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

DIVISION OF
INVESTMENT MANAGEMENT

May 9, 1996

ACT ICA
SECTION
RULE 2a-7
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Dear Ms. Lancellotta:

Since the adoption of amendments to rule 2a-7 on March 21, 1996, the staff has received a number of inquiries regarding the rule amendments. Enclosed are the staff's responses to the issues raised in these inquiries. Please note that these responses are based on the facts as presented, and that different facts may warrant a different result. Questions concerning these interpretations or other aspects of the rule should be addressed to Marjorie S. Riegel or the undersigned at (202) 942-0660.

This letter will be made public immediately.

Sincerely,

Jack W. Murphy

Jack W. Murphy
Associate Director
(Chief Counsel)

May 9, 1996

QUESTIONS AND ANSWERS ON AMENDMENTS TO RULE 2a-7

These questions and interpretive answers reflect positions taken by the staff of the Division of Investment Management. They should be read in conjunction with the rule, and the rule and form amendments adopted by the Securities and Exchange Commission ("Commission") in Investment Company Act Release No. 21837 (March 21, 1996) [61 FR 13956 (March 28, 1996)] ("Release 21837").

Puts Not Relied Upon

(1) Q. Paragraph (c)(4)(vi)(B)(4) of rule 2a-7 permits a fund to exclude from the put diversification requirements a put that is not relied on to determine the quality or maturity of the underlying security or for liquidity purposes. May the fund exceed the five percent limitation on second tier puts with respect to such a put?

(1) A. Yes.

(2) Q. May the fund ignore the put described in Question and Answer (1) for purposes other than applying the rule's put diversification standards?

(2) A. Although paragraph (c)(4)(vi)(B)(4) only applies to the put diversification requirements, the Division would not object if funds ignore such a put for *all* purposes under the rule 2a-7, including: (i) paragraph (a)(9)(iii)(D)(1) (requiring demand features to be rated (or requiring the issuer of the demand feature to be rated)), and (ii) paragraph (c)(5)(i)(C) (requiring the fund's board of directors to reduce investment in securities subject to downgraded demand features absent finding).

(3) Q. May a fund that is treating a put that is an unconditional demand feature that is not being relied on for purposes of diversification under paragraph (c)(4)(vi)(B)(4), use the demand feature to permit the fund to invest in a security subject to the demand feature in excess of the applicable diversification limitations pursuant to paragraph (c)(4)(i)?

(3) A. No.

Puts and Demand Features -- Definitional Matters

(4) Q. A security with a remaining maturity of 397 days at the time of acquisition by the fund is subject to a letter of credit (LOC) that will pay principal and interest upon default of the issuer of the underlying security, and which does not contain any particular provision permitting demand. Could the LOC be treated as an unconditional demand feature so that (i) the fund may substitute the credit of the LOC provider pursuant to paragraph (c)(3)((ii), and (ii) the note is not subject to issuer diversification pursuant to paragraphs (c)(4)(1) and (ii)?

(4) A. Yes. The question raises the issue of whether the LOC may be treated as a "demand feature" within the meaning of paragraph (a)(7) of the rule. Paragraph (a)(7) defines a demand feature as a put that may be exercised (i) at any time on no more than 30 days notice, or (ii) at specified intervals not exceeding 397 days and upon no more than 30 days' notice. Although the LOC is only exercisable upon default, it can be said to meet the definition of a demand feature because the default must, if it occurs at all, occur at the end of an interval no greater than 397 days.

NOTES: (1) The analysis described above only applies if the period until of the final maturity date of the security subject to the put is 397 calendar days or less (*e.g.*, if the put falls within the definition of demand feature under paragraph (a)(7) of rule 2a-7). (2) The analysis described above also could be applied to a security subject to bond insurance. (3) If the fund is treating the put as an unconditional demand feature, the demand feature (or the issuer of the demand feature) must have received a short-term rating. *See* paragraph (a)(9) of rule 2a-7.

Layered Puts

(5) Q. A variable rate demand note (VRDN) is subject to two demand features. One is provided by the issuer of the VRDN, the other by another institution. May a fund exclude the value of securities subject to these puts pursuant to paragraph (c)(4)(vi)(B)(1) from the put diversification requirements?

(5) A. The fund may exclude the value of the securities subject to the issuer-provided demand feature from the put diversification requirements, but must include the value of the securities subject to the demand feature provided by the other institution in determining compliance with the put diversification requirements. That is, the fund is not required to "double count" assets subject to layered puts where one of the puts was issued by the issuer.

(6) Q. A fund holds a security subject to an unconditional demand feature and an unconditional put (that is not a demand feature). The issuer of the underlying security and the issuer of the put are under common control pursuant to section 2(a)(9) of the Investment Company Act of 1940 ("Investment Company Act"). How should the fund determine compliance with the rule's issuer and put diversification tests?

(6) A. (i) *Put Diversification* -- Paragraph (c)(4)(vi)(B)(3) of rule 2a-7 states that a fund holding a security subject to an unconditional demand feature and put (that is not a demand feature) may disregard the put, and consider only the unconditional demand feature for purposes of determining compliance with the put diversification tests.

(ii) *Issuer Diversification* -- Because the underlying security is subject to an unconditional demand feature issued by a non-controlled person, the fund need not include the security's value in determining compliance with the rule's issuer diversification tests. *See* paragraphs (c)(4)(i), (c)(4)(ii) and (c)(4)(iv) of rule 2a-7.

Unconditional Demand Feature Issued by a Non-Controlled Person

(7) Q. A security is subject to an unconditional demand feature from a non-controlled person that covers 20% of the value of the security. Is the security subject to the rule's issuer diversification requirements?

(7) A. Yes. Paragraph (c)(4) excludes from the issuer diversification requirements only securities the

entire value of which is subject to an unconditional demand feature (or features) from a non-controlled person (or persons).

Issuer-Provided Unconditional Demand Features

(8) Q. A VRDN is subject to an issuer-provided unconditional demand feature. How are the VRDN and the unconditional demand feature analyzed under the rule?

(8) A. The unconditional demand feature is not subject to the rule's put diversification requirements because it is an issuer-provided put. *See* paragraph (c)(4)(iv)(B)(1). The security subject to the unconditional demand feature (the VRDN), however, is subject to the rule's issuer diversification requirements. This is because an issuer-provided demand feature is not a demand feature issued by a non-controlled person. *See* paragraph (a)(8) of rule 2a-7, and Release 21837 at note 76.

Securities Subject to Second-Tier Demand Features Issued by Non-Controlled Persons

(9) Q. Paragraphs (c)(4)(i) and (ii) exclude from the issuer diversification requirements securities subject to unconditional demand features issued by a non-controlled person, but paragraph (c)(4)(iv), which provides the special diversification requirements for second tier securities, does not. Are securities subject to second tier demand features from non-controlled persons subject to the rule's issuer diversification requirements?

(9) A. No. Paragraph (c)(4)(iv) is intended to be a modification to the general diversification requirements in paragraphs (c)(4)(i) and (ii), which exclude securities subject to unconditional demand features issued by a non-controlled person.

Conditional Demand Features

(10) Q. Under paragraph (c)(3)(iii)(C), a fund is required to consider the short-term ratings of a security subject to a conditional demand feature if the security has a remaining maturity of 397 days or less, the long-term ratings of a security with a

remaining maturity of more than 397 days, and to do a comparable quality analysis if the security is not rated. When a security that, when purchased, had a remaining maturity of more than 397 days, draws toward maturity so that it has a maturity of 397 days or less, must a fund begin to look to the short-term ratings of the security or, in the case of a security that is not rated, do a new comparable quality analysis?

(10) A. No. The paragraph should be interpreted so that the fund looks only to the long-term ratings (or, in the case of an unrated security, determine that it is of comparable quality to long-term rated securities) if the security had a remaining maturity of 397 days or more at the time it was purchased by the fund. The Division would not object, however, if the fund subsequently decides to determine the eligibility of the security by reference to the rating of the short-term securities of the issuer when the security has a remaining maturity of 397 days or less.

Rating Requirement for Demand Features

(11) Q. Paragraph (a)(9)(iii)(D)(1) requires a demand feature to be rated in order to be an eligible security. Does this apply to issuer-provided demand features?

(11) A. Yes. However, a demand feature upon which the fund is not relying is not required to be rated by a NRSRO. In addition, securities issued on or before June 3, 1996 are grandfathered. *See* Release 21837 at Section V.B.

Repurchase Agreements ("Repos")

(12)(i) Q. A repo is partially collateralized by cash. Cash is not one of the items in the list of eligible collateral in section 101(47) of the Federal Bankruptcy Code. Is the repo considered to be "collateralized fully" under paragraph (a)(4) of rule 2a-7?

(12)(ii). Q. A repo is collateralized by obligations issued by the Student Loan Marketing Association ("Sallie Mae"). Sallie Mae obligations are "Government securities" under section 2(a)(16) of the Investment Company

Act; however, they are not included in the list of eligible collateral under the relevant provisions of the Bankruptcy Code. Is the repo "collateralized fully" under rule 2a-7?

(12) A. The rule is intended to ensure that the securities collateralizing a repo can be promptly liquidated under applicable bankruptcy law. Therefore, the question of whether a repo is collateralized fully so that a fund can ignore the repo counterparty and look solely to the issuer of the collateral to determine compliance with the rule's issuer diversification standards is governed by the applicable bankruptcy law.

Asset Backed Securities and Synthetic Securities ("ABSs") -- Definitional Matters

(13) Q. Paragraph (a)(2) of rule 2a-7, in part, defines a special purpose entity as a "trust, corporation or partnership or other entity organized for the sole purpose of issuing *fixed income securities* . . ." (Emphasis added.) May a fund purchase ABSs issued by an entity that issues both fixed income and non-fixed income securities, if the other provisions of the rule relating to ABSs are satisfied?

(13) A. Yes. The rule was intended to permit money market funds to purchase ABSs that are fixed income securities issued by a special purpose entity, even if the entity also issues other types of securities.

ABSs -- Diversification Standards

(14) Q. As a practical matter, how can a fund determine that no one obligor has obligations that constitute ten percent or more of the qualifying assets underlying the ABSs?

(14) A. The fund may use any reasonable method to make this determination. This would include reasonable reliance on written representations made by representatives of the sponsor or other knowledgeable persons concerning the percentage of an obligor's obligations.

ABSs and First Loss Guarantees

(15) Q. An ABS is supported by a cash collateral account. The cash collateral account represents a multiple of expected losses on an average pool of receivables. The sponsor of the asset backed program establishes the cash collateral account as an escrow account with a bank. The cash collateral account is drawn on if the losses in the portfolio exceed a certain percentage. Is the cash collateral account a first loss guarantee, as that term is used in paragraph (c)(4)(vi)(B)(2) of rule 2a-7?

(15) A. On the basis of the facts presented, the staff believes that the cash collateral account is not a put, and therefore is not a first loss guarantee under the rule.

(16) Q. An ABS is subject to a first loss guarantee and two other puts. Each provider of the two additional puts has guaranteed only a specified portion of the value of the security. The ABS is designed so that a fund holding the ABS need only rely on the first loss guarantee. Because the fund is required to treat the provider of the first loss guarantee as if it has guaranteed the entire principal amount of the ABS (paragraph (c)(4)(vi)(B)(2) of rule 2a-7), may the fund ignore the two additional puts for purposes of determining its compliance with the put diversification requirements and other requirements of the rule?

(16) A. Yes. The two other puts are layered puts under paragraph (c)(4)(vi)(B)(3) of rule 2a-7. Each institution must be deemed to guarantee the entire principal amount of the ABS, unless the fund's board of directors (or its delegate)
(i) determines that the fund is not relying on the puts to determine the credit quality or maturity of the ABS, or for liquidity purposes pursuant to paragraph (c)(4)(vi)(B)(4) of the rule; and
(ii) makes a contemporaneous record of this determination pursuant to procedures adopted by the fund's board. *See* paragraphs (c)(8)(ii) (required procedures) and (c)(9)(vi) (recordkeeping and reporting) of the rule.

ABSs -- Maturity Provisions

(17) Q. Section V.B of Release 21837 states that ABSs issued on or before June 3, 1996 are "grandfathered" from the provisions of the rule concerning maturity determinations. In note 151 of the Release, the Commission stated that the maturity determination provisions of the rule applicable to ABSs supersede the interpretive position taken by the Division of Investment Management in Merrill, Lynch, Pierce, Fenner & Smith (pub. avail. April 6, 1987) ("Merrill, Lynch"). The securities at issue in Merrill, Lynch were non-ABSs. Does the "grandfathering" provision described in Section V.B of Release 21837 also apply to non-ABSs of the type described in Merrill, Lynch?

(17) A. Yes.

(18) Q. A fund holds an ABS having a remaining maturity of 397 calendar days. The terms of the ABS permit the fund to affirmatively elect to extend the maturity of the security by an additional 397 days. How should the fund measure the maturity of the security under the rule?

(18) A. The fund should measure the maturity of the security by reference to the date on which it must be paid. The existence of a right to extend the maturity does not affect the maturity unless and until the right is exercised. In Release 21837, the Commission stated that funds may continue to treat a "mandatory tender" feature as an unconditional right to receive principal, provided that the issuer's obligation to pay is not dependent on the fund taking any action (such as giving notice to the issuer of the intent to redeem), other than physically delivering the notes or bonds for redemption. *See* Release 21837 at note 151.

(19) Q. A particular tranche of a CMO has an anticipated payment date of less than 397 days, and the securities issued are not subject to a demand feature. These securities do not satisfy the maturity standards for asset backed securities because the date on which the fund must unconditionally receive payment exceeds 397 days. May funds hold securities of this type if the

securities have been issued on or before June 3, 1996?

(19) A. Yes. Securities of the type described above that are issued on or before June 3 are grandfathered. Funds holding such securities may continue to determine their maturities by reference to the expected payment date.

Pre-Refunded Bonds

(20) Q. The payment of certain bonds are funded by and secured by escrowed Government securities. The bonds have been irrevocably funded before June 3, 1996. The certification described in paragraph (a)(18) of rule 2a-7 [definition of refunded security] was not obtained from a certified public accountant at the time the Government securities were escrowed. May funds that either hold or purchase the refunded bonds described above look through the bonds to the escrowed securities for diversification purposes?

(20) A. In Release 21837, the Commission gave the Director of the Division delegated authority to address issues regarding compliance dates not addressed in the release. Pursuant to this authority, the Division is grandfathering refunded securities with respect to which the escrow arrangements were finalized on or before October 3, 1996, provided such securities comply with the Division's interpretive position in T. Rowe Price Tax-Free Funds (pub. avail. June 24, 1993). Please note that funds need no longer comply with the 25% limit in that letter. *See* Release 21837 at note 122 and accompanying text.

Other Amendments

(21) Q. In the 1991 release adopting amendments to rule 2a-7, the Commission stated that "[f]or purposes of the diversification and quality tests, subsidiaries of parent companies are treated as separate issuers." Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)] at note 34. Did recent amendments to the rule change this position?

(21) A. No.

(22) Q. A money market fund operates under a fundamental policy, the language of which tracks section 5(b)(1) of the Investment Company Act (and not rule 2a-7). May the fund rely on the diversification safe harbor codified in paragraph (c)(4)(vii) of rule 2a-7, even though the safe harbor mentions section 5(b)(1) only?

(22) A. The board of directors of a fund may be able to interpret the fundamental policies of the fund as permitting compliance with the new diversification provisions of rule 2a-7 without obtaining a shareholder vote to amend those policies. If, however, the board believes that the terms of the fundamental policies do not permit such an interpretation, the Division would not recommend enforcement action under Section 13 of the Investment Company Act of 1940 if the fund operated in compliance with the diversification requirements of rule 2a-7 without obtaining a shareholder vote until the next meeting of the fund's shareholders.

(23) Q. In Release 21837, the Commission stated that amendments to rule 2a-7 "require a fund to maintain a written record of the determination that a security presents minimal credit risks and to maintain a record of NRSRO ratings (if any) used to determine the status of a security under the rule." [Section II.G.4.] Paragraph (c)(9)(iii) of the rule suggests that this recordkeeping requirement is only applicable with respect to a security whose maturity is determined by reference to a demand feature. What is the correct application of the recordkeeping requirement?

(23) A. A line of text was deleted inadvertently from the final rule amendments. Paragraph (c)(9)(iii) was intended to codify the staff's position that the fund's board of directors (or its delegate) should document the minimal credit risk determination with respect to all securities in the fund's portfolio.