

PUBLIC

ACT ICA of 1940
SECTION _____
RULE 2a-7
PUBLIC
AVAILABILITY July 27, 1998

July 27, 1998
Our Ref. No. 98-441-CC
ICI Mutual Insurance Company
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated July 22, 1998 requests our concurrence with your view that the board of directors of a money market fund may consider the terms and conditions of insurance coverage of the type described in your letter in determining whether it is not in the best interests of the fund to dispose of a portfolio security following the occurrence of a default or other credit-related event described in subparagraphs (A) through (D) of Rule 2a-7(c)(6)(ii) under the Investment Company Act of 1940 (the "Act").

Background

ICI Mutual Insurance Company ("ICI Mutual") plans to introduce through its wholly owned subsidiary, ICIM Reinsurance Company (the "Insurer"), an insurance bond (a "Bond") designed to insure participating money market funds ("Insured Funds") from losses resulting from payment defaults, issuer insolvencies and other credit-related events with respect to portfolio securities held in compliance with Rule 2a-7. The Bonds will be issued by the Insurer and administered by ICIM Services, Inc., another wholly owned subsidiary of ICI Mutual. You anticipate that money market funds that are affiliated with each other may seek to purchase a Bond on a joint basis to secure higher coverage at a lower cost than might be available if they purchased Bonds individually.¹

The Bonds will provide coverage to Insured Funds for "Loss Events" that occur with respect to "Protected Assets." Subject to any exclusions set forth in the Bond, "Protected Assets" will include any security, as defined in Section 2(a)(36) of the Act (but excluding any security or obligation backed by the full faith and credit of the United States), that, on the first Business Day (as defined in Rule 2a-7) prior to the Loss Event and without considering the potential effect of the Bond, the Insured Fund was entitled to hold in its portfolio pursuant to Rule 2a-7.² "Loss

¹ You believe that affiliated money market funds purchasing insurance on a joint basis may rely on Rule 17d-1(d)(7) under the Act to exempt them from the prohibitions of Section 17(d) of the Act. You have not asked for, and we do not express, any view as to whether the Bonds fall within the joint insurance arrangements contemplated by Rule 17d-1(d)(7).

² You state that all Protected Assets at the time of acquisition must therefore be Eligible Securities under Rule 2a-7(a)(10), meet the portfolio maturity requirements of Rule 2a-7(c)(2), the portfolio quality requirements of Rule 2a-7(c)(3), and the portfolio diversification requirements of Rule 2a-7(c)(4). You state that an assessment by a board of directors or its delegate as to whether a portfolio security presents "minimal credit risks" for purposes of Rule 2a-7(c)(3)(i) at the time of acquisition or thereafter is separate from the issue addressed in your letter of whether a security (apart from the effect of a Bond) should be disposed of or retained upon the occurrence of a Loss Event. You therefore believe that at least until a Loss Event

Events" will include: (1) defaults by the issuer of the Protected Asset in the payment of all or any portion of the principal or accrued interest when due and payable, or the issuer becoming subject to an Event of Insolvency (as defined in Rule 2a-7) ("Issuer Defaults"); (2) the uncollectibility, in whole or in part, of a demand feature, guarantee, letter of credit or similar credit enhancement backing a Protected Asset as a result of the credit enhancement provider becoming the subject of an Event of Insolvency ("Credit Enhancement Insolvencies"); (3) final judgments by a court that payments received by Insured Funds from issuers or credit enhancement providers constitute voidable preferences, or, if earlier, appropriate determinations by the boards of Insured Funds that the Funds' net asset values must be reduced to reflect preference claims by trustees in bankruptcy, debtors in possession, receivers, conservators or analogous entities ("Preference Events"); and (4) events of seller default under repurchase agreements ("Repo Defaults").

Upon the occurrence of a Loss Event, and subject to the terms, conditions and limitations of the Bond, the Insurer will be obligated to pay the Insured Fund the "Covered Loss." The "Covered Loss" is the amount of the loss ("Loss") less any deductible on the Bond, up to the maximum aggregate limit of coverage available under the Bond.³ The Loss generally will be the excess, if any, of the amortized cost over the fair market value of the affected portfolio security, both as determined at the close of business on the "Payment Date." The Payment Date will be selected by the Insurer after consulting with the Insured Fund, and generally must be no later than the "Maturity Date" of the portfolio security experiencing the Loss Event. The Maturity Date is defined as the earlier of the asset's stated maturity date or 397 days following the Loss Event. The Insured Fund will be required under the terms of the Bond to hold the distressed security until the Payment Date.⁴ You state that because the Insurer is obligated to pay the excess, if any,

occurs, any determination made by the board of directors or its delegate that a security presents minimal credit risks would need to be made without regard to the potential availability of any insurance coverage under a Bond.

³ You state that the Bonds will be offered on an "aggregate limit" basis rather than on a "per occurrence" basis.

⁴ You represent that actuarial studies commissioned by ICI Mutual demonstrate that securities subject to an issuer default or insolvency often decline in value immediately following the event but then recover a significant portion of their value. You state that structuring the Bonds to require an Insured Fund to hold the portfolio security until the Payment Date allows the Insurer to obtain the potential benefit of any market recovery without the expense of buying the security outright from the Insured Fund. You state that this reduced net loss to the Insurer is accomplished at no additional risk to the Insured Fund. In addition to benefiting the Insurer, you represent that this structure benefits an Insured Fund by allowing the Insurer to charge lower

of the amortized cost over the fair market value of the security as measured on the Payment Date, if the spread of the security's amortized cost over its fair market value increases between the day following the Loss Event and the Payment Date, the Insurer will absorb the increased loss.⁵

You state that following a Loss Event, an Insured Fund should be able to reflect the then-current value of any pending claim under a Bond when "shadow-pricing," i.e., computing the market-based value of its assets as required by Rule 2a-7(c)(7)(ii)(A). You state that an Insured Fund therefore should be able to continue to use the amortized cost or penny-rounding method of calculating its net asset value so long as any portion of the loss that is not insured does not cause the Insured Fund to deviate from its stable net asset value. You state that in order to take the value of a claim into account in determining the market value of an Insured Fund's portfolio, the board of directors of the Insured Fund (or its delegate) would need to make a good faith determination as to the sufficiency of the coverage available under the Bond and that, based on the facts and circumstances known at the time, the Insured Fund has a valid claim with respect to the security concerned.

Rule 2a-7(c)(6)(ii) requires that, in the event of a default or any of the other events described in subparagraphs (A) through (D) thereunder, a money market fund must dispose of the affected portfolio security as soon as practicable consistent with achieving an orderly disposition of the security, unless the board of directors makes a finding that such disposition would not be in the best interests of the fund. Because the terms of the Bond will require an Insured Fund to hold the portfolio security until the Payment Date in order to receive coverage under the Bond, you believe that an issue may be raised under paragraph (c)(6)(ii) of the rule, which contemplates disposal of such securities.

You note that in making a finding of whether disposition of an affected security is not in the best interests of a money market fund, the board of directors likely will evaluate the amount of coverage under the Bond, the probability of recovery under the Bond, and the fact that the Insured Fund would lose any insurance coverage under the Bond if it disposed of the affected security prior to the Payment Date. You state that if the board determines that the Bond's coverage should be available to cover all or a portion of the Insured Fund's loss, such conclusion is likely to be an influential and, in many cases, the determinative factor in the board's finding

insurance premiums, and by potentially increasing the amount of remaining coverage available to the Insured Fund under the Bond in the event of a subsequent Loss Event.

⁵ You also represent that if the spread of a security's amortized cost over its fair market value increases between the day following the Loss Event and the Payment Date, the aggregate policy limits on the Bond will be reduced only by the difference between the amortized cost of the security and its fair market value as of the business day following the Loss Event (or such other date that notice is given).

regarding disposition of the security.⁶ You believe that neither the Bond's requirements nor the potentially adverse effect of the disposition of a portfolio security on the Insured Fund's coverage under the Bond should be viewed as improperly circumscribing a board's discretion in making this determination under Rule 2a-7(c)(6)(ii).

Discussion

Rule 2a-7(c)(6)(ii) provides that the board of directors of a money market fund, in making a finding of whether it is in the best interests of the fund to retain a security, "may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security." The Commission added this provision to Rule 2a-7 in recognition of the concern that it may not be in the best interests of a money market fund to dispose of distressed securities in a "fire sale" environment.⁷ Rule 2a-7, however, does not specify what "other factors" the board may consider when determining whether retention of a security is in the best interests of a fund. You assert that the existence of insurance coverage of the type described in your letter is an appropriate factor for the board of directors of a money market fund to consider.

The staff is generally of the view that a board of directors should consider any and all factors that it believes to be material in assessing whether retention of a security is in the best interests of the fund.⁸ Indeed, as a general matter, the staff believes that in order for directors to satisfy their duties as fiduciaries under the Act and under state law, they always must consider all material factors in determining whether any course of action is in the best interests of a fund. The staff concurs with your view that the board of directors of an Insured Fund may find, consistent with the requirements of Rule 2a-7, that in light of the terms and conditions of a Bond it is not in the best interests of the fund to dispose of a portfolio security following the occurrence of a

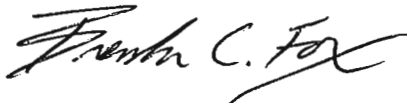
⁶ You note that there may be instances in which the board of directors of an Insured Fund concludes that it is in the best interests of the Insured Fund to dispose of an affected security as soon as practicable, notwithstanding any potential recovery under a Bond. Such a conclusion might be reached when coverage is unlikely to be available under the Bond, or the aggregate limit of liability has been exhausted by prior claims made under the Bond.

⁷ See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991).

⁸ Cf. Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 17589 (July 17, 1990) at n.50 and accompanying text (indicating that boards of directors should consider all material factors in analyzing whether a security presents minimal credit risks, not just the elements suggested by the staff) (citing Letter to Registrants (pub. avail. May 8, 1990) and Investment Company Institute (pub. avail. Dec. 6, 1989)).

default or other credit-related event described in subparagraphs (A) through (D) of Rule 2a-7(c)(6)(ii)⁹. We believe that the existence of insurance coverage does not improperly circumscribe the board's discretion in making this determination.¹⁰

We note that if the board of directors of an Insured Fund makes a determination under Rule 2a-7(c)(6)(ii) that it is not in the best interests of the Insured Fund to dispose of a security, the board or its delegate should continually monitor subsequent events that may affect the value of the security or the availability of the insurance coverage. If, as a result of such subsequent events, the board determines that retention of the security is no longer in the best interests of the Insured Fund, the Insured Fund should dispose of the security as soon as practicable consistent with achieving its orderly disposition.¹¹



Brendan C. Fox
Special Counsel

⁹ Our response is expressly limited to the question raised in your letter. You have not asked for, and we do not express, any view with regard to the operation of the Bonds under any provision of Rule 2a-7 other than paragraph (c)(6)(ii).

¹⁰ We note that, under Rule 2a-7(c)(10), a money market fund must maintain a written record of the board's considerations and actions taken in connection with the discharge of its responsibilities under the rule, and that such records must be available for inspection by the Commission.

¹¹ We also take this opportunity to express our views regarding an Insured Fund's disclosure obligations with regard to insurance coverage of the type described in your letter. We believe that, consistent with the requirements of Form N-1A, an Insured Fund should disclose the nature and extent of any insurance coverage under a Bond in its registration statement and, if required by generally accepted accounting principles, in its financial statements. We also believe that, because a Bond does not guarantee that an Insured Fund will not incur a loss, it may be misleading for an Insured Fund to market itself as an "insured" or "guaranteed" fund.

KIRKPATRICK & LOCKHART LLP

1800 MASSACHUSETTS AVENUE, N.W.
2ND FLOOR
WASHINGTON, D.C. 20036-1800

RICHARD M. PHILLIPS
(202) 778-9040
phillirm@kl.com

TELEPHONE (202) 778-9000
FACSIMILE (202) 778-9100
www.kl.com

July 22, 1998

Office of Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: ICI Mutual Insurance Company and its Subsidiaries;
1940 Act/Rule 2a-7

Ladies and Gentlemen:

ICIM Reinsurance Company ("ICIM Re" or "Insurer"), a wholly-owned insurance subsidiary of ICI Mutual Insurance Company ("ICI Mutual"), plans shortly to introduce an insurance bond ("Money Market Fund Bond" or "Bond") designed to protect insured money market funds ("Insured Funds") from losses resulting from payment defaults, issuer insolvencies and similar credit-related events occurring with respect to portfolio securities held in compliance with Rule 2a-7 under the Investment Company Act of 1940 ("1940 Act").¹ The Money Market Fund Bond will be issued by ICIM Re and will be administered by ICIM Services, Inc. ("ICIM Services"), another wholly-owned subsidiary of ICI Mutual. Money Market Fund Bonds will be offered only to money market funds that are members of the Investment Company Institute ("ICI").²

On behalf of ICIM Re, we ask the staff of the Division of Investment Management ("Staff") of the Securities and Exchange Commission ("Commission") to confirm that it concurs with our

¹ 17 C.F.R. § 270.2a-7, as most recently amended by Inv. Co. Act Rel. No. 22921 (December 2, 1997).

² The ICI is the national association for the American mutual fund industry. Its members include investment companies, their investment advisers and principal underwriters, and sponsors of unit investment trusts. Its mutual fund members have assets accounting for approximately 95% of total industry assets. In addition, the ICI has over 480 associate members, which render investment advisory services exclusively to non-investment company clients.

Securities and Exchange Commission
July 22, 1998
Page 2

view that, following the occurrence of an issuer default or other "Loss Event" (as defined in the Bond) with respect to a portfolio security held by an Insured Fund, and in recognition of the terms and conditions of coverage under the Money Market Fund Bond and under the circumstances described below, the Fund's board of directors or trustees ("Board") may properly make a finding under Rule 2a-7(c)(6)(ii) that it is not in the best interests of the Insured Fund to dispose of that portfolio security.

A. ICI Mutual; Description of the Money Market Fund Bond Program

1. ICI Mutual

ICI Mutual is a captive mutual insurance company for the investment company industry. It was formed in 1987 under the sponsorship of the ICI. Since that time, ICI Mutual has become the predominant provider to registered investment companies and their affiliated service providers of directors and officers/errors and omissions ("D&O/E&O") insurance and of bonds required by Rule 17g-1 under the 1940 Act ("Rule 17g-1 Bonds").³ ICI Mutual estimates that it currently writes approximately 46% of the Rule 17g-1 Bond requirements and approximately 40% of the total D&O/E&O insurance requirements of the American investment company industry.⁴

ICIM Re was organized in 1997 and is a wholly-owned subsidiary of ICI Mutual. Like ICI Mutual, ICIM Re is a captive insurance company under Vermont law and is subject to regulation and oversight by the Vermont Department of Banking, Insurance, Securities and Health Care Administration ("Vermont Department").

³ ICI Mutual currently provides insurance to insureds in 126 mutual fund complexes, including 21 of the 25 largest mutual fund complexes in the United States. ICI Mutual's member insureds include over 3,900 investment companies with assets of approximately \$2.8 trillion, representing approximately 60% of the industry's total assets.

⁴ ICI Mutual is unaware of any statistics compiled by an independent source on the insurance needs of the investment market for D&O/E&O and Rule 17g-1 Bond insurance. ICI Mutual has calculated its market share by estimating the total investment company market based on the insurance purchased by ICI Mutual's member insureds from ICI Mutual and other carriers.

Securities and Exchange Commission
July 22, 1998
Page 3

Through ICIM Services, ICI Mutual will provide exclusive administrative services (including underwriting services) to ICIM Re in connection with the Money Market Fund Bond program. ICIM Services was formed in 1992 and currently performs the underwriting duties for ICI Mutual.

In the event of a claim under a Money Market Fund Bond, ICIM Re will be obligated to the Insured Fund for any and all amounts that may be owed under the Bond. However, as is customary with insurance coverage providing significant aggregate limits of liability to insureds, ICIM Re plans to cede a significant portion of its risk to various reinsurers.⁵ ICIM Re's net retention under the Money Market Fund Bonds will not exceed any limits established on such retention by Vermont insurance law.

2. The Program

As previously stated, the Money Market Fund Bond is designed to protect Insured Funds from losses resulting from payment defaults, issuer insolvencies and similar credit-related events occurring with respect to certain of their portfolio securities. The impetus for the development of the Bond is the twofold recognition that: (1) while the portfolio constraints imposed by Rule 2a-7 substantially limit a money market fund's exposure to credit risk, that risk cannot be entirely eliminated; and (2) money market funds that do incur such losses may be forced to compute their share prices based on reduced net asset values ("NAVs") and thereby "break a dollar" if they cannot be indemnified for all or part of the loss. The Money Market Fund Bond will be a potential source for such indemnification.

It is generally believed that the breaking of a dollar by a money market fund may have significant, adverse consequences not only for the affected money market fund and its shareholders and for the related fund complex, but also for the investment company industry as a whole. Historically, the investment advisers for money market funds that have incurred such losses have stepped forward to provide capital infusions or to take other remedial actions, frequently at substantial cost to themselves. However, in many instances, the investment advisers have had no legal obligation to take such actions, and there can be no assurance that these advisers will be willing or able to make the necessary payments in the future. Indeed, it was just such an inability that resulted in the one instance to date in which a money market

⁵ Each of the reinsurers participating in the reinsurance arrangement will be acceptable to the Vermont Department.

Securities and Exchange Commission
July 22, 1998
Page 4

fund did break a dollar. The availability of the Money Market Fund Bond will reduce the risk of a recurrence of such an event.⁶

As is common with D&O/E&O insurance policies and with Rule 17g-1 Bonds, it is anticipated that affiliated money market funds may wish to purchase Money Market Fund Bonds on a joint basis so as to secure more extensive limits of liability and lower aggregate premiums than might otherwise be available if they were to purchase singly.⁷ In order to accommodate the reasonable

⁶ The Director of the Division of Investment Management has also pointed to the existence of a potentially troublesome inconsistency between investors' expectations that advisers will make such payments and the fact that such payments are voluntary. The Director noted that proposals involving the development of money market fund insurance "appear to be the first steps by the industry, on its own initiative, to avoid bailouts." Barry P. Barbash, Director, Division of Investment Management, U.S. Securities and Exchange Commission, "Mutual Funds in the New Millenium: The Opportunity to Invent Their Future" (1997 ICI General Membership Meeting) (May 16, 1997).

⁷ It is our understanding that, by complying with Rule 17d-1(d)(7) under the 1940 Act, affiliated Insured Funds would be excepted from the prohibition that Section 17(d) and Rule 17d-1 thereunder might otherwise impose on them in connection with a joint purchase of Money Market Fund Bonds. Although subpart (d)(7)'s reference to "liability insurance policies" might arguably be read to restrict the type of joint insurance to which the subpart could apply, it appears that no such restriction was intended by the Commission. Rather, the Commission appears to have selected this language in order to expand the exception provided by subpart (d)(7) beyond the only type of insurance (other than Rule 17g-1 Bonds) then commonly purchased by investment companies, i.e., "errors and omissions" insurance. The expansive intent of subpart (d)(7) is clearly evidenced by the Commission's release proposing subpart (d)(7), which states:

The Commission does not propose limiting the exemptive rulemaking to joint insurance arrangements regarding errors and omissions insurance only. Rather, it believes that, other than the bonding required by rule 17g-1, the question of whether any other type of joint insurance coverage is appropriate and necessary for any particular investment company's operation should be a matter within the discretion of that investment company's board of directors, provided that conditions prescribed in the proposed rule are satisfied. *Inv. Co.*

Securities and Exchange Commission
July 22, 1998
Page 5

coverage needs of Insured Funds purchasing both separately and jointly, ICIM Re expects to offer Money Market Fund Bonds with limits of liability of up to \$100 million, with the ability to make arrangements for additional limits on a facultative (i.e., individual) basis.⁸

It is anticipated that a number of Insured Funds will also purchase D&O/E&O insurance and/or Rule 17g-1 Bonds from ICI Mutual. However, Insured Funds will not be required to purchase D&O/E&O insurance or Rule 17g-1 Bonds from ICI Mutual, and it is anticipated that a number of Insured Funds will purchase their D&O/E&O insurance and/or Rule 17g-1 Bonds elsewhere.

B. Description of the Money Market Fund Bond

The Money Market Fund Bond will provide coverage to Insured Funds for "Loss Events"⁹ occurring with respect to their

(Cont'd.)

Act Rel. No. 10700 (May 16, 1979), at n.7 (emphasis added).

Since, based on the foregoing, it appears that the Money Market Fund Bonds would fall within the ambit of the joint insurance coverages contemplated by Rule 17d-1(d)(7), we are not asking the Staff to concur with our view on that subject.

⁸ As is virtually always the case with D&O/E&O insurance policies, the Money Market Fund Bonds will be offered on an "aggregate limit" basis. ICI Mutual and its subsidiaries do not believe that it is economically feasible for this insurance to be provided on a "per occurrence" basis, as is generally the case with Rule 17g-1 Bonds.

⁹ "Loss Events" will include the following:

(1) defaults by the issuer of the Protected Asset in the payment of all or any portion of the principal or accrued interest when due and payable, or the issuer becoming subject to an Event of Insolvency (as defined in Rule 2a-7) ("Issuer Defaults");

(2) the uncollectibility, in whole or in part, of a demand feature, guarantee, letter of credit or similar credit enhancement backing a Protected Asset as the result of the credit enhancement provider becoming the subject of an Event of Insolvency ("Credit Enhancement Insolvencies");

Securities and Exchange Commission
July 22, 1998
Page 6

"Protected Assets." Subject to any exclusions set forth in the Bond,¹⁰ a Protected Asset under the Bond will be:

any security, as defined in Section 2(a)(36) of the [1940] Act (but excluding any security or obligation backed by the full faith and credit of the United States), that, on the first Business Day prior to the Loss Event and without considering the potential effect of the Bond, the Insured Money Market Fund was entitled to hold in its portfolio pursuant to Rule 2a-7.

Thus, in addition to excluding securities backed by the full faith and credit of the United States from coverage, the Bond will not protect an Insured Fund for losses with respect to securities that, in the absence of the Bond, the Insured Money Market Fund was not entitled to hold in its portfolio pursuant to Rule 2a-7 on the first Business Day prior to the Loss Event. For example, the Bond would not protect an Insured Fund for losses with respect to portfolio securities that, at the time of purchase or roll over,¹¹ were not Eligible Securities within the

(Cont'd.)

(3) final judgments by a court that payments received by Insured Funds from issuers or credit enhancement providers constitute voidable preferences, or, if earlier, appropriate determinations by the Boards of Insured Funds that the Funds' NAVs must be reduced to reflect preference claims by trustees in bankruptcy, debtors in possession, receivers, conservators or analogous entities ("Preference Events"); and

(4) events of seller default under repurchase agreements ("Repo Defaults").

¹⁰ Although not finally determined at this time, the Bond may contain exclusions for certain securities that otherwise would constitute Protected Assets under the Bond. For example, ICIM Re and its reinsurers may determine that the Bond should exclude Unrated Securities (as defined in Rule 2a-7(a)(28)) that have received a long-term rating from an NRSRO that is only in the third highest rating category. It also is possible that there may be other types of exclusions from coverage under the Bond, such as for Loss Events resulting from the "Year 2000 problem."

¹¹ This is the time of most recent "Acquisition" under Rule 2a-7(a)(1).

Securities and Exchange Commission

July 22, 1998

Page 7

meaning of Rule 2a-7(a)(10) or did not satisfy the other portfolio quality requirements of Rule 2a-7(c)(3) (including the requirement that the security be determined to present minimal credit risks).¹² Similarly, the Bond would not protect an Insured Fund for losses with respect to portfolio securities that were acquired in violation of the portfolio maturity requirements of Rule 2a-7(c)(2) or the portfolio diversification requirements of Rule 2a-7(c)(4).

Upon the occurrence of a Loss Event and subject to the terms, conditions and limitations of the Bond,¹³ the Insurer will be obligated to pay the Insured Fund the "Covered Loss," i.e., the "Loss," less the deductible on the Bond, up to the maximum aggregate limit of coverage available under the Bond.¹⁴ For most Loss Events, the Loss will be the excess, if any, of the amortized cost over the fair market value of the affected portfolio security, both as determined at the close of business on a specified date ("Payment Date").¹⁵ The Insurer will be

¹² A Board's assessment (or that of its investment adviser or officers, acting under delegated authority) as to whether a portfolio security presents "minimal credit risks" for purposes of Rule 2a-7(c), either at the time of acquisition or thereafter, is separate from the question, addressed herein, of whether a security that (apart from the effect of the Bond) no longer meets that requirement should be disposed of or retained. At least until a Loss Event occurs, any minimal credit risk determination would need to be made without regard to the potential availability of insurance under the Bond.

¹³ Other terms and conditions of the Bond address such items as the Insured Fund's reporting obligations, cancellation and termination of coverage, the Insurer's subrogation rights, the extent to which an Insured Fund's interests under a Money Market Fund Bond may be transferred, and the computation and allocation of remaining aggregate limits of liability.

¹⁴ The aggregate limit of coverage and the deductible will be specified in the Bond but will vary depending on the terms selected by the Insured Fund. The deductible under each Bond will apply separately to each Loss Event and will be derived from applying a specified number of basis points to the value of the total assets of the Insured Fund as of the close of business on the first business day prior to the related Loss Event.

¹⁵ The Loss will be computed in the manner specified in the text in the case of Loss Events constituting Issuer Defaults or Credit Enhancement Insolvencies. In the case of Preference Events, the

Securities and Exchange Commission

July 22, 1998

Page 8

obligated to make any payment due under the Bond on the Payment Date, subject to the provisions of the Bond and provided that a satisfactory written proof of loss and requisite additional information has been submitted by the Insured Fund to the Insurer.

The Payment Date will be a date selected by the Insurer that, for most Loss Events, must be no later than the "Maturity Date" of the portfolio security experiencing the Loss Event, with "Maturity Date" defined as the earlier of the asset's stated maturity date or 397 days following the Loss Event.¹⁶ Consequently, the Fund would not be required to continue to hold the portfolio security experiencing the Loss Event for a period that would be longer (measured from the Loss Event) than the time frame permitted under Rule 2a-7 for the remaining maturity of an Eligible Security.¹⁷ The Bond will require the Insurer to consult with the Insured Fund before establishing the Payment Date, and

(Cont'd.)

Loss will be equal to the amount by which the NAV of the Insured Fund is reduced by reason of the related preference, or the amount of payment found to be a preference by the court. In the case of Repo Defaults, the Loss will be the excess, if any, of: (i) the repurchase price due to the Insured Fund over (ii) any amount received by the Insured Fund from the repo seller plus the fair market value of the purchased securities or other collateral held by or for the Insured Fund under the repurchase agreement, determined as of the first business day following the date of the repo seller's default.

¹⁶ In certain cases, the Payment Date might be later. For Loss Events constituting Issuer Defaults or Credit Enhancement Insolvencies, if the Loss Event occurs within five business days of the Maturity Date of the Protected Asset, the Payment Date could be up to five business days following the Loss Event. For Loss Events constituting Preference Events, the Payment Date could not be later than five business days following the payment by the Insured Fund of the amount determined to be a preference. For Loss Events constituting Repo Events, the Payment Date could not be later than five business days following the Loss Event.

¹⁷ See Rule 2a-7(a)(10). Note, however, that if such period were deemed to be the "remaining maturity" of the security for purposes of Rule 2a-7, then the Fund's portfolio maturity might be lengthened, requiring the Fund to take appropriate measures to ensure compliance with the dollar-weighted average portfolio maturity requirements of Rule 2a-7(c)(2)(iii).

Securities and Exchange Commission
July 22, 1998
Page 9

it will require the Insurer to give the Insured Fund at least one business day's prior notice of the Payment Date.

In addition to its obligation to pay the Covered Loss, if between the date of a Loss Event constituting an Issuer Default or Credit Enhancement Insolvency and the Payment Date, payments become due on the affected portfolio security by its issuer or credit enhancement provider, the Insurer also will be obligated to pay promptly after such due date, subject to the Deductible and the other provisions of the Bond (including the provision of requisite notice and information), an amount equal to the excess, if any, of payments due by the issuer or credit enhancement provider over the payments actually made. If such payments represent principal or interest that would otherwise be reflected in the Loss, the amount of the payments will be applied against the Covered Loss (i.e., will reduce the Loss for the purposes of computing the amount payable under the Bond on the Payment Date).¹⁸

C. Discussion

The Money Market Fund Bond protects the Insured Fund from losses arising from Issuer Defaults or Credit Enhancement Insolvencies with respect to Protected Assets by covering the excess, if any, of the amortized cost over the fair market value of the Protected Asset, both as measured on the Payment Date ultimately selected by the Insurer. Since, following a Loss Event, an Insured Fund normally should be able to reflect the then-current value of any pending claim under the Bond in computing the market-based value of its assets pursuant to Rule 2a-7(c)(7)(ii)(A) ("shadow pricing"), the Insured Fund with such a claim should be able to continue to use the amortized cost method of calculating its NAV as long as the portion of the loss that is uninsured (by reason of the application of the deductible and the overall policy limits) does not itself cause the Insured Fund to break a dollar.¹⁹

¹⁸ Other special provisions in the Bond set forth (1) the circumstances under which the Insurer may exercise a right to purchase a portfolio security from an Insured Fund; and (2) the limited circumstances under which an investment adviser to an Insured Fund may itself seek coverage under the Bond.

¹⁹ The same considerations would apply to any Insured Fund using the penny-rounding method. Regardless of the method used, in order to take the value of a claim under the Money Market Fund Bond into account in an Insured Fund's market-based value

Securities and Exchange Commission

July 22, 1998

Page 10

Under the terms of the Bond, however, the Insured Fund will be required to continue to hold the Protected Asset until the Payment Date. The requirement that an Insured Fund continue to hold until the Payment Date a Protected Asset that is in default or that otherwise has become subject to a Loss Event may raise an issue under Rule 2a-7(c)(6)(ii), which contemplates that money market funds normally will promptly dispose of such securities.

Rule 2a-7(c)(6)(ii) requires that, upon the occurrence of an issuer default (other than an immaterial default unrelated to the financial condition of the issuer) or any of the other events specified therein, a money market fund must dispose of the affected portfolio security "as soon as practicable consistent with achieving an orderly disposition of the security" unless its Board makes an affirmative finding that such disposal "would not be in the best interests of the money market fund."

In making such a finding, the Board of an Insured Fund having a claim under the Money Market Fund Bond will necessarily evaluate the likelihood and amount of coverage under the Bond. The Board would also consider the fact that the Insured Fund would lose the benefit of any such coverage under the Bond if it disposed of the affected security prior to the Payment Date. If, after taking into consideration the terms and conditions of the Bond's coverage, a Board concludes in good faith that coverage (less the applicable deductible) should be available for all or a portion of the Fund's loss, that conclusion is likely to be an influential -- and in many cases, determinative -- factor in the Board's finding regarding the disposition of the security.²⁰

(Cont'd.)

computations, the Insured Fund's Board (or its investment adviser or officers, acting under delegated authority) would need to have made a good faith determination as to the sufficiency of the coverage available under the Bond and that, based on the facts and circumstances known to it at the time, the Insured Fund has a valid claim with respect to the security involved.

²⁰ There may be circumstances under which the Board of an Insured Fund would conclude that it is in the best interests of the Fund to dispose of the security as soon as practicable, notwithstanding that, by doing so, the Fund would surrender any potential recovery under the Money Market Fund Bond. For example, if a Board concludes, based on the information available to it, that coverage is unlikely to be available under the Bond -- perhaps because the aggregate limit of liability has been exhausted by prior claims made under the Bond, or because a

Securities and Exchange Commission
July 22, 1998
Page 11

Thus, while the Board will continue to be obligated to make the finding called for under Rule 2a-7(c)(6)(ii), its conclusion may be strongly influenced by the requirements of Bond. Nevertheless, since the Board ultimately must reach its own determination based on what the Board members deem to be in the best interests of the Fund, we believe that neither the Bond's requirements nor the potentially adverse effect of a disposition on the Insured Fund's coverage under the Bond should be viewed as improperly circumscribing a Board's discretion. Thus, notwithstanding the terms and conditions of the Bond, a Board's determination not to dispose of the affected security should constitute an independent "finding" within the meaning of Rule 2a-7(c)(6)(ii).

Rule 2a-7(c)(6)(ii) does not specify the factors that may be considered by a Board in making its finding, other than to state that the Board "may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security." Thus, the Rule does not, by its terms, preclude a Board from considering the Bond as a factor in making its determination. Indeed, the Rule implies that the effect of a disposition of the security on coverage under the Bond could be one of the "other factors" that the Board could consider.

Moreover, there are sound policy reasons for the Bond's requirement that Protected Assets that are subject to pending claims be retained following an issuer default or other Loss Event. Actuarial studies commissioned by ICI Mutual indicate that portfolio securities that sustain an issuer default or an issuer insolvency often decline precipitously in value during the period immediately following the event but then recover a significant portion of their value, sometimes within a period of weeks or months. The structure of the Bond enables the Insurer to extend the Payment Date under the Bond in appropriate cases so as to obtain the potential benefit of these market recoveries without expending the capital necessary to buy the affected security outright from the Insured Fund. This reduced net loss (as calculated on an overall actuarial basis) to the Insurer -- accomplished at no additional risk to the Insured Fund²¹ --

(Cont'd.)

condition to coverage has not been satisfied -- the Board may be unable to find that it is in the best interests of the Insured Fund to retain the security.

²¹ If the spread of the security's amortized cost over its fair market value increases between the day following the Loss Event and the Payment Date, the increased loss is absorbed by the

Securities and Exchange Commission
July 22, 1998
Page 12

permits Money Market Fund Bonds to be offered at lower premiums than would be feasible if the Bonds required the Insurer to pay a loss amount as measured immediately following the default or other Loss Event. Moreover, to the extent the Insurer is able to reduce its loss for a given Loss Event through extension of the Payment Date, the Insured Fund(s) under the Bond will have greater remaining policy limits to draw upon in the event of a subsequent Loss Event.²²

(Cont'd.)

Insurer because the Insurer continues to be obligated to pay the excess, if any, of the amortized cost over the fair market value of the affected security as measured on the Payment Date. The Insurer also is obligated, subject to the deductible and the other provisions of the Bond, to pay any interest that becomes due during the holding period. Thus, provided that the Insured Fund supplies timely notices and required information, there is no additional risk to the Insured Fund by reason of the extension of the Payment Date.

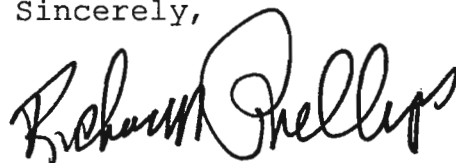
²² If the spread of the security's amortized cost over its fair market value decreases between the day following the Loss Event and the Payment Date, only the lesser amount (i.e., the excess of the security's amortized cost over its fair market value as of the Payment Date) will be applied against the aggregate policy limits of the Bond. Thus, an Insured Fund will generally obtain a benefit, in the form of greater remaining policy limits, from any savings to the Insurer that results from an extension of the Payment Date. Moreover, the Insured Fund will not be penalized if the spread of the asset's amortized cost over its fair market value increases between the day following the Loss Event and the Payment Date; in such a case, the aggregate policy limits will be reduced only by the difference between the amortized cost of the security and its fair market value as of the business day following the Loss Event (unless the notice and information that the Insured Fund is required to provide to the Insurer is provided subsequent to the first business day after the Loss Event, in which case any increase in the amount of the Covered Loss that occurred prior to the date that such notice and information was provided would also be applied against the aggregate limit of liability).

Securities and Exchange Commission
July 22, 1998
Page 13

* * * * *

For the reasons set forth above, we request that you confirm that you concur with our view as set forth herein. If you wish further information regarding any of the matters raised by this no-action request, please contact Robert A. Wittie (202-778-9066) of this office or the undersigned.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard M. Phillips". The signature is written in a cursive, flowing style with a large initial "R".

Richard M. Phillips