



DIVISION OF
INVESTMENT MANAGEMENT

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

Catherine S. Bardsley, Esq.
Kirkpatrick & Lockhart
1800 M Street, N.W.
Washington, D.C. 20036-5891

January 27, 1995
ACT ICA-40
SECTION _____
RULE 17a-7
PUBLIC
AVAILABILITY 1/27/95

Re: United Municipal Bond Fund (pub. avail.
July 30, 1992)

Dear Ms. Bardsley:

By letter dated October 29, 1991, United Municipal Bond Fund, Inc. and United High Income Fund, Inc. (the "Funds") requested the staff's assurance that it would not recommend enforcement action to the Commission under Section 17(a) of the Investment Company Act of 1940 ("1940 Act") if the Funds, in reliance on Rule 17a-7 under the 1940 Act, bought and sold between themselves municipal bonds for which market quotations are not readily available. The Funds proposed to value the bonds by using the price provided by the Funds' independent pricing service for purposes of calculating net asset value under Rule 2a-4 under the 1940 Act. The staff granted the Funds no-action relief in United Municipal Bond Fund (pub. avail. July 30, 1992), but not on the terms requested. Instead, the staff required that the Funds value the municipal bonds by averaging prices obtained from at least three independent matrix pricing services, or by averaging three independent bid prices, or by averaging three prices obtained from some combination of pricing services and bid prices.

By letter dated October 18, 1994, you requested that the staff reconsider its position, and permit the Funds to buy and sell certain municipal bonds between themselves using the price provided by their independent pricing service, as proposed in the Funds' initial no-action request. You state that taking the average of prices provided by pricing services, bid prices, or some combination thereof results in an artificial gain or loss for the purchasing or selling Fund because the average price is unlikely to be the same as the price that the Fund uses to compute net asset value. Moreover, completing the transaction using the average of two or three bid prices always will be disadvantageous to the seller of the security.

You believe that the use of the Funds' pricing service to price transactions between the Funds provides a reliable method

of determining the value of the securities, particularly in view of the steps the Funds take to verify the accuracy of the prices quoted. The Funds' use the prices provided by an independent pricing service, Muller Data Corporation ("Muller"), to value their municipal bonds for purposes of Rule 2a-4. Muller's staff determines the price of a particular security by "hand pricing," which consists of gathering market information about that security (e.g., trade execution data and the latest bid and ask quotes for the security, as well as information about offerings of similar securities). 1/ The Funds' adviser, Waddell & Reed (the "Adviser"), regularly tests the overall accuracy of Muller's pricing system. Each week, the Adviser obtains prices from another pricing service for those securities that represent 1% or more of the net assets of each of its funds that use Muller's pricing service. The Adviser compares the total of the alternate prices to the total of Muller's prices. 2/ Further, each Fund's board annually reviews and approves the use of Muller and the Adviser's testing methodology. In addition, the Funds' independent auditor, Price Waterhouse, as part of its annual review of the Funds' internal control structure, tests the reliability of Muller's pricing system. Specifically, Price Waterhouse compares the aggregate of Muller's prices with the aggregate of the alternate prices from its own pricing module.

The Funds are not requesting relief with respect to transactions involving municipal bonds with an embedded swap, cap or floor, or other derivative structure that would impair the liquidity of the bond because of the customized nature of the structure, the information (or lack thereof) available about the bond, or other factor(s). The Adviser will determine whether a

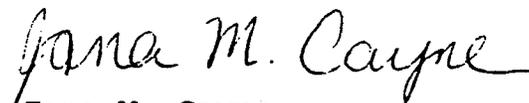
1/ On November 9, 1994, the Commission approved a program by the Municipal Securities Rulemaking Board to make pricing information available to investors. Securities Exchange Act Release No. 34955 (November 9, 1994), 59 FR 59810 (order approving file No. SR-MSRB-94-09). Under the first phase of the program, reports of inter-dealer transactions and daily high-low and average price figures for the most frequently traded issues will be made public. Under phase two and phase three of the program, these requirements will be expanded to include institutional customer transactions and retail transactions. Finally, the program will implement more contemporaneous reporting of transaction information. We expect that such information will be utilized by pricing services and persons charged with evaluating the performance of pricing services as it becomes available.

2/ You state that the Adviser believes that its testing methodology is accurate and that it would promptly consider alternatives if, in the future, its methodology did not accurately test Muller's prices.

bond should be excluded on the basis of this description, subject to the general review and oversight by each Fund's board of directors. You also state that the Funds will not rely on the staff's no-action position to engage in transactions in municipal bonds that the Adviser knows or has reason to know are in default, including those that are in technical default. 3/

The staff agrees to modify the pricing condition in the original no-action relief granted to the Funds, and, accordingly, would not recommend that the Commission take any enforcement action under Section 17(a) if the Funds buy and sell portfolio securities between themselves using a price provided by the pricing service that values the Funds' municipal bonds for Rule 2a-4 purposes, provided that the Funds comply with the conditions in your October 18, 1994 letter and above. 4/

Sincerely,



Jana M. Cayne
Attorney
Office of Chief Counsel

3/ Confirmed in a telephone conversation between Catherine Bardsley and Amy Doberman, November 3, 1994.

4/ The other conditions to no-action relief that were included in the original no-action letter remain unchanged.

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October 18, 1994

VIA MESSENGER

Amy R. Doberman, Esq.
Special Counsel
Division of Investment Management
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Your Ref. No. 91-536-CC
United Municipal Bond Fund, Inc.
United Municipal High Income Fund, Inc.

Dear Ms. Doberman:

This letter is to respond to the issues raised in the telephone conference call August 12, 1994, regarding the request of United Municipal Bond Fund, Inc., and United Municipal High Income Fund, Inc. ("Funds") for no-action assurance as to the application of Rule 17a-7 under the Investment Company Act of 1940 ("1940 Act") and the staff's above-referenced response. In that call, the staff requested that the Funds: (a) make certain changes in their proposed definition of an embedded derivative for purposes of determining which municipal bonds are to be excluded from the relief requested; (b) address further the testing of the prices from the pricing service used by the Funds; and (c) provide a consolidated statement of the facts and discussions contained in the prior letters submitted on behalf of the Funds since the issuance of the staff's initial response.

As presented more fully below, the Funds agree to the staff's requested revisions to the definition of embedded derivatives and have provided further information as to the testing of the pricing service's prices. This letter also consolidates the substance of my prior letters of April 20, 1993 and January 4, 1994 to Thomas S. Harman and of June 22, 1994 to Jana M. Cayne (copies of which letters are attached for your reference). As in each of those prior letters, the Funds respectfully request that the staff re-evaluate its no-action response and modify that response to permit the Funds to use the price provided by an independent pricing service as the current market price for purposes of compliance with Rule 17a-7.

Amy R. Doberman, Esq.
October 18, 1994
Page 2

BACKGROUND

By letter dated October 29, 1991, the Funds requested that the staff provide assurance that it would not recommend enforcement action if the Funds between themselves buy and sell municipal bonds at the prices provided by the independent pricing service which is also used by each Fund to value the municipal bonds in its portfolio for purposes of Rule 2a-4 under the 1940 Act. The staff's response, which was sent to the Funds and made publicly available on July 30, 1992, stated that the staff would not recommend enforcement action under Rule 17a-7 if, as the first of five conditions set forth in the response:

(1) the municipal bonds are valued by averaging prices obtained from at least three independent matrix pricing services, or by averaging three independent bid prices, or by averaging three prices obtained from some combination of independent pricing services and independent bid prices; [footnote omitted]

(Copies of the respective request and no-action letters are enclosed for your reference.) Shortly thereafter, at the Funds' request, I spoke with Ms. Cayne about whether in certain circumstances, the number of prices required to be averaged could be reduced from three to two.

This possibility was not pursued further by the Funds because, after the first transaction in accordance with the no-action letter, it became apparent that there was a more fundamental problem with the averaging approach itself. Specifically, in a sale made in reliance on the no-action letter and at a price determined by averaging two independent bid prices and one price from an independent pricing service, the selling Fund experienced a loss, because each of the bid prices, and therefore the average of the three prices, was lower than that provided by the pricing service (whose price, had there been no sale, would have been used for the Fund's valuation pursuant to Rule 2a-4).^{1/} Waddell & Reed Investment Management Company, the investment adviser to each Fund, thereafter informed the Directors of the Funds that it would investigate further the impact of the averaging approach

^{1/} The Fund did not suffer any actual loss because an amount representing the difference between the sale price and the price provided by the pricing service was promptly paid to the Fund by the Fund's investment adviser.

Amy R. Doberman, Esq.
October 18, 1994
Page 3

and that until the issue was resolved to the satisfaction of the Funds, no further transactions would be made in reliance upon the no-action letter.

SPECIFIC ISSUES

Artificial Gain or Loss

As previously expressed in telephone conversations with the staff and in my letter of April 20, 1993, the Funds believe that implementation of the first condition set forth in that response disadvantages one, and possibly both, of the parties to the transaction in that the execution price prescribed by that condition results in an artificial element of gain or loss on the transaction. This gain (or loss) is artificial for two reasons. One is that the prescribed execution price rarely, if ever, will be the price at which the particular securities would otherwise be traded with an unaffiliated counter-party. In addition, the gain or loss is artificial because the execution price is calculated differently from the method used by the Funds in calculating net asset value per share. As a result, the purchaser (as opposed to the seller) will have an immediate and unintended, unrealized gain or loss. The use of a price based on the average of three prices, as required under the first condition of the no-action letter, creates an element of gain or loss that is economically artificial but nonetheless has real, adverse tax and accounting effects to the Funds and their respective shareholders.

For purposes of Rule 2a-4 under the 1940 Act each Fund typically values the municipal bonds held in its portfolio on the basis of prices provided by an independent pricing service. The problem with the first condition of the no-action letter is simply that, in virtually all cases, the price derived from the average of three numbers will be different from any one of the three. Certainly this differential does not represent a better or more accurate market-based valuation but does result in more or less gain or loss on a sale transaction. The problem is illustrated by the following example:

Fund A has a municipal bond in its portfolio that it purchased at par (100.00) and is currently priced at 105.00 by Fund A's independent pricing service. In order to sell the bond to Fund B under the no-action letter, Fund A obtains two independent bids, 105.00 and 104.00, which when averaged with the price from the pricing service, produce a price of 104.66.

KIRKPATRICK & LOCKHART

Amy R. Doberman, Esq.
October 18, 1994
Page 4

Using a sale price of 104.66 results in a gain of 4.66; had the pricing service price been used as the sale price, the gain to Fund A would have been 5.00. Fund A's net asset value is also 0.34 less using the average than it would have been using the price provided by the pricing service (which would have been used to value the bond had it not been sold). There is a corresponding impact on Fund B. If 104.66 is the initial value of the bond in Fund B's portfolio, Fund B will have a built-in potential gain or loss of 0.34 simply by virtue of the differential between the averaged price and the pricing service valuation. Thus, when Fund B next determines its net asset value and values the bond at the price provided by the independent pricing service (assume 105.00 or higher), Fund B's net asset value will reflect an increase of 0.34 which is artificial in that it derives solely from the change in pricing methodology. Thus, the pricing methodology prescribed in the first condition of the no-action letter creates an artificial element of gain or loss to each party that distorts the economic reality of the transaction.

In condition one of the no-action letter, the staff may have sought to parallel the approach in section (b)(4) of the Rule 17a-7, i.e., using the average of the highest current independent bid and lowest current independent offer. Rule 17a-7(b)(4) may reflect the appropriate valuation for securities whose values under Rule 2a-4 are derived according to that methodology. It is not, however, an appropriate methodology for securities which regularly use a different valuation method such as an independent pricing service.

To apply the general methodology of Rule 17a-7(b)(4), as reflected in condition one, so as to require a Fund to use a different methodology for inter-fund transactions than the Fund does for Rule 2a-4 net asset value determinations serves no policy purpose and instead has unwarranted and adverse consequences to the Fund and its shareholders. Indeed, it seems contrary to the policy underlying Rule 17a-7 that two funds with the same pricing policy that enter into a cross-transaction could not use that pricing policy and instead must use a different pricing method that will almost always result in an immediate unrealized gain or loss to the purchaser together with a distortion of the seller's gain or loss. Accordingly, the Funds request that the staff permit the Funds to use the price provided by an independent pricing service which the Fund otherwise uses for Rule 2a-4 purposes as the current market price for purposes of compliance with Rule 17a-7.

Amy R. Doberman, Esq.
October 18, 1994
Page 5

Pricing Service

Each Fund has, since its inception, used the prices provided by Muller Data Corporation ("Muller") to value the municipal obligations in the Fund's portfolio for purposes of Rule 2a-4 under the 1940 Act. In our discussions with Muller personnel, Muller has described its services to the Funds as "hand pricing" rather than "matrix pricing." Muller does not attempt to follow a general universe of municipal securities for its mutual fund clients, but rather, it has advised us, it follows only the securities in those clients' portfolios. Muller has a staff of evaluators to whom clients' securities are assigned, typically according to particular segments of the municipal market, such as pre-refunded bonds or general obligations. We understand that evaluators operate generally as follows: in the morning, an evaluator calls his or her contacts in the market (e.g., dealers and portfolio managers) to gather further information about recent trades, current bids, offerings of similar securities, general conditions or movements in the market or in particular market sectors, etc.; and in the afternoon, the evaluator makes an evaluation of each security for which he or she is responsible.

We have discussed with Muller personnel certain of the publicized concerns relating to municipal bonds with embedded derivatives and the attendant pricing issues. In this context, we note that Muller regards these issues as raised primarily by bonds with embedded swaps, caps or floors. This is in contrast to municipal bonds with common variable or floating rate features, which Muller characterizes as relatively easy to follow.

We understand, however, that dealers have responded to concerns regarding embedded derivatives by increasing the amount and frequency of information provided to services such as Muller and others in the secondary market. Muller is one of the participants in the Task Force on Derivatives Information Standardization formed last fall by the Public Securities Association to study the standardization and dissemination of information on municipal bond derivatives.

Amy R. Doberman, Esq.
October 18, 1994
Page 6

Testing of Pricing Service Prices

Waddell & Reed Investment Management Company ("Manager"), in its capacity as the investment adviser to each Fund, regularly tests the overall accuracy of Muller's pricing system. Under its current procedures, each week the Manager obtains from another pricing service prices for those securities which represent 1% or more of the net assets of all funds advised by the Manager that use Muller's pricing service. The total of these alternate prices is then compared to the total derived from Muller's prices for the same securities. Under current procedures, on an annual basis each Fund's Board of Directors reviews and considers the continuance of the use of the pricing service and the Manager's testing methodology.

In addition, in connection with its annual review of the internal control structure for the Funds and the other funds for which it serves as independent accountants, Price Waterhouse tests the reliability of Muller's pricing. Price Waterhouse uses its Automated Systems and Services for Investment Securities Transactions ("PW-ASSIST") pricing module to evaluate the prices provided by Muller. Price Waterhouse compares the aggregate of the prices provided by Muller and the aggregate of the alternate PW-ASSIST prices. Where the difference is immaterial in relation to a fund's net assets, Price Waterhouse is able to establish an independent basis for reliance that the prices provided by Muller are indicative of market value.

As reported in my letter of June 22, 1994, a then-recent, representative application of the 1% test performed by the Manager was as follows:

For United Municipal Bond Fund, Inc., 30 of a total of approximately 100 securities were tested, representing approximately \$400 million of a total \$1 billion in assets.

For United Municipal High Income Fund, Inc., 30 of a total of approximately 150 securities were tested, representing approximately \$90 million of a total \$350 million in assets.

In addition, please be advised that a recent representative application of the 1% test was follows:

Amy R. Doberman, Esq.
October 18, 1994
Page 7

For United Municipal Bond Fund, Inc., 31 of a total of approximately 205 securities were tested, representing approximately \$377 million of a total \$944 billion in assets.

For United Municipal High Income Fund, Inc., 28 of a total of approximately 191 securities were tested, representing approximately \$89 million of a total \$328 million in assets.

Further, the turnover rates, as stated in the annual reports for the respective Funds' fiscal years ended September 30, 1989, through 1993, were as follows:

For United Municipal Bond Fund, Inc., the turnover rates were 226%, 181%, 144%, 125% and 94.5%, respectively.

For United Municipal High Income Fund, Inc., the turnover rates were 38%, 27%, 60%, 54% and 26%, respectively.

For the fiscal year ended September 30, 1994, the portfolio turnover rates were 62.6% (unaudited) for United Municipal Bond Fund, Inc., and 26.3% (unaudited) for United Municipal High Income Fund, Inc.

The Manager believes that its testing methodology provides a meaningful test of the overall accuracy of the prices provided by the pricing service used by the Funds. If the Manager were to determine this methodology did not meaningfully test that service's prices, it would promptly consider the alternatives available and take such actions as it deemed necessary or appropriate, including notice to the Fund's Board of Directors of the actions taken and/or recommended.

Exclusion of Municipal Bonds with Embedded Derivatives

In view of the concerns previously expressed by the staff regarding municipal bonds with embedded derivatives, the Funds had proposed limiting their original no-action request so as to exclude inter-Fund sales of municipal bonds with embedded derivatives from the scope of the relief requested. Based on our discussions with the staff with respect to defining embedded derivatives for this purpose, the Funds agree that the municipal bonds to be excluded from the no-action relief requested by the Funds are those with an "embedded swap, cap or floor, or other derivative structure that would impair the liquidity of the bond

KIRKPATRICK & LOCKHART

Amy R. Doberman, Esq.
October 18, 1994
Page 8

because of the customized nature of the structure, the information (or lack thereof) available about the bond, or other factor(s)."

Each Fund anticipates that determinations as to a bond's exclusion or eligibility would be made by its investment adviser, subject to the general review and oversight by the Board of Directors. It is the Funds' understanding that certain types of municipal bonds with aspects which might technically be deemed "derivative", such as those having a variable amount, adjustable rate or put feature, nevertheless do not necessarily present valuation concerns. Further, a determination that a bond had an embedded structure which "would impair liquidity" would not necessarily constitute a determination that the bond is illiquid for purposes of a Fund's limitation on illiquid securities.

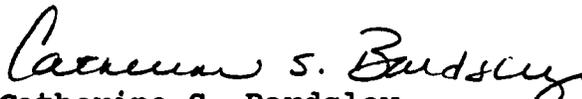
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We hope the foregoing is responsive to your requests and will enable the staff to permit the Funds, for purposes of Rule 17a-7, to treat the price provided by an independent pricing service, and which is the price otherwise used for Rule 2a-4 purposes, as the current market price of a municipal bond, other than a municipal bond with an embedded derivative.

If you have further questions or believe that there are further issues which remain to be resolved, please contact either the undersigned or Clifford J. Alexander at 202/778-9068.

Thank you for your consideration of this important matter for the Funds.

Very truly yours,


Catherine S. Bardsley

Enclosures

cc: Sharon K. Pappas, Esq.
Clifford J. Alexander, Esq.