



DIVISION OF
INVESTMENT MANAGEMENT

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

May 10, 1994

Mr. Sean J. Egan
Director of Research
Red Flag Research Inc.
300 Berwyn Park
Suite 120
Berwyn, Pennsylvania 19312

ACT ICA-40
SECTION _____
RULE 2a-7
PUBLIC _____
AVAILABILITY 5/10/94

Dear Mr. Egan:

This is in response to your letter of April 7, 1994 in which you request guidance regarding the proper use by money market funds and their advisers of credit analyses prepared by unaffiliated firms.

Rule 2a-7 requires a money market fund to limit its portfolio investments to United States dollar-denominated instruments that its board of directors or adviser determines present minimal credit risks.¹ This determination must be based on factors pertaining to credit quality "in addition to the rating assigned to such instruments by a NRSRO."² You represent that Red Flag gathers, organizes, and provides analytical support regarding securities issuers for use by money market funds when making the credit quality determinations required by the rule.

You have asked for clarification of whether it is permissible under rule 2a-7 for a fund or its adviser³ to use credit reports prepared by firms such as Red Flag ("credit information services") when making credit determinations, or whether the fund's adviser must gather all the information pertaining to the security's credit analysis independently. Rule 2a-7 does not specify the sources of information which a money market fund or its adviser may consult when evaluating securities' creditworthiness, and we believe the use of reports prepared by credit information services is consistent with the rule.

¹ Paragraph (c)(3) of rule 2a-7.

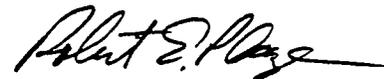
² Id. The term "NRSRO" is defined in the rule to mean any nationally recognized statistical rating organization, as that term is used in rule 15c3-1 under the Securities Exchange Act of 1934. Paragraph (a)(10) of rule 2a-7.

³ A money market fund may delegate the minimal credit risk determination to the fund's investment adviser or officers provided certain conditions are met. Paragraph (e)(1) of rule 2a-7. For purposes of this letter, we have assumed that the fund's board of directors has delegated the responsibility of making minimal credit risk determinations to the fund's adviser in accordance with paragraph (e) of rule 2a-7.

The conclusions presented to a fund by a credit information service may not provide the sole basis for the fund's decision whether to purchase a security.⁴ The responsibility for reaching a conclusion as to whether the security presents minimal credit risks and meets rule 2a-7's other requirements remains at all times with the fund's adviser and may not be delegated to a credit information service. Therefore, information received from the credit information service must be carefully reviewed by the adviser in the course of its overall review of the creditworthiness of the security described.⁵ When relying on information provided by a credit information service, the adviser must not have any reason to believe that the information is inaccurate.

We emphasize that a report by a credit information service is not a substitute for the minimal credit risk analysis by the fund's investment adviser. During an inspection of a money market fund, the Commission staff will not accept a fund's possession of a report on a security (or its issuer) from a credit information service as demonstrating that the fund's adviser has performed a minimal credit risk analysis with respect to the security. The fund should present documentation to substantiate that it has performed a minimal credit risk analysis and reached its own conclusion about whether the security presents such risks.

Sincerely,



Robert E. Plaze
Assistant Director

⁴ You represent that Red Flag provides information for a fund to use when making a credit determination regarding a security but does not present a conclusion regarding whether a security presents minimal credit risks for a money market fund.

⁵ See Investment Company Act Rel. No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)] at nn. 17-19 and accompanying text for a discussion of what the minimal credit risk analysis should entail. We have not evaluated the quality or adequacy of the sample report included with your request to determine whether it presents sufficient information that would allow an adviser to perform a minimal credit risk analysis.

Red Flag Research Inc.

April 7, 1994

Mr. Kenneth J. Berman (mailstop 10-6)
Deputy Office Chief
The Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20549

Dear Mr. Berman:

Thank you for speaking with me regarding Rule 2a-7 questions on the collection and formatting of data used in the creditworthiness evaluations.

We have found that some fund managers are confused about whether they must assemble all the data themselves (prior to their reaching a creditworthiness decision), or if they can use an outside service for gathering, organizing, and providing analytical support for the data. Because of the time and labor intensive process in gathering the necessary financial and peer group data, we have observed that managers spend 80-90% of their research time gathering and organizing the information, and only 10-20% (or less) time assessing credit quality under various economic, industry and financial conditions as required by 2a-7. In some cases, managers do almost no analysis, claiming lack of information. A firm such as ours attempts to enable managers to perform more and higher quality analysis (by gathering, organizing, and providing analytical support on issuer information) and thereby do a better job of protecting money fund investors. We were hoping to obtain some clarification on managers' using outside services to gather and organize information on various issuers. The responsibility for ultimately determining whether the issuer is of "high quality and possesses minimal credit risks" as required by 2a-7 remains with the money fund manager.

I have enclosed a copy of an opinion from Willkie Farr & Gallagher which supports the use of outside services for gathering and organizing information, provided the managers remain responsible for determining creditworthiness (see the last paragraph). I have also enclosed a copy of a typical research report which was generated from software purchased from a "Big 6" accounting firm. The managers can change the assumptions used in the report to "stress test" the issuer's credit quality.

Thank you for your time, and I look forward to speaking further with you.

Sincerely,



Sean J. Egan
Director of Research

WILLKIE FARR & GALLAGHER

New York
Washington, DC
London
Paris

January 31, 1994

Republic New York Securities Corporation
452 Fifth Avenue
New York, New York 10018

Ladies and Gentlemen:

You have asked for advice concerning the standards that would apply pursuant to Rule 2a-7 (the "Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), with respect to determinations of the credit quality of investment grade portfolio investments proposed to be made by a money market fund. Your question was raised in connection with a research service that Republic New York Securities Corporation proposes to distribute to its institutional customers. The research service is prepared by Red Flag Research, Inc. ("Red Flag"). You have informed us that it consists of detailed analytical research concerning the creditworthiness of an issuer of eligible securities (as such term is defined in the Rule). It also provides, you noted, a basis on which a determination can reasonably be made that a particular proposed investment presents minimal credit risks within the meaning of paragraph (c) (3) of the Rule.

In that regard, you have asked what the portfolio manager's review of the Red Flag research would have to entail to satisfy the standard of the Rule. For the reasons set forth below, we believe that an adviser may use and rely on research reports such as those prepared by Red Flag, pursuant to delegated authority and subject to ratification by the fund's board of directors. In reviewing the reports, the adviser should draw his or her own conclusions as to whether the information presented in the report is sufficiently comprehensive in scope to support the proposed determination on credit risk and other relevant factors identified by the fund's board and whether the information and analysis in the report would lend reasonable support to that determination.

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New York, NY 10022-4677
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Paragraph (c)(3) of the Rule provides that a money market fund must limit its portfolio investments, including puts and repurchase agreements, to those U.S. dollar-denominated instruments that its board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to the rating assigned to such instruments by one or more nationally recognized statistical rating organizations (each, an "NRSRO")) and that are, at the time of acquisition, "eligible securities" as that term is defined in the Rule.

Presumably, an NRSRO reporting a credit rating for a security will already have undertaken a rigorous analysis of the customary factors that affect creditworthiness of an issuer and the quality of a particular security. Indeed, the rating itself should represent the result of an elaborate process of review and analysis. Nevertheless, the Rule's requirement that the fund's own analysis go beyond the rating implies the need for additional review.

The Commission noted in the release adopting the Rule some illustrative examples of the further review a money market fund's board (and, by extension, the investment adviser acting on its behalf) would be expected to exercise:

The requirement that a security have a high quality rating provides protection by ensuring input into the quality determination by an outside source. However, the mere fact that an instrument has or would receive a high quality rating may not be sufficient to ensure stability. The Commission believes that the instrument must be evaluated for the credit risk that it presents to the particular fund at that time in light of the risks attendant to the use of amortized cost valuation or penny-rounding. Moreover, the board may look at some aspects when evaluating the risk of an investment that would not be considered by the rating services.

1940 Act Release No. 13880 (July 11, 1983) in text following n. 31.

The factors a fund's board of directors should take into account in that regard are further described in

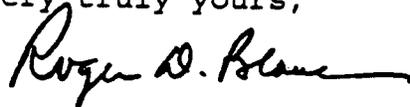
an interpretive letter from the Director of the Securities and Exchange Commission's Division of Investment Management to the General Counsel of the Investment Company Institute (December 6, 1989), 1898 SEC No-Act. LEXIS 1185. The Director stated in that letter that the board should take into account, as appropriate, among other things, macro-economic factors which might affect the issuer's or guarantor's current and future credit quality; the strength of the issuer's or guarantor's industry within the economy and relative to economic trends; the issuer's or guarantor's market position within its industry; cash flow adequacy; the level and nature of earnings; financial leverage; asset protection; the quality of the issuer's or guarantor's accounting practices and management; and the likelihood and nature of event risks. See also letter from the Director, Division of Investment Management re: Credit Analysis of Portfolio Securities (May 8, 1990), 1990 SEC No-Act. LEXIS 753.

Paragraph (e) of the Rule provides that a fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make the determination that a proposed investment presents minimal credit risks as long as the adviser's determination is subject to ratification by the money market fund's board of directors and provided that the board: (1) establishes and periodically reviews written guidelines (including guidelines for determining whether instruments present minimal credit risks as provided in paragraph (c)(3) of the Rule) and procedures under which the person to whom the authority is delegated by the fund's board makes such determinations; and (2) exercises adequate oversight through periodic review of fund investments and the delegated person's procedures in connection with, among other things, the making of credit determinations to assure that the guidelines and procedures are being followed.

Our research has not uncovered any interpretations by the Commission or its staff that bear on the extent to which a fund's adviser can rely on credit information and analysis provided by third parties in making the determination contemplated by paragraph (c)(3) of the Rule. Nevertheless, we believe that a fund's adviser may reasonably conclude that he or she can use and rely on a research report such as the one prepared by Red Flag in performing the analysis contemplated by Rule 2a-7. In that regard, the fund adviser should read and review carefully the information presented in the report and

should reach his or her own conclusions as to whether the information presented in the report is sufficiently comprehensive in scope to support a determination that the proposed investment presents minimal credit risks and such other factors as the board has determined affect the suitability of the security for the fund and whether the information and analysis in the report in fact would lend reasonable support to that determination.

Very truly yours,



Roger D. Blanc

RDB:em