November 1, 2002

Ms. Lisa Good
Executive Director
National Federation of Municipal Analysts
P.O. Box 14893
Pittsburgh, PA 15234

Re: NFMA Draft Recommended Best Practices in Disclosure for Variable Rate and Short-Term Securities

Dear Ms. Good:

The Investment Company Institute\textsuperscript{1} appreciates the opportunity to comment on the National Federation of Municipal Analysts' ("NFMA") Draft Recommended Best Practices in Disclosure for Variable Rate and Short-Term Securities (the "Draft Paper") released by the National Federation of Municipal Analysts. The Institute supports the NFMA's efforts to improve the level of disclosure in the municipal securities market. Mutual funds, particularly money market funds, are significant purchasers of variable rate demand notes ("VRDNs") and other short-term securities, and thus have a keen interest in improving the disclosure in this area. The Draft Paper is an excellent step in this direction and, like the other papers the NFMA has developed over the last several years, will serve as a valuable resource to issuers, bond counsel and other market participants inasmuch as it will facilitate greater understanding of the needs of money market funds with respect to VRDNs and other short-term securities.

Our comments are set forth below.

A. Organization of the Document

Rule 2a-7 under the Investment Company Act of 1940 permits money market funds to use special share pricing and portfolio valuation methods, subject to certain requirements provided in the rule. Specifically, the rule provides detailed regulatory parameters that must be satisfied in order for a money market fund to purchase VRDNs and other securities. Because of these parameters, which, among other things limit a money market fund's investments to high quality, short-term, U.S. dollar-denominated

\textsuperscript{1} The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,982 open-end investment companies ("mutual funds"), 513 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.373 trillion, accounting for approximately 95% of total industry assets, and over 90.2 million individual shareholders.
debt instruments, we believe that it would benefit all municipal market participants to have a better understanding of the requirements of the rule. In our view, an issuer’s understanding of Rule 2a-7 would facilitate greater access to short-term funding, since transactions that are structured in accordance with the provisions of the rule will enable money market funds to better evaluate, analyze, and consequently purchase, that issuer’s securities.

Accordingly, we recommend that the NFMA insert in the Draft Paper a new Appendix 3, entitled “Requirements of Rule 2a-7 Regarding Independent Minimal Credit Risk Determination,” that outlines the main requirements of Rule 2a-7, including the need for a money market fund to independently determine (and therefore to receive information sufficient to permit an independent determination) that the VRDN or other security satisfies the “minimal credit risk” requirement of the rule. To facilitate this recommendation, we have provided a draft appendix at the end of this letter that summarizes the requirements of the rule. We encourage the NFMA to insert it into the Draft Paper.

B. Variable Rate Securities

1. General Items – Official Statement Disclosure

The Institute recommends that the Draft Paper urge issuers to disclose near the front of their official statements a concise outline of the terms of the deal that affect compliance with the requirements of Rule 2a-7. Such terms should relate to: (1) mandatory tenders and/or notice provisions, and/or provisions of opinions associated with (i) substitution, termination (scheduled or early) or extension of credit facilities; (ii) substitution, termination (scheduled or early) or extension of liquidity facilities; (iii) mode changes; and (iv) creation of or a change in a control relationship between a credit facility or liquidity facility provider and obligor; and (2) conditions that may cause termination of a credit facility or liquidity facility prior to a mandatory tender. While a money market fund will still need to make a determination as to Rule 2a-7 eligibility, the upfront summary of these terms will facilitate review of the official statement by the fund’s analysts, and provide a checklist for issuers, underwriters and bond counsel regarding satisfaction of key structural requirements for money market fund eligibility.

The Institute also recommends placing certain information in an appendix to the official statement, such as any financial information or other credit-related information regarding the issuer/obligor. The placement of financial information in an appendix would provide a more concise official statement and enable readers to hone in on structure-related information and, to the extent still applicable, credit-related information.

Moreover, the Draft Paper should note that an official statement for a VRDN is used in connection with a continuous primary offering of securities (i.e., each remarketing constitutes a primary offering), and that all material terms of the security must be updated (through a revised or supplemented official statement) in connection
must be updated (through a revised or supplemented official statement) in connection with each remarketing. For example, the identity of the current provider, current expiration date or other material terms of the current credit enhancement facility or liquidity facility must be reflected in the official statement provided at the time of a remarketing.

In the following sections, the Institute recommends various modifications to the bullet-point provisions to better clarify the meaning and purpose of the provision. Modified language is italicized.

a. **Underlying Obligor and Project**

In the second bullet point under this section, the Draft Paper requests that the issuer “Identify the purpose of the borrowing and the use of proceeds.” The Institute supports the inclusion of this information, as it is relevant to an assessment of the tax-exempt status of a security and the fund’s decision to purchase it. We note that money market funds would find other information, such as the project location and its anticipated completion date, equally useful inasmuch as it would better enable monitoring of the tax status and continued viability of the project. Therefore, we recommend modifying the sentence to request the issuer to “Identify the purpose of the borrowing, the use of proceeds, the project location, and the completion date or anticipated completion date of the project.”

b. **Demand Feature or Optional Tender**

The fourth bullet point in this section requests the issuer to “Identify any events that cause a bondholder to lose the ability to tender.” The Institute notes that because the ability to exercise a tender is critical to a money market fund, we recommend adding the term, “Prominently” at the beginning of the sentence.

c. **Tax Issues**

The issue of taxability is obviously of extreme importance to a tax-exempt money market fund. Because investors in VRDNs generally view any IRS audit of municipal securities they own as a material event, an issuer should disclose whether a VRDN is under review by the IRS for taxability concerns, irrespective of whether the review is categorized as a “random” audit or “targeted” audit, and irrespective of the issuer’s/obligor’s view of the likely outcome of the audit. If the issuer/obligor is confident that the VRDN will not be declared taxable, or intends to enter into a closing agreement with the IRS if the VRDN is declared taxable, it is free to make that disclosure together with the disclosure of the IRS audit, but such belief or intention should not result in non-disclosure of the audit.

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2 The Institute notes that the recommendations in this section, as well as the following section entitled “Miscellaneous,” are equally applicable to the section in the Draft Paper entitled “Short-term Notes,” and as such should be incorporated in that section as well.
d. Miscellaneous

The second bullet in this section, subtitled “Contact information,” requests the issuer to provide certain information on various parties involved in the transaction, including the issuer, obligor, credit enhancer, liquidity provider, trustee, bond counsel, and remarketing agent. The Institute supports this provision. Indeed, our members have informed us of the difficulty they often face when trying to obtain certain contact information. Of particular importance, however, is the ability to obtain information on any changes in the trustee or liquidity provider. Therefore, we recommend modifying the first sentence to read, “Provide the title, phone number, e-mail address, and regular mailing address for the following, including any successors: Issuer, Obligor …”

The second sentence in this provision addresses conflicts and recommends the use of different entities to perform the trustee and credit enhancer functions so as to avoid possible conflicts of interest in a default situation. The Institute supports this provision but notes that the Draft Paper does not preclude the same entity from being both the provider and the beneficiary of the credit enhancement facility. To address those situations, therefore, we recommend adding a third sentence that states: “If, however, the Credit Enhancer and the Trustee are the same entity, there should be disclosure about possible conflicts of interest in a default situation.”

2. Securities Enhanced by a Letter of Credit (LOC)

a. Official Statement Disclosure

The fourth bullet in the subsection entitled “LOC Substitution” discusses notification of substitute credit facilities. The first sentence requests issuers to “Identify how beneficial owners will be notified of any substitute credit facilities.” To reinforce the importance of obtaining this information in a timely manner and to help investors stay abreast of credit facility substitutions, we recommend adding at the end of this sentence the phrase, “and the timeframe in which such notification will occur if a mandatory tender is not required prior to such substitution.” Related to this, we note that it is important to remind investors that the Depository Trust Corporation (“DTC”) may not necessarily provide this information. Thus, we recommend inserting the following sentence at the end of this paragraph: “It should be noted that DTC may not forward to its participants a notice of a credit facility substitution not involving a change in rating - even though a money market fund must evaluate the new credit facility irrespective of the ratings.”

b. Secondary Market Disclosure

The Institute suggests the following changes. First, we recommend changing the title to “Updated Disclosure” since remarketings of VRDNs constitute primary market transactions, not secondary market transactions. Second, we recommend inserting a new first bullet point that states: Material changes in the original terms of a VRDN or the credit enhancement or liquidity for the VRDN must be disclosed through a revised Official Statement or a supplement to the Official Statement in connection with VRDN remarketings,
which constitute primary offerings under the securities laws. In addition, any such material information is required by existing holders of a VRDN, including money market funds, in order to enable them to satisfy their ongoing obligations to monitor portfolio securities.

Third, the Institute recommends that the current second bullet point, which provides a list of informational items a bond trustee should be instructed to provide to beneficial holders, including "credit enhancements, bond redemptions or tenders, etc.," be extended to include "evidence of extension of a credit facility's expiration date."

The current third bullet point in this section notes "trustees should be instructed to provide an affirmative statement annually to the remarketing agent that the trustee has not received a notice of non-renewal from the LOC Provider." (Emphasis supplied.) The Institute recommends adding the following sentence at the end of this bullet point: "In addition, the transaction documents should provide for an acknowledgement from the issuing bank of an evergreen LOC, acknowledging that it has not sent a notice of non-renewal to the trustee." This provision would protect bondholders in the case of potential miscommunications between the trustee and the issuing bank.

The current fourth bullet point suggests that secondary market disclosure should include "an annual affirmative statement regarding the control relationship between the institution providing the enhancement or liquidity and the obligor and notification to beneficial owners if there is ever a change in the relationship." The provision explains that this is particularly relevant since the requirements for diversification under Rule 2a-7 are tighter if there is a control relationship. As such, the Institute recommends replacing this provision with one that suggests prompt notification to beneficial owners upon the creation of any new control relationship or change to an existing control relationship, describing the nature of the change.

3. Securities with Conditional Demand Features

   a. Insured Securities with Liquidity – Official Statement Disclosure

The subsection entitled "Insurance Substitution" contains three bullet points related to the disclosure of various aspects of substituted bond insurance policies: (1) the procedures and timing for providing a substitute bond insurance policy; (2) the prerequisites for providing an alternative bond insurance policy; and (3) the ways in which beneficial holders will be notified of any substitute credit facilities. The Institute recommends inserting a fourth bullet point in this section that states that "If the VRDN is supported by a liquidity facility with conditional demand features, and the demand feature terminates upon any change, amendment, modification, cancellation, or substitution of the bond insurer without the written consent of the liquidity facility provider, the official statement should include disclosure to the effect that the trustee has covenanted (in the indenture) not to take any actions in furtherance of a bond insurer substitution without the written consent of the liquidity facility provider."
4. Unenhanced Securities with Internal or Self-Liquidity

   a. Official Statement Disclosure

   This section contains eight bullet points related to various aspects of official statement disclosure. The Institute recommends adding a ninth bullet point indicating that if the obligor has the option to provide or to cancel a liquidity facility based on satisfaction of requirements specified in the indenture, a mandatory tender with a bondholder right to retain (affirmative opt-out) should result upon obligor’s exercise of such option.

   b. Secondary Market Disclosure

   This section contains nine bullet points related to various aspects of updated disclosure. The Institute recommends inserting a tenth bullet that states: “Any disclosure should pertain to the specific obligor, not to a corporate affiliate that is not obligated to repay the security (e.g., disclosure updates about an obligor that is a subsidiary of a holding company should not be made by reference to the holding company’s financial statements or other data relating to the holding company.)”

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   The Institute appreciates the NFMA’s consideration of our views on the Draft Paper. If you have any questions, or would like additional information, please feel free to contact me at (202) 326-5824 or Barry Simmons at (202) 326-5923.

   Sincerely,

   [Signature]

   Amy B.R. Lancellotta
   Senior Counsel

   cc: Mary Colby
   Vice President
       Charles Schwab Investment Management Inc.

   Nancy Belz
   Vice President
   Federated Investment Management Companies
Appendix

Requirements of Rule 2a-7 Regarding
Independent Minimal Credit Risk Determination

All mutual funds that hold themselves out as "money market funds" are
governed by Rule 2a-7 under the Investment Company Act of 1940. Rule 2a-7 allows a
fund to use the "amortized cost" method (rather than the mark-to-market method) to
value its portfolio securities, which enables it to maintain a stable share price – typically
$1.00 per share. Rule 2a-7 is a complex rule. It prescribes substantive limits on securities
that are "eligible securities" for a money market fund, and it imposes procedural
requirements on the fund, its board of directors and investment manager as a condition
of reliance on the rule.

Rule 2a-7 imposes strict limits on (1) the quality of instruments in which a money
market fund may invest, (2) the diversification of instruments in the fund’s portfolio,
and (3) the weighted average maturity of such instruments. With limited exceptions, at
least 95 percent of a money market fund’s total assets must be invested in securities that
are rated in one of the two highest short-term rating categories by a specified number of
nationally recognized statistical rating organizations ("NRSROs"), or if not rated,
comparable in quality to such rated instruments.

In addition to meeting the requirements of Rule 2a-7, noted above, all securities
purchased by a money market fund must meet a "minimal credit risk" requirement.
Rule 2a-7 requires the board of directors of a money market fund to make this
independent "minimal credit risk" determination. This function can be delegated to the
fund’s investment adviser pursuant to written procedures. It is important to note,
however, that the fact that a rating agency has given a qualifying short or long-term
rating to a security is not equivalent to a determination of minimal credit risk and,
therefore, does not mean that the security is automatically suitable for sale to a money
market fund. The fund’s board of directors or adviser must make the independent
minimal credit risk determination prior to purchase. If a security ceases to present

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3 Paragraph (b) of Rule 2a-7 enumerates the types of activities that constitute “holding out” and that require compliance with the rule.

4 The SEC's Division of Investment Management has stated that examples of elements of such an independent credit analysis include: (1) a cash flow analysis; an assessment of the issuer’s ability to react to future events, including a review of the issuer’s competitive position, cost structure and capital intensiveness; an assessment of the issuer’s liquidity, including bank lines of credit and alternative sources of liquidity to support its commercial paper; and a 'worst case scenario' evaluation of the issuer’s ability to repay its short-term debt from cash sources or assets liquidations in the event that the issuer’s backup credit facilities are unavailable; Letter from staff of SEC Division of Investment Management to Registrants (pub. avail. May 8, 1990); (2) macro-economic factors which 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; Letter from staff of SEC Division of Investment Management to Investment Company Institute (pub. avail. Dec. 6, 1989); and (3) any additional factors it believes to be material in assessing the credit risks posed by a particular investment; Revisions to Rules Regulating Money Market Funds, July 17, 1990.
minimal credit risk, it becomes an ineligible security and may have to be sold as promptly as practicable.

A security with a nominal maturity that exceeds the maturity restrictions of Rule 2a-7 (as is the case with the typical VRDN) may nonetheless qualify if the money market fund has the right to tender or put the security within the time period specified under Rule 2a-7. Such tender or put right may be unconditional, or, subject to certain limitations, conditional. The following requirements of Rule 2a-7 must be satisfied for a security with a conditional tender or put right (a “Conditional Demand Feature”) to be an eligible money market fund investment:

Rule 2a-7(c)(3)(iv) - Portfolio Quality: Securities Subject to Conditional Demand Features

“A security that is subject to a Conditional Demand Feature (“Underlying Security”) may be determined to [satisfy the maturity and credit requirements of Rule 2a-7] only if:

(A) The Conditional Demand Feature [meets the requirements of Rule 2a-7];

(B) At the time of the [acquisition of the Underlying Security, the money market fund’s board of directors has determined that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur; and

(1) The conditions limiting exercise either can be monitored readily by the fund, or relate to the taxability, under federal, state or local law, of the interest payments on the security; or

(2) The terms of the Conditional Demand Feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand Feature in accordance with its terms; and,..."