable on the receivables affect the pass-through rate paid to securityholders.

As described in Item 5 below, the rating agency, the underwriter and any insurer or other credit support provider each have requirements with respect to the characteristics of the receivables to be transferred after the closing date. In addition, such parties may require the establishment of yield supplement arrangements and capitalized interest accounts. Both of these control mechanisms directly or indirectly mitigate the effect of receivable interest rate fluctuations. However, it is the sponsor who is directly obligated under the pooling and servicing agreement to take whatever actions are necessary to maintain the pass-through rate in the event of interest rate fluctuations. The sponsor has the responsibility to transfer the appropriate receivables to the issuer to support the pass-through rate. The rating agencies, underwriters, insurers or other credit support providers, servicers or trustees are not concerned about how this is accomplished, as long as the end result is that the receivables held by the issuer are able to support such pass-through rate.

4. Maintenance of the Pre-funded and Capitalized Interest Accounts.

The pre-funded and capitalized interest accounts and all other cash accounts maintained by the issuer are either kept in separate sub-accounts or are invested on a commingled basis. Where the accounts are invested on a commingled basis, precise accounting records are kept by an independent, substantial, institutional trustee in order to assure that, at all times, the assets which belong to each account can be identified and that the investment income is properly credited. The pooling and servicing agreement sets forth each account to be established, states in very specific terms what cash is to go into each account, when moneys are to be paid out and when, and in what circumstances, moneys can be transferred from or to an account. The pooling

and servicing agreement also specifies the permitted investments for the cash held in these accounts.

The sponsor must fund the capitalized interest account. Funds are paid out periodically to the securityholders as needed on distribution dates to support the pass-through rate. In addition, a portion of such funds may be returned to the sponsor from time to time as the receivables are transferred to the issuer and the need for the capitalized interest account diminishes. As the sponsor has the economic burden of maintaining this account, it will sometimes negotiate with the rating agencies to allow a return of funds to the sponsor as the receivables are purchased and the funds are no longer needed. In other cases, the rating agencies may insist on maintenance of the capitalized interest account until the end of the pre-funding period.

5. Characteristics of Receivables Transferred after the Closing Date.

We understand that investors place a particularly strong reliance on the rating agency review because of the complexities of structured finance offerings. In rating an offering with a pre-funded component, the rating agencies consider the nature of the receivables, the sponsor's ability to generate the receivables on a timely basis, the sponsor, and the criteria of the underlying documents regarding additional assets.

The characteristics of the receivables transferred to the issuer after the Closing Date are substantially similar to the characteristics of those transferred on the closing date and have such characteristics as are necessary to satisfy the requirements of the rating agency, the underwriter and the insurer or other credit support provider. All of these parties examine the receivables acquired during the pre-funding period to ascertain if their characteristics are in fact substantially similar to those acquired on the closing date (based on their own criteria which may be different from each other). The factors which may be considered include the following: the range of interest rates payable on the receivables and the weighted average interest rate of such receivables; the range of the remaining term to maturity of the receivables and the weighted average of such terms; a "seasoning factor" indicating how long the receivable has been outstanding (which indicates the payment history of the debtor); the loan-to-value ratios of the receivables compared to the loan collateral; a debt service coverage ratio indicating the size of the receivable as a percentage of the borrower's monthly expenses; the geographic dispersment and concentration of the receivables; the average balance outstanding; the type of collateral and the maximum and minimum rates of variable rate receivables. Not all of the above factors are necessarily relevant to every asset type.

The emphasis on specific factors varies from transaction to transaction and may vary significantly for different types of receivable pools. For example, in automobile transactions, the loan-to-value ratios are not considered to be that significant, but for mortgage transactions, the loan-to-value ratios generally are considered quite important.

Compliance with the requirements established by the rating agencies, insurers or other credit support providers and underwriters are monitored by such parties and the sponsor's accountants. For example, the rating agencies typically review a tape setting forth the specific characteristics of the receivables to be transferred for compliance with the required criteria, and actual loan files may be spot-checked against the tape, especially for new sponsors who do not have an established performance record. Non-conforming receivables are rejected.

6. Insurer and Credit Support Provider's Right to Veto Receivables.

In certain transactions, the insurer and/or other credit support provider may have the right to veto specific receivables. This right usually takes the form of a requirement that the sponsor obtain the consent of these parties before the receivables can be transferred to the issuer. The insurer and/or credit support provider may, therefore, reject certain receivables or require that the sponsor establish certain reserve accounts as a condition of including the receivables. Virtually all issuers which have insurers or other credit support providers are structured to give such veto rights to these parties. The percentage of issuers that have insurers and/or credit support providers, and accordingly feature such veto rights, varies but we believe that a majority of transactions have some kind of credit support.

7. Permitted Investments in the Pre-funded and Capitalized Interest Accounts.

The permitted types of investments in the pre-funded account and capitalized interest account are highly rated, conservative investments as set forth in the pooling and servicing agreement and as required by the rating agencies. The investments are selected in a manner designed to insure that the return is both secure and sufficient, when combined with the amount contributed to the capitalized interest account, to fund the pass-through rate. In the unlikely event that any of these conservative investments failed to pay interest and principal at maturity, the loss would be distributed pro-rata to the securityholders in the same manner as if one of the issuer's permanent investments failed.

Investment decisions for the pre-funded account are usually made by the indenture trustee. We understand from speaking to industry participants that indenture trustees do not normally actively manage the investments of the pre-funded account. Indenture trustees tend to invest the pre-funded account at the closing of the offering for the duration of the pre-funded period according to the anticipated dates for future transfers of receivables paid for out of the pre-funded account. Any amounts in the pre-funded account which are not used to purchase additional assets must be returned to the securityholders at the end of the pre-funding period. While the issuer is often over-collateralized in some manner to provide for some default on the assets it owns, the pre-funded account is not subject to a separate over-collateralization requirement.

8. Benefits of Pre-Funding.

Pre-funding has benefits to both sponsors and investors in that it reduces the high transaction costs of securitization by spreading them over a broader base. It benefits sponsors by allowing them to lock in funding and to take timely advantage of market opportunities. It benefits investors by allowing them to purchase fixed income investments they believe are attractive for their portfolio without waiting for all of the underlying assets to be created.

An investor must consider whether the sponsor can originate sufficient additional assets during the pre-funded period for the issuer to purchase. A failure to do so results in a prepayment to the security holders of the amounts remaining in the pre-funded account, with a probable decrease in the duration and yield of the securities. We understand that the standard practice is to disclose these risks in the prospectus.²

Sponsors seeking regular access to the structured finance market have strong incentives to make sure that amounts in the pre-funded account are successfully invested in additional assets. There would be serious negative long term market consequences to a sponsor if (i) cash in the pre-funded account was returned to securityholders or (ii) the issuer purchased additional assets which did not meet the expectations of securityholders, even if the assets complied with the terms of the governing documents. An issuer's ability to sell securities with a pre-funded component is dependent on the market's confidence that the issuer will successfully complete the pre-funding. To the extent that the market's confidence waned in a particular issuer's ability to successfully utilize pre-funded amounts, the pricing of the securities would reflect that concern.

Issuers regularly invest servicing accounts in MMFs but are reluctant to do so with pre-funded accounts due to regulatory uncertainty. As a result, pre-funded accounts are being invested directly in money market instruments such as commercial paper. We understand that the Staff has concerns about issuers exempt from the 1940 Act investing a sizeable percentage of their assets in registered investment companies for other than short-term cash management purposes, thereby avoiding registration under the 1940 Act even though the underlying

² For example, see Registration Statement No.333-07249, August 12, 1996 for The CIT RV Trust 1996-B in which the issuer sought to sell securities with a face value of \$240,000,000. The initial assets had a value of approximately \$164,000,000, with the balance of the remaining \$76,000,000 to be held in a pre-funded account for a maximum of 90 days. The risk factors segment of the prospectus had an extensive discussion of the risk of pre-payment if (i) the sponsor did not generate sufficient assets which met the eligibility criteria of the issuer within the pre-funding period or (ii) if a rating agency, after receiving prior notice of the issuer's intention to purchase certain additional assets pursuant to the governing documents, advised the issuer of its intention to modify its rating of the issuer's outstanding securities.

investments may be similar to those of a registered investment company. However, we believe these investments are permitted under Rule 3a-7 and that the Staff could adequately address its concerns in a way other than a de-facto prohibition.

If MMF investments are permitted for the servicing account, they should logically be permitted for other short-term cash management purposes. The use of MMFs allows diversification, continuous professional management, enhanced liquidity and lower costs in an entity regulated by the Commission under the 1940 Act. Prohibiting such use results in credit concentrations, management only at the time the investment is made rather than the continuous professional management of a mutual fund, liquidity which is dependent solely on the market for the securities held by the issuer, and lower returns, while depriving investors of the safeguards of the 1940 Act. This raises issuance costs and diminishes investor protection. Moreover, pre-funded accounts may in many cases be invested in the commercial paper of a single issuer, or at best a few issuers, resulting in possibly unsound credit concentrations. It seems somewhat illogical to restrict the use of MMFs in circumstances for which they are the ideal short-term money management vehicle.

BASIS FOR THE NO-ACTION REQUEST

Rule 3a-7 excludes certain issuers engaged in the business of acquiring and holding "eligible assets" from the definition of "investment company" under the 1940 Act. In drafting the rule, the Commission was careful to include certain provisions to advance its goal of allowing the rule to accommodate developments in the markets. At the same time, these provisions were carefully crafted to allow the Commission the opportunity to consider such developments in light of the intent of the rule and to act accordingly. For example, in the Issuing Release, the Commission stated that:

"Although the definition of eligible assets is intended to be broad, it is impossible to devise a definition of eligible assets that will include all types of assets that can be securitized. Accordingly, issuers, or other parties on their behalf, may request that the Division of Investment Management take a no-action position with respect to the holding of specified assets that do not meet the definition of "eligible assets," provided such assets meet the intent of the definition." 52 SEC Docket at 2576, fn. 17.

We are of the opinion that investment of the pre-funded account by an issuer in MMFs is permissible under Rule 3a-7 and respectfully request the Staff's written concurrence in the opinion set forth herein. We recognize that given the intent of the rule, the Staff's concurrence might be contingent on limitations as to the amount of the pre-funding and the length of the pre-funding period.

Rule 3a-7(a) is available to "any issuer who is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets... (and in activities related or incidental thereto)." [underlining added]. The underlined language was not in the Proposing Release but was added by the Issuing Release to make sure that issuers were not subject to unduly narrow restrictions on the scope of their activities. The Issuing Release states that the purpose of this added language was to provide flexibility to issuers. In Citicorp Securities Inc., (SEC April 6, 1995) the Staff provided further guidance when it stated that "[I]t is the Division's view that the 'related or incidental activities' permitted by Rule 3a-7 include only those activities that support or further, and therefore are secondary to, the entity's business of purchasing, or otherwise acquiring, and holding eligible assets." In meeting this standard, the staff relied on the opinion of counsel to the issuer that (i) the issuer was engaged solely in the business of acquiring and holding eligible assets and (ii) the related activity was an activity related to or incidental to that business.

We are of the opinion that the investing of pre-funded accounts in MMFs during the pre-funded period is a secondary activity which supports an issuer's primary activity of acquiring and holding eligible assets and that such activity meets the standard of "related to or incidental thereto" set forth in Rule 3a-7. Whether or not a particular issuer is engaged solely in the business of acquiring and holding eligible assets should be covered by an opinion issued by counsel to a particular issuer.

Pursuant to Release No. 33-6269, seven additional copies of this letter are enclosed. Please do not hesitate to contact the undersigned or Stephen Burger of this office (212-732-3200) if you require any further information concerning the matter addressed in this letter.

Sincerely,


Bernard J. Karol

BJK:slf

cc: Eugene F. Maloney, Esq.