Dear Mr. Cimmet:

Reference is made to our letter to you of March 23, 1979 in which we requested advice on behalf of The Adams Express Company ("Adams") as to whether a so-called "standby" letter of credit, issued under the circumstances described in said letter, could be used to collateralize a securities loan by a registered investment company in compliance with Section 17(f) of the Investment Company Act of 1940 ("1940 Act") and Rule 17f-2 thereunder. In a subsequent telephone conversation, you indicated that the staff of the Securities and Exchange Commission ("Commission") would appreciate certain additional information in respect of
standby letters of credit. The following is provided as supplemental information in response to this request:

1. "Honoring" Demands For Payment Under a Letter of Credit

You have inquired as to the time it might take for the beneficiary of a letter of credit to collect cash following a demand for payment thereunder. The time within which a bank issuer must "honor" a draft or demand for payment presented under a letter of credit is prescribed by § 5-112(1) of the Uniform Commercial Code ("UCC") and Art. 8(d) of the Uniform Customs and Practice for Documentary Credits, 1974 Revision ("UCP"). Pursuant to UCC § 5-112(1), an issuing bank is permitted to defer honor until the close of the third banking day following receipt of the documentation required by the letter of credit although the presenter may consent to a further extension of time. The Official Comment to § 5-112(1) indicates that this period may be necessary to fulfill the issuer's obligation under UCC § 5-109(2) to examine documents with "care" so as to ascertain whether "on their face" they comply with the terms of the letter of credit.

"Honor" is defined by UCC § 1-201(21) as "to pay or to accept and pay . . . ." Thus the beneficiary is entitled to realize the cash to which he is entitled no later than three business days after making a complying presenta-
tion. Pursuant to UCC § 5-112(1), a bank's failure to honor a complying presentation within the specified time constitutes dishonor of the draft or demand and of the letter of credit, giving rise to the beneficiary's right under UCC § 5-115(1) to recover from the issuer the face amount of the draft or demand together with any incidental damages.

Pursuant to Art. 7 of the UCP, an issuing bank must examine all documents with "reasonable care" to ascertain that they appear on their face to be in accordance with the terms and conditions of the letter of credit. UCP Art. 8(d) provides that the issuer shall have a "reasonable time" to examine the documents received by it and to determine, as provided in Art. 8(c), whether to claim that the demand for payment was not effected in accordance with the terms and conditions of the letter of credit. Notice of such a claim, stating the reasons therefor, must be given without delay. UCP Art. 8(e). What constitutes a "reasonable time" for the documentary examination is not specified. Under both the UCC and UCP, however, the parties could agree to a specific time period within which the issuer must determine whether to honor a draft or demand for payment. We have been advised that a letter of credit could be issued with a provision that it be honored on the same day as a presentation of the required documentation.
as well as a provision that payment be made in federal or "same-day" funds. Thus, the beneficiary could effectively convert a letter of credit into cash on the same day as a complying demand for payment, presumably subject to the issuer's duty of careful examination of the documents.

It is important to emphasize that, as indicated in our prior correspondence, the issuer's obligation to the beneficiary under a letter of credit is an absolute obligation to the beneficiary wholly independent from the beneficiary's underlying transaction with the customer. Accordingly, under both the UCC and the UCP an issuer must honor a draft or demand for payment upon a complying presentation without regard to any questions of such parties' performance of their respective obligations pursuant to their underlying contract or arrangement. In the case of a standby letter of credit, the required presentation typically consists of no more than the beneficiary's sight draft and certification of the customer's default in his obligations to the beneficiary. As observed in one recent legal commentary, "The most significant commercial feature of the standby letter of credit is that it represents the issuer's promise to pay on little or nothing more than the beneficiary's certification of default." Jarvis, "Standby

2. "Establishment" of a Letter of Credit

You have also inquired as to when a letter of credit is "established" as to the respective parties. Pursuant to UCC § 5-106, unless otherwise agreed to, an irrevocable letter of credit is established as regards the customer as soon as the letter of credit is "sent" to him or the letter of credit or an authorized written advice of its issuance is sent to the beneficiary; thereafter the letter of credit cannot be modified or revoked without the customer's consent. The letter of credit is established as to the beneficiary when he "receives" the letter of credit or an authorized written advice of the issuance thereof; thereafter it can only be modified or revoked with the beneficiary's consent. Thus, the beneficiary cannot rely on the letter of credit as against the issuer until he receives it, although this would not affect the beneficiary's right to protest its cancellation or modification as against the customer if its issuance and the terms thereof were agreed to in an underlying contract. The primary legal consequence of establishment of a letter of credit is that thereafter the issuer can no longer take unilateral action to cancel it or modify its terms.
The UCP does not specifically regulate the point of "establishment" of a letter of credit but, as with virtually all terms and conditions of a letter of credit, the parties can agree as to the terms of its establishment.

3. Status of a Beneficiary Against an Insolvent Issuer

Further, you have inquired as to the status of a letter of credit as a liability of the issuing bank, specifically in the event of the bank's insolvency. The status of a beneficiary holding an outstanding letter of credit of an insolvent issuer will depend on a number of circumstances including applicable law governing the letter of credit and the issuer's insolvency, the particular terms and conditions of the letter of credit, and the stage in the time frame of the transaction in which the insolvency occurs. Thus, it is not practicable to determine in advance Adams' status as a beneficiary of a letter of credit with respect to the categories of creditors whose claims against the issuing bank's assets must be allocated within the traditional bankruptcy categories of secured, priority and general creditors.

There are, however, certain legal principles which apply in general to letter of credit transactions upon the insolvency of an issuing bank. The UCC prescribes rules for situations where the issuer becomes insolvent before
final payment has been made under a letter of credit if funds or collateral to secure or meet the issuer's obligations under the letter of credit have been received either before or after the insolvency. Pursuant to § 5-117(1)(a), drafts or demands for payment are entitled to payment in preference over depositors or other general creditors of the issuer with respect to funds or collateral furnished by the customer to the issuing bank specifically as indemnity against, or for the purpose of payment of, drafts or demands for payment drawn under the letter of credit.

UCC § 5-117(1)(c) also provides that a charge to a general or current account maintained by the customer for the purpose of so securing or indemnifying the bank's payment obligations will be subject to the same rule of preference.

The UCP makes no specific reference to the status of an outstanding letter of credit upon an issuer's insolvency. The rules of preference codified in UCC § 5-117, however, are supported by pre-Code case law, indicating that such principles might be applied under appropriate circumstances even in instances where the UCC was not applicable. See e.g. William H. Shawmut Corp. v. Bobrick Sales Corp., 260 N.Y. 499, 184 N.E. 68 (1933), aff'd 235 App. Div. 665, 255 N.Y.S. 841 (1st Dep't 1932).

Whether or not a bank will require its customer
to provide any prepayment or security in connection with issuance of a standby letter of credit depends on a variety of factors, including the prior banking relationship, if any, between the bank and the customer and the bank's evaluation of the credit risks involved in the loan of its credit. In a sale transaction in which payment by the issuer in the ordinary course of the transaction is expected, arrangements for prepayments or segregating funds to secure reimbursement of the issuer for amounts drawn down under the letter of credit may be more common than in transactions involving a standby letter of credit, which contemplate payment only upon the customer's non-performance or default in its underlying obligations to the beneficiary.

Absent circumstances which would give rise to a beneficiary's right to status as a preferred or even a secured creditor of an issuing bank, authorities indicate that a beneficiary is generally considered to rank as a general creditor with depositors, including holders of certificates of deposit, and would share ratably with such general creditors in the distribution of assets of the insolvent bank. H. Harfield, Bank Credits and Acceptances 257 (5th Ed. 1974); B. Kozolchcyk, Commercial Letters of Credit in the Americas 331 (1966); 5B Michie, Banks and Banking, § 313, at 234-36 (rev. ed. 1973 & Supp. 1979).
A letter of credit is not, however, reflected as a liability on the balance sheet of the issuing bank, nor is the customer's obligation to reimburse the bank treated as an asset. Generally, letters of credit are treated as "contingent liabilities", like other executory contracts, although pursuant to applicable banking regulation the total amounts of letters of credit outstanding must be adequately disclosed in the bank's published financial statements. The fact that letters of credit are not carried as a liability on the balance sheet of a bank does not, however, preclude the beneficiary from asserting a claim to share ratably in the assets of an insolvent bank. There is an almost total absence of case law concerning the status of a beneficiary under a standby letter of credit upon the issuing bank's insolvency. In one recent decision, however, the United States Court of Appeals for the Ninth Circuit held that claims of creditors based on standby letters of credit issued by a national bank prior to its insolvency were provable as contingent contract obligations in the national bank's receivership and, thus, the beneficiaries were entitled to share ratably with other general creditors in the distribution of the bank's assets. First Empire Bank v. Federal Deposit Insurance Corp., 572 F.2d 1361 (9th Cir. 1978), cert. denied, 99 S. Ct. 293 (1979). In First
Empire, a central concern was whether a standby letter of credit was a contingent claim which was of a worth or amount which could be determined "by recognized methods of computation at a time consistent with the expeditious settlement of estates." *Id.* at 1369. In that case, the customers had defaulted on their underlying obligations by the time the action against the bank's receiver was filed and prior to any distribution of assets. Because the claims were based on letters of credit which were in existence before the insolvency and were not dependent on any new contractual obligations arising later, the court held that the bank's liability on the standby letters of credit was absolute and certain in amount, and under applicable equitable principles the letters of credit were provable in their face amount.

As a practical matter, under the terms of the proposed letter of credit described in our prior correspondence, a claim based on a letter of credit would be a provable contingent liability under the principles relied upon in the First Empire case. Adams would be authorized to terminate the loan or require a substitution consisting of cash or government securities as collateral if there has been, or events have occurred which may reasonably be expected to result in, a material adverse change in the financial condition of the issuer. Thus, even assuming that Adams had not made a demand for payment under a letter
of credit until public announcement of the issuing bank's insolvency, it could immediately terminate the loan and recall the loaned securities or require a substitution of collateral. If the borrower defaulted at this time Adams then could demand payment and, thus, have a provable contingent claim against the bank if its demand was not timely honored.

In addition, since the underlying transaction between the beneficiary and the customer is independent of the issuer's obligation to the customer, Adams still would have recourse against the customer if its claim was not satisfied due to the issuer's insolvency. See UCC §§ 5-115 and 2-325(2). This right is only lost if the customer and beneficiary have agreed that the letter of credit will serve as the absolute source of payment. See e.g. Greenough v. Munroe, 53 F.2d 362 (2nd Cir. 1931); H. Harfield, Bank Credits and Acceptances 244 (5th ed. 1974).

4. Possible Conflict of Interest of Issuer

As a final matter, you noted that our prior correspondence indicated that if the Commission responded favorably to use of letters of credit as collateral, Adams would consider accepting a letter of credit issued by its present bank custodian. In this regard, you inquired whether consideration had been given to any possible conflicts of interest which might arise from the custodian
performing in both capacities.

The fact that a particular bank serves as Adams' custodian in accordance with the provisions of Section 17(f) of the 1940 Act does not, of course, preclude such bank from performing other banking services for Adams and the proposed arrangements described in our prior correspondence regarding issuance of a letter of credit to Adams would not contravene the provisions of Section 17(d) of the 1940 Act or the rules and regulations thereunder. Nor does there appear to be any potential inconsistency between the bank's fiduciary duties and its professional responsibilities as custodian for Adams and its serving as an issuer of a letter of credit held by Adams as collateral for a securities loan. In fact, Adams' present custodian also serves as its transfer agent and registrar and as the agent for its automatic dividend reinvestment plan, and in the past has performed various other banking services for Adams. Further, under the standby letter of credit Adams is merely the beneficiary of such letter and the issuing bank is primarily concerned with the financial position of its customer and the customer's ability to reimburse it for authorized payments made to the beneficiary. Therefore, the bank is performing a service not for Adams, but for its customer who has requested issuance of the letter of credit and it is difficult for us to construct
any potential conflict of interest in this arrangement. If you desire any further information or if we can be helpful in any other way, please contact the undersigned or Robert A. Howes of this office.

Very truly yours,

Mary Ellen Pindyck

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Based on the facts and representations in your letters of March 23, 1979 and July 13, 1979, we will not recommend any enforcement action to the Commission under section 17(f) of the Investment Company Act of 1940 and rule 17f-2 thereunder if The Adams Express Company (Fund) accepts irrevocable standby letters of credit as collateral for the loan of the Fund's portfolio securities under the terms and in the manner described by you.

Stanley B. Judd
Assistant Chief Counsel

Our Ref. No. 79-105-CC
The Adams Express Company
File No. 811-2624
March 23, 1979

Investment Company Act of 1940/Section 17(f); Rule 17f-2

Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Attention: Sidney L. Cimmet, Esq.
Chief Counsel
Division of Investment Management

Re: The Adams Express Company
File No. 811-2624

Dear Mr. Cimmet:

We are counsel to The Adams Express Company ("Adams"), a closed-end investment company registered under the Investment Company Act of 1940 ("1940 Act"), and as such are writing to you on its behalf to seek an interpretation of the guidelines ("Guidelines") prescribed by the staff of the Securities and Exchange Commission ("Commission") governing the lending of portfolio securities by investment companies registered under the 1940 Act.
Specifically, our inquiry concerns Guideline (1) which, as originally enunciated by the staff, required that the lender receive from the borrower 100% cash collateral equal to the full market value of the securities loaned. State Street Bank and Trust Co. (Available January 29, 1972 and September 29, 1972). In response to subsequent inquiries regarding the use of forms of non-cash collateral either partially or wholly in lieu of cash, which were considered as essentially "cash equivalents" or providing "maximum liquidity", the staff indicated that it would not object to the use of certain alternative forms of collateral. As presently interpreted by the staff, Guideline (1) permits an investment company to accept securities issued or guaranteed by the U.S. Government or its agencies as the sole collateral for a securities loan providing all other Guidelines concerning collateral are met. Lionel D. Edie Capital Fund, Inc. (Available May 15, 1975); Salomon Brothers (May 4, 1975); Standard Shares, Inc. (Available August 24, 1974).

Adams has from time to time entered into various securities loan agreements in compliance with each of the Guidelines as then interpreted by the staff, including arrangements pursuant to which U.S. Government and agency securities have been accepted as the exclusive se-
curity for the loan. We have been advised by the management of Adams of the following:

Recently certain of Adams' major institutional borrowers have proposed that Adams enter into a form of securities loan agreement ("Proposed Agreement") which would authorize the borrower to collateralize the loan with a letter of credit, either in lieu of or in combination with cash and/or government securities. Specifically, it has been proposed that the borrower would arrange for issuance of an irrevocable, non-negotiable letter of credit in a form acceptable to Adams by any bank of Adams' choice. Adams' present bank custodian has indicated that it would issue such a letter of credit which would be drawn for the account of the brokerage firm in a face amount at least equal to 102% of the aggregate current market value of the outstanding securities on loan to that firm.

Under the terms of the proposed letter of credit, Adams would be authorized to draw down the full face amount, or any portion thereof, at any time by presenting its sight
draft accompanied by an affidavit certifying (i) that the borrower is in default of its obligations under the terms and conditions of the underlying securities loan agreement thereby entitling Adams to apply collateral to cure the default (e.g., to purchase replacement securities if the borrower has failed to return the loaned securities in accordance with the terms of the underlying agreement); and (ii) that the amount being drawn down represents the current market value of the outstanding loaned securities on the date thereof or the amount required to cure any other borrower default (e.g., nonpayment of the loan premium when due or dividends and interest accruing on the loaned securities).

The date of expiration of the proposed letter of credit will be mutually agreed upon by Adams and the borrower and it is anticipated that initially the term will be six months.

The proposed letter of credit would also authorize Adams to draw down on the day immediately preceding its expiration date an amount equal to the current market value of all outstanding loaned securities on that date by presenting
its sight draft accompanied by an affidavit certifying as to such market value; provided, however, that pursuant to the Proposed Agreement, Adams would agree not to present such sight draft if any of the following conditions are met: (i) the borrower has arranged for issuance of a new letter of credit in a form and amount, and by a bank, acceptable to Adams, commencing concurrently with maturation of the expiring letter of credit; (ii) the parties have mutually agreed upon, and have obtained the bank’s consent to, an extension of the expiring letter of credit; (iii) the borrower has deposited alternative forms of collateral permitted by the Proposed Agreement (i.e., cash and government securities) in substitution for the expiring letter credit; or (iv) the loan has been terminated and all loaned securities have been returned. Thus unless arrangements have been made to "roll-over" or extend the expiring letter of credit or to replace it with substitute collateral, Adams would be entitled to draw down an amount equal to the market value of the outstanding loaned securities and hold
the cash as collateral or apply it in accordance with the terms of the Proposed Agreement.

For purposes of complying with the requirement of Guideline (2) that collateral be adjusted to reflect changes in the market value of the loaned securities, the Proposed Agreement would provide that in marking to market (which is done on a daily basis by Adams) any increases in the amount of collateral needed to cover fluctuations in the market value of the loaned securities could be satisfied by the deposit of cash or government securities. Any increase in the amount of collateral required of a more permanent nature, however, resulting from an increase in either the amount or market value of securities on loan may, with the lender's consent, be satisfied by amendment of the letter of credit increasing its face amount or by issuance of an additional letter of credit. Under the terms of the Proposed Agreement, the value of the collateral at all times must be equal to at least 102% of the market value of all outstanding loaned securities, but only cash or government securities, if any, may be withdrawn as collateral at the
borrower's option if the value of the collateral at any given time exceeds 104% of the value of the outstanding loaned securities. Thus, after a letter of credit has been issued, its face amount would not be adjusted prior to maturation to reflect marking to market decreases. The borrower and the lender, however, by mutual consent may agree at any time that a letter of credit be cancelled and reissued in a different face amount or with different terms and conditions specified therein, provided that the foregoing are in compliance with the relevant provisions of the Proposed Agreement.

A basic understanding of the concept and mechanics of a letter of credit is essential to evaluate whether it is an acceptable form of collateral for securities loans by registered investment companies. In its most basic form, a letter of credit is a commitment by a bank or other entity (the "issuer") in accordance with the instructions and for the account of the applicant (the "customer") which is issued in favor of a third party (the "beneficiary") whereby the issuer is obligated for a specific time period to make payment to or to pay drafts drawn by the beneficiary upon presentation of stipulated documents, provided the terms and conditions of the letter of credit have been complied with.
Typically three distinct agreements are involved in a transaction involving a letter of credit: (i) the underlying agreement between the customer and the beneficiary; (ii) the agreement between the issuer and its customer setting forth the terms and conditions under which the issuer agrees to issue the letter of credit and the arrangements governing the customer's obligation to reimburse the issuer for payments to the beneficiary; and (iii) the letter of credit itself, which is an agreement between the issuer and the beneficiary entirely separate and independent of the agreements described in clauses (i) and (ii).

Because the letter of credit is an independent contract, the issuer's obligation is considered to be absolute assuming compliance with the terms of the letter of credit, and the ultimate risk in such transactions resides with the issuing bank who must accurately assess the financial ability of its customer to reimburse the issuer for authorized payments made to the beneficiary. For assuming such risk, the issuer typically charges a fee to the customer which is a percentage of the face amount of the letter of credit and is based on its duration and the risks involved.

The legal principles governing a letter of credit have been codified in Article V of the Uniform Commercial Code ("UCC") and in the Uniform Customs and Practice for
Documentary Credits, 1974 Revision ("UCP").* The only formal requirements for the creation of a valid letter of credit under the UCC are that the credit (i.e., the issuer's "engagement" to honor the beneficiary's demands for payment upon specified terms) be in writing and signed by the issuer (UCC § 5-104(1)). Thus the terms of the credit are left almost entirely to the parties' agreement.** Under both the UCC and the UCP the issuer is obligated to honor a draft or demand for payment which complies with the terms of the relevant credit without reference to their compliance with the terms of the underlying contract between the beneficiary and the customer (UCC § 5-114(1); UCP, General Provisions and Definitions, Item (c) and Art. 3). Although an issuer is

* Subject to certain conflict of law rules and depending on the jurisdiction involved, the parties may stipulate which body of law, or both, will govern the letter of credit.

** The Comptroller of the Currency has by regulation permitted national banks to issue letters of credit permissible under the UCC and the UCP, and prescribed the following conditions for issuance thereof "as a matter of sound banking practice": (1) each letter should conspicuously state that it is a letter of credit or be conspicuously entitled as such; (2) the bank's undertaking must contain a specified expiration date or be for a definite term; (3) the bank's undertaking must be limited in amount; (4) the bank's obligation to pay must arise only upon the presentation of a draft or specific documents, and the bank must not be called upon to determine disputed questions of fact or law at issue between the customer and the beneficiary; and (5) the bank's customer must have an unqualified obligation to reimburse the bank for payments made under the letter of credit. Interpretive Ruling 7.7016, 12 C.F.R. § 7.7016 (1977).
Sidney L. Cimmet, Esq. 10 March 23, 1979

obligated to examine any required documentation for compliance with the terms of the credit and may refuse to honor the beneficiary's demand for payment due to noncompliance or inherent defects such as forgery or fraud in the transaction, the issuer is not authorized to investigate, nor does it assume any responsibility for, the underlying transaction between the customer and the beneficiary, and it must honor complying demands whether or not the customer consents (UCC §§ 5-109 and 5-114(1); UCP, General Provisions and Definitions, Item (c) and Arts. 7-9). The beneficiary who presents a draft or demand for payment thereby warrants to all interested parties that the necessary conditions of the credit have been complied with (UCC § 5-111(1)).

In the event of a wrongful dishonor or cancellation or repudiation of the letter of credit without the beneficiary's consent, the beneficiary's remedies against the issuer include the right to recover the face amount of the draft plus incidental damages and interest (UCC §§ 5-115(1) and 2-710). The beneficiary's claim against the issuer is not subject to any defenses of the issuer against its customer and the issuer cannot dishonor a complying demand on the grounds that the customer fraudulently induced the issuer to issue the credit, failed to provide the promised consideration for the credit, or became bankrupt following issuance of the credit,
rendering worthless any ultimate claim by the issuer for reimbursement. An irrevocable letter of credit may be revoked or modified only with the consent of the customer once it is "established" as to him and with the consent of the beneficiary once it is "established" as to him (UCC § 5-106(2); UCP Art. 3).

The traditional commercial letter of credit was designed as a mechanism to insure payment in international sale of goods transactions. Domestic uses for letters of credit, however, have been expanded far beyond a payment function and there has been an increasing use of the so-called "standby" letter of credit as a financing or security device in connection with nonsale transactions. Unlike sales transactions in which the issuer expects to make payments under the credit upon performance of the underlying agreement, transactions involving a standby letter of credit only contemplate payment in the event of nonperformance of or other specified default under the underlying agreement between the beneficiary and the customer. Among the more widespread uses of standby letters of credit are as security in lieu of cash collateral or a performance bond in connection with the performance of a construction contract, as a back-up source of payment to support the issuance of commercial paper, and as a payment mechanism for deferred compensation agreements. A standby
letter of credit is, however, capable of adaptation to innumerable situations where the credit of a financially solvent and reliable third party is substituted and, as defined by the Board of Governors of the Federal Reserve System, broadly includes "an obligation to the beneficiary on the part of the issuer . . . (3) to make payment on account of any default by the [customer] in the performance of an obligation." 12 C.F.R. § 208.8(d)(1) (1977).

In certain respects, a standby letter of credit functions as a guarantee. The documents required for presentation by the beneficiary under a standby letter of credit usually consist of only a draft accompanied by the beneficiary's certification that the customer has defaulted in its obligations under the underlying agreement. Unlike a guarantee however, in which recovery is based on the guarantor's secondary liability for the obligor's default under the obligor's primary obligations, the issuer is primarily liable under its letter of credit to the beneficiary with respect to its obligations under such credit. Recovery from the issuer by the beneficiary requires only presentation of the requisite documents and compliance with the terms of the letter of credit; whether the customer has in fact failed to perform its obligations pursuant to the underlying agreement does not affect the issuer's primary obligation to pay the beneficiary upon presentation of
complying documentation. The issuer's liability is independent of the parties' rights pursuant to the underlying agreement and the issuer neither promises to perform its customer's obligations nor guarantees that its customer will perform them. Thus, commentators have observed that the "hallmark" of a letter of credit is that at a certain point it becomes "as good as cash." Armstrong, "The Letter of Credit as a Lending Device in a Tight Money Market," 22 Bus. Law. 1105, 1109 (1967); see Verkuil, "Bank Solvency and Guaranty Letters of Credit," 25 Stan. L. Rev. 716 (1973).

From the beneficiary's point of view, the principal risks attendant to acceptance of a standby letter of credit as collateral for a securities loan are (i) that the issuer will be unable to make payment in accordance with the terms of the letter of credit due, for example, to its insolvency or a force majeure (such as riots, strikes or other interruptions of business) and (ii) the issuer's wrongful refusal to honor the beneficiary's complying demands for payment. Adams would seek to minimize any risk of insolvency by setting high standards of issuer eligibility. We understand that a letter of credit may not be accepted from an issuer proposed by a borrower unless Adams' Board of Directors has given its prior approval to such issuer and to the aggregate maximum face amounts of all letters of credit which may be issued there-
by, and that only banks which, at a minimum, satisfy the qualifications under Section 17(f) of the 1940 Act applicable to bank custodians of registered investment companies would be eligible for consideration. In addition, such bank's policies with respect to issuing letters of credit, including relevant information in its published financial statements, will be evaluated.*

As previously noted, it is presently anticipated that Adams' bank custodian would issue such proposed letters of credit, thus providing an issuer whose financial reliability has already been carefully scrutinized and tested and will

* Federal bank regulatory agencies have adopted regulations that place similar "lending limit" restrictions upon the issuance of standby letters of credit by state and national banks. Generally, such restrictions dictate that standby letters of credit must be combined with all loans for purposes of applying any legal limitations on loans of the state banks and customer lending limitations on loans of the national banks. Exceptions to this general rule are available if the issuing bank has been paid, or has set aside separately, an amount equal to its maximum potential liability under the standby letter of credit, or in the case of state banks there is an independent limit on standby letters of credit. State banks that are members of the Federal Reserve System are further restricted in that they may not issue a letter of credit unless their customer has been the subject of a "credit analysis equivalent to that applicable to a potential borrower in an ordinary loan situation." Moreover, these state banks, as well as non-member state banks insured by the Federal Deposit Insurance Corporation, are required to make adequate disclosure of the amount of all of their outstanding letters of credit in their published financial statements. See 12 C.F.R. §§ 7.1160, 208.8 and 337.2 (1977).
continue to be monitored by Adams, as required by the applicable provisions of the 1940 Act. Were Adams to accept solely cash or government securities as collateral, such collateral would be required to be deposited in the safekeeping of the same issuing bank. We understand, however, that other banks with which Adams has or has had substantial business dealings have expressed an interest in issuing such proposed letters of credit and, assuming the foregoing minimum eligibility standards are met, may be considered as an approved issuer.

Moreover, Adams will be further insulated from any potential risk of insolvency during the term of the letter of credit due to events occurring, or becoming known to Adams, subsequent to its initial evaluation of the issuer's eligibility. We have been advised that the Proposed Agreement will provide that if in the sole judgment of Adams there has been, or events have occurred which may reasonably be expected to result in, a material adverse change in the financial condition of the issuer, Adams may (i) terminate the loan in respect of an amount of loaned securities equal to the face amount of any letter of credit or (ii) require that the borrower substitute as collateral cash or government securities for all or any portion of such letter of credit.

In loan arrangements secured by non-cash collateral
such as government securities, the borrower pays a negotiated
loan premium to the lender and retains all rights in and to
the collateral. The borrower is entitled to retain all income
or interest earned on such collateral and the lender looks
solely to the loan premium as its compensation, rather than
any return resulting from the income which might be earned on
investment of the cash collateral. Accordingly, we have been
advised that the fee payable to Adams pursuant to the Proposed
Agreement would be a negotiated loan premium comparable to
that which Adams would receive under existing arrangements
providing for the deposit of non-cash collateral. In this
context, the sole purpose of collateral is security for the
loan and the most important quality of such collateral is that
it be readily realizable and provide "maximum liquidity" such
that if the borrower defaults, the investment company may
easily apply the collateral to replace the loaned securities
or cure any other default in the borrower’s obligations.

Thus in certain respects a letter of credit may be a
more effective form of collateral for securities loans than
Treasury bills and other U.S. Government and agency securi-
ties. In the event of borrower default, the latter must be
liquidated, i.e., converted into cash by sale in the market
place, before it can be applied to make the borrower whole by
replacing the borrowed securities or curing other defaults.
advantages to both the borrower and the lender. On the basis of the foregoing, we are of the opinion that a letter of credit, issued under the circumstances described herein, may be used to collateralize, either in whole or in part, a securities loan by a registered investment company in compliance with Section 17(f) of the 1940 Act and Rule 17f-2 thereunder which require that securities on loan be collateralized to the extent of their full market value.

We would appreciate your advice as to whether you concur in our view. If any further information is needed or if we can be helpful in any other way, please contact Mary Ellen Pindyck of this office by collect telephone at (212) 541-5800.

Very truly yours,