



DIVISION OF  
INVESTMENT MANAGEMENT

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

ACT ICA-1940  
SECTION \_\_\_\_\_  
RULE 2a-7  
PUBLIC  
AVAILABILITY 7-20-94

July 20, 1994

Adam W. Glass, Esq.  
Orrick, Herrington & Sutcliffe  
599 Lexington Avenue  
New York, NY 10022

Dear Mr. Glass:

Your letter dated July 19, 1994 (a copy of which is attached) requests that the Division of Investment Management agree that the short-term municipal ratings assigned to Series C Revenue Anticipation Warrants issued by the State of California ("RAWs") will be treated as long-term debt ratings under paragraph (c)(3)(ii) of rule 2a-7 if the RAWs are converted into Variable Rate Instruments (as this term is defined in paragraph (a)(21) of rule 2a-7) that are eligible for purchase by money market funds ("Synthetic RAWs"). You represent that, consistent with this definition, upon adjustment of the interest rate of a Synthetic RAW, the market value of the Synthetic RAW can reasonably be expected to approximate its par value.

You state that the RAWs will mature in 22 months, and the entire principal and interest amount will be payable on April 25, 1996. Principal and interest on the RAWs is guaranteed by the unconditional obligation of a consortium of fourteen banks ("Banks") to purchase the RAWs on the maturity date under the terms described in your letter.<sup>1</sup>

The RAWs will receive "short-term" ratings from three nationally recognized statistical rating organizations ("NRSROs") as follows: Moody's Investors Service -- MIG-1; Standard & Poor's Corporation -- SP-1; and Fitch Investors Service -- F-1+. Thus, the RAWs will be rated by the Requisite NRSROs (as such term is defined in paragraph (a)(13) of rule 2a-7) within the highest generic rating category for short-term municipal obligations (within which there may be sub-categories or gradations indicating relative standing). You represent that the short-term obligations of each of the Banks are also rated in the highest generic short-term categories by a NRSRO. Not all the Banks will have long-term debt obligations rated in one of the two highest generic long-term rating categories by a NRSRO. You also advised that the short-term debt of the issuers of the Demand Features (as that term is defined in paragraph (a)(4) of the rule) will have the highest short-term debt ratings from the Requisite NRSROs.

---

<sup>1</sup> The obligations of the Banks are several; that is, if one Bank defaults in its obligation to repurchase its portion of the RAWs, the other Banks are not required to assume the obligation of the defaulting Bank and purchase more than their allotted shares.

The Synthetic RAWs will be subject to a conditional Demand Feature. The Demand Feature will permit the holder of a Synthetic RAW to "put" the instrument back to the put provider on each interest rate reset date. In your letter and subsequent telephone calls, you advised that the Demand Feature "will be subject to customary conditions on its exercise," including the downgrade of the ratings of the RAWs or any Bank to below investment grade.

Paragraph (c)(3)(ii) of rule 2a-7 provides that an instrument subject to a conditional Demand Feature is an Eligible Security (as that term is defined in paragraph (a)(5) of rule 2a-7) if: (1) the Demand Feature is rated by the Requisite NRSROs in one of the two highest rating categories for short-term debt obligations; and (2) the underlying security is rated in one of the two highest rating categories for long-term debt obligations. If such instruments are not rated by a NRSRO, they must be determined to be of comparable quality.

Based on your oral and written representations and without necessarily agreeing with your legal analysis, the Division will not object if money market funds purchasing the Synthetic RAWs treat the short-term ratings assigned to the RAWs as ratings assigned to long-term debt obligations for purposes of paragraph (c)(3)(ii) of rule 2a-7. We note that, as with any other instrument, a money market fund may invest in Synthetic RAWs only if its board of directors (or the board's delegate) determines that the Synthetic RAWs present minimal credit risks (which determination must be based on factors pertaining to credit quality other than the rating assigned by an NRSRO). Paragraph (c)(3) of rule 2a-7. This letter does not address whether Synthetic RAWs present minimal credit risks. Because the Banks' obligations are several, a fund must evaluate, among other things, the credit quality of each Bank.

Sincerely,



Robert E. Plaze  
Assistant Director

---

**O**RRICK, HERRINGTON  
& SUTCLIFFE

July 19, 1994 *Direct Dial*

**VIA TELECOPIER**

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

Re: Status of Certain Synthetic Securities  
Backed by California RAWs as Eligible  
Investments for Money Market Funds

Dear Mr. Plaze:

As we discussed earlier today, this letter sets forth our view as to why the synthetic securities described below are eligible for purchase by money market funds under Rule 2a-7.

**Background**

Tomorrow the State of California will price \$4 billion of revenue anticipation warrants ("RAWs") maturing in 22 months. The entire amount of principal and interest due on the RAWs will be payable in a single payment on April 25, 1996, the maturity date of the RAWs (i.e., there will be no periodic payments of interest prior to maturity). The RAWs are issuable in separate series. Payment of principal and interest on the Series C RAWs is effectively guaranteed by the unconditional obligation of a consortium of 14 banks (the "Banks") to purchase the RAWs on the maturity date, pursuant to a bond purchase agreement, at a purchase price equal to the principal and accrued interest thereon, if payment of the principal and interest of the RAWs is not made in full by the State of California on the maturity date. The obligations of the Banks under the bond purchase agreement are several; that is, if one Bank defaults in its obligation to repurchase its portion of the Series C RAWs, the other Banks are not required to assume the obligation of the defaulting Bank and purchase more than their allotted shares. The Series C RAWs will be rated F-1+ by Fitch Investors Service ("Fitch"), MIG-1 by Moody's Investors Service ("Moody's") and SP-1 by Standard & Poor's Corporation ("S&P"), and will not be rated by any other NRSRO. (Fitch, Moody's and S&P are referred to collectively hereinafter as the Rating Agencies.) Each such rating represents the highest generic rating category used by the assigning NRSRO in rating short-term municipal obligations. The short-term debt obligations of each Bank are rated "A1/P1" or the equivalent.

Robert E. Plaze  
Securities and Exchange Commission  
July 19, 1994  
Page 2

However, we understand that not all the Banks have long-term debt obligations rated "AA" or higher by an NRSRO.

### Proposed Synthetic Securities

We represent CS First Boston and other investment bankers as potential purchasers of the Series C RAWs. Our clients intend to repackage the Series C RAWs into synthetic floating rate securities for sale to money market funds. While the details of the synthetic securities to be issued may vary from sponsor to sponsor, you may assume for purposes of this letter that each such synthetic security (each, a "Synthetic Security") will be a Variable Rate Instrument as defined in paragraph (a)(21) of Rule 2a-7 (the "Rule"); that is, its interest rate will adjust on set dates and upon such adjustment its market value can reasonably be expected to approximate its par value. Furthermore, such Synthetic Security will be subject to a Demand Feature which permits the holder to "put" the Synthetic Security to a bank or other put provider at a purchase price equal to par plus accrued interest on each interest rate reset date. The Demand Feature will be subject to customary conditions on its exercise and will therefore not qualify as an "Unconditional Demand Feature" as defined in paragraph (a)(19) of the Rule.

### Analysis

Based on earlier conversations with you we understand that for the Synthetic Securities to be "Eligible Securities" under paragraph (a)(5) of the Rule, in pertinent part, (1) the Demand Feature must be rated by the Requisite NRSROs in one of the two highest rating categories for Short-term debt obligations, and (2) the underlying or "core" security (in this case the Series C RAWs) must be rated in one of the two highest rating categories for Long-term debt obligations. (We understand the staff's interpretation of this provision under the existing Rule to be substantially the same as what is set forth somewhat more explicitly in paragraph (c)(3)(ii) of proposed Rule 2a-7.)

A question has arisen whether the ratings of F-1+, MIG-1 and SP-1 by the Rating Agencies of the Series C RAWs are sufficient to constitute ratings in one of the two highest rating categories for Long-term debt obligations for purposes of the Eligible Security determination under the Rule. Because these

Robert E. Plaze  
Securities and Exchange Commission  
July 19, 1994  
Page 3

ratings are generally recognized as short-term rather than long-term ratings, concern has been expressed that these ratings may not satisfy the Rule's requirement that the "core security" have a Long-term rating in one of the two highest categories.

While we are not familiar with the reasons for the Rating Agencies' determination to rate the California RAWs with a rating customarily given to short-term obligations (i.e., those maturing in a year or less), we believe that these ratings are sufficient to meet the "core security" rating requirement applicable to synthetic securities packaged with a conditional Demand Feature under the Rule.

The Series C RAWs mature in 22 months, and are therefore Long-term debt obligations within the Rule, by virtue of paragraph (a)(9), which defines "Long-term" to mean "having a remaining maturity greater than 366 days." The Rating Agencies have rated the Series C RAWs in their highest generic rating categories. Thus, the ratings appear to be long-term ratings within the meaning of the Rule, notwithstanding that they are ratings customarily given to short-term instruments. Although it is rather unique for a rating agency to assign a rating customarily applied to short-term obligations to an obligation with a maturity greater than 366 days, the F-1+, MIG-1 and SP-1 ratings appear to satisfy in substance the requirements of the Rule. Moreover, this situation is distinguishable from the case where an issuer or put provider has a short-term rating which is higher than its long-term rating. There is no other rating by the Rating Agencies of the Series C RAWs, and the F-1+, MIG-1 and SP-1 ratings appear to have the functional significance of a traditional long-term rating. Therefore, it would appear to be an overly technical reading of the Rule, and inconsistent with the Rule's significant reliance on the judgment of rating agencies, to find that because the Rating Agencies used short-term nomenclature to designate their ratings of the Series C RAWs, the Synthetic Securities cannot be purchased by money market funds.

Substantively, the Rating Agencies have determined that the Series C RAWs are of high credit quality. The purpose of requiring a rating of the core security for a synthetic security is presumably to provide an additional element of protection to money funds in the event that the conditional put is not available because one of the conditions permitting the put

Robert E. Plaze  
Securities and Exchange Commission  
July 19, 1994  
Page 4

provider to avoid its obligation has occurred. The F-1+, MIG-1 and SP-1 ratings of the Series C RAWs appear more than sufficient to provide this additional element of protection.

Long-Term Credit Ratings Of Consortium Banks

A concern has also been raised whether, notwithstanding the ratings by the Rating Agencies, the Synthetic Securities may not be Eligible Securities because not all of the Banks have credit ratings in the two highest categories for Long-term debt obligations. Therefore, the argument runs, if the Series C RAWs were unrated so that a determination of credit quality depended on an analysis of Bank ratings, the Bank ratings would be insufficient.

However, the Series C RAWs are not unrated. Thus, a fund has no choice but to look to the ratings assigned to the Series C RAWs in making the Eligible Security determination. The concern that funds might "game" the Rule by choosing to look through to the rating of the underlying credit enhancers only when it suited their purposes is inapplicable in this context, since the actual ratings assigned to the Series C RAWs preclude reference to any other means of determining the creditworthiness of the Series C RAWs for Eligible Security purposes.

For any synthetic securities where, as here, the "core security" has been assigned an actual rating, there is no leeway for "comparable quality arbitrage" by funds seeking to choose the most favorable method of determining credit quality of the core security. (Moreover, if funds were to be required to "look through" to the credit ratings of the Banks, as a practical matter, the presence of 14 banks with different credit ratings in the consortium would make the comparable quality determination difficult and unwieldy.)

Finally, while the terms of the Rule do not require looking behind the ratings assigned by the Rating Agencies, which are sufficient to provide the core security rating element required by the Rule, if the staff were inclined to do so, we believe that the Banks' short-term ratings should be taken into account in light of the 22 month maturity of the Series C RAWs. We note that within 9 months after issuance, both the Synthetic Securities and the Series C RAWs will have actual final maturities of less than 397 days. As mentioned above, the short-

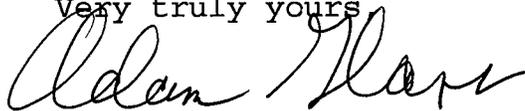
Robert E. Plaze  
Securities and Exchange Commission  
July 19, 1994  
Page 5

term rating of each of the Banks is A-1/P-1 or the equivalent (i.e. the highest generic rating category for short-term debt obligations).

Conclusion

Based on the analysis set forth above, we would appreciate your confirming that Synthetic Securities having the features described above will be Eligible Securities for money market funds under the Rule. If you have any further questions, please feel free to contact the undersigned at (212) 326-8819 or Michael Voldstad of this office at (212) 326-8806. Thank you for your prompt consideration of this matter.

Very truly yours



Adam W. Glass