112-28

FEB 26 1976

MEMORANDUM

TO : The Commission

FROM : The Division of Investment Management Regulation

RE : Registered unit investment trusts having insurance contracts guaranteeing timely payment of interest and principal on their portfolios of municipal bonds.

SUBJECT : Valuation of the insurance feature for purposes of the sale, repurchase and redemption of units issued by such unit investment trusts.

RECOMMENDATION: That the Commission authorize the Division to send the attached letter to the unit trusts involved stating the positions discussed herein.

NOVEL, UNIQUE OR COMPLEX ISSUES:

(1) Whether, pursuant to Section 2(a)(41) of the Investment Company Act of 1940 ("Act") and Rule 2a-4 thereunder, any value should be ascribed to insurance against default as to interest and principal on municipal bonds held in the portfolios of registered unit investment trusts.

(2) Whether the names and advertising of certain of such trusts are deceptive or misleading.

(3) Whether, pursuant to Section 22(e) of the Act, redemptions of trust units should be suspended if bonds in the portfolio are in actual or imminent default.

OTHER DIVISIONS AND OFFICES CONSULTED: The Division of Corporation Finance

ACTION REQUESTED BY:

CALENDAR TREATMENT: Regular

Summary

During the past year and a half, several unit investment trusts which have insured the municipal bonds in their portfolios against default, have been organized and offered to the public. Although such trusts pay for the insurance and advertise the advantages of such a feature, they do not ascribe any value to the insurance when calculating their respective net asset values. It is the Division's position that, pursuant to Rule 22c-1 under the Act, a value should be attributed to the insurance, consistent with the definitions of "value" in Section 2(a)(41) of the Act and of "net asset value" in Rule 2a-4 thereunder. Such a procedure would be particularly significant when a bond's market price reflects actual or imminent default. Moreover, in such situations, it would appear that investors who redeem their units or sell their units in the secondary market will be injured to the extent that the calculated net asset value, which governs the price paid for their units, does not reflect the value of the insurance. The Division also believes that, at the least, changes should be made in the trust agreements and insurance policies to make the insurance more meaningful, or, alternatively, the names of such trusts should delete any reference to the insurance.

Background

There currently are several unit investment trusts which have obtained insurance policies guaranteeing interest and principal payments on the municipal bonds in their portfolios.1/ The registration statement of the first of these trusts, The First Trust of Insured Municipal Bonds, was declared effective under the Securities Act of 1933 ("Securities Act") on August 9, 1974. Their only unique feature is such insurance.

1/ Those companies are:

The First Trust of Insured Municipal Bonds (Investment Company Act File No. 811-2451)

	Securities Act File Nos.	effective date under Securities Act
Series 1,	(2-50303)	(8/4/74);
Series 2,	(2-51877)	(2/5/75);
Series 3,	(2-53025)	(4/8/75);
Series 4,	(2-53411)	(5/13/75);
Series 5,	(2-53722)	(5/10/75);
Series 6,	(2-54007)	(7/9/75);
Series 7,	(2-54070)	(7/29/75);
Series 8,	(2-54375)	(9/9/75);
Series 9,	(2-54609)	(10/7/75);
Series 10,	(2-54787)	(11/5/75);
Series 11,	(2-55020)	(12/2/75);
Series 12	(2-55172)	(2/4/76);

Tax Exempt Municipal Trust (811-2551)

First New York Series,	(2-52590)	(2/19/75);
1st National Series,	(2-52898)	(5/14/75);
2nd,	(2-53891)	(7/15/75);
3rd,	(2-54251)	(9/8/75);
4th,	(2-54598)	(10/10/75);
5th,	(2-54910)	(11/25/75);
6th,	(2-55207)	(1/23/76);
7th,	(2-55337)	(2/20/76);

Pennsylvania Insured Municipal Bond Trust (811-2586)

1st Series,	(2-54323)	(9/16/75);
2nd	(2-54833)	(11/18/75);

Municipal Income Fund (811-2537)

First Insured Discount Series	(2-52208)	(4/8/75);

Michigan Tax Exempt Bond Fund (811-2019)

Insured Series A	(2-54566)	(9/19/75).

The First National Dual Series Tax-Exempt Bond Trust (811-2590)

Series 1	(2-54744)	(1/13/76).

In both insured and uninsured municipal bond unit investment trusts, the trust agreement is the governing document. The trust sponsor purchases a number of tax-exempt municipal bonds which are deposited with the trustee after accumulation. The sponsor and other underwriters and/or dealers then offer to the public units which represent fractional undivided interests (usually $1000 of principal amount) in the portfolio. The public offering price of such units is based on the aggregate offering price of the bonds in the trust divided by the number of units, and a sales charge of generally 3 1/2% to 4 1/2% plus accrued interest on the portfolio bonds.

After the units have been sold and until the termination of the trust, the trustee distributes the net income of the trust to unitholders at monthly or other intervals. However, pursuant to the trust agreement, if the initial offering of units results in the sale of less than a certain percentage of the outstanding units, the trust is terminated. Similarly, under most trust agreements, when either the principal amount or market value of the bonds remaining in the trust is reduced below a certain amount, the trust either is terminated automatically or can be terminated at the discretion of the trustee.2/ Upon termination of the trust, all remaining bonds are sold and the net proceeds are distributed to the remaining unitholders.

After purchasing a unit, a unitholder may redeem his unit by tendering it to the trustee. The redemption price is typically based on the aggregate bid price of the portfolio bonds divided by the number of outstanding units, and accrued interest. The trustee ordinarily must sell portfolio bonds to obtain money necessary for redemptions. However, each sponsor voluntarily maintains a secondary market for units although it does not obligate itself to do so. The sponsor's secondary market repurchase price is generally based on the aggregate offering price of the portfolio bonds divided by the number of outstanding units and accrued interest.3/ Accordingly, while the secondary market is maintained, there will be no redemptions and no resultant depletion of the trust assets except to the extent that the sponsor redeems units in its possession.

2/ For example, in Tax-Exempt Municipal Trust (First National Series), the trust agreement provides for an initial portfolio of $9,000,000 principal amount of bonds. The trust agreement provides that if the principal amount falls below $3,000,000, it may be terminated, and, if the principal amount falls below $1,000,000, it will be terminated. The common provisions recognize, perhaps, that the expenses of a trust per unit as the corpus falls may render the trust's continued existence uneconomic.

3/ The difference between the offering and bid price is represented to average 1½% of principal amount and to be dependent on market activity. If the sponsor resells such units, the price is the repurchase price he has paid, plus a sales load. The price for secondary market transactions is actually determined once weekly, on Fridays, for use the following week. Trust sponsors have been granted exemptions from Rule 22c-1 for this purpose. However, they represent that a full evaluation will be ordered on any day if the trust evaluator estimates that the prices have increased or decreased more than minimally.

Unit Trusts with Insurance Feature

As stated above, the insured municipal bond trusts are distinguished from other unit trusts in that their sponsors have obtained insurance policies against loss due to default in the payment of interest and principal on the municipal bonds in their portfolio. Substantially identical policies have been obtained by each insured trust.4/

The major feature of such insurance policies is that the insurer is obligated to make payment to the trustee of all amounts due but unpaid on the specified bonds in the trust portfolio. Such amounts are due thirty days after notification to the insurer that non-payment in full or in part of interest or principal "has occurred or is threatened (but not earlier than the date on which the /interest or principal is/ due for payment)." When the insurer has made such payment, it is subrogated to all of the rights to payment of the unit trust to the extent of such payment. The trustee is obligated to make premium payments to the insurer. Such insurance premiums constitute an expense of the trusts and result in reduced yields.5/ The insurance policies cannot be cancelled by either the insurer or the insured and continue in effect with respect to each bond as long as it is held in the trust portfolio. The insurance lapses on the bonds once they are disposed of by the trustee. This insurance should not be confused with insurance obtained by the issuers of municipal bonds which insurance stays in effect until the issuer redeems the bonds and which insurances follows the bonds regardless of their ownership.

The trust prospectuses state that the insurer determines the eligibility of bonds and that only insurable bonds are placed in the portfolio. It is also stated that objectives of insurance include assurance of prompt payment of interest and principal, and receipt of a higher yield on the portfolio bonds than would be available on bonds having a rating of "AA" from Standard and Poor's Corporation ("S&P"). With regard to the rating, it is represented that while selection of portfolio bonds will be limited to those with at least a "BBB" rating from S&P, the trust units have been rated "AA" by S&P. S&P has submitted a memorandum in which it asserts that the "AA rating for the units is based on the quality of the insurer.

4/ MGIC Indemnity Corporation, a subsidiary of MGIC Investment Corporation, is the issuer of the insurance policies held by the trusts.

5/ For example, the prospectus for the First Trust of Insured Municipal Bonds (Series 9) indicates that the yield on the same portfolio without insurance would be approximately 0.12% greater.

Valuation Procedure

The trust evaluator makes determinations of the offering and redemption prices for trust units. In connection with evaluations, value is never assigned to the portfolio insurance maintained on portfolio bonds prior to collection from the insurer.6/ Disclosure of this policy is made in the prospectuses of the insured municipal bond trusts. For example, the prospectus for Tax-Exempt Municipal Trust (First National Series) states that "The Evaluator will not attribute any value to the insurance on the Bonds as such insurance will terminate as to any Bond on its disposition by the Trust."

Staff Position

It is the staff position that the procedure established by the insured bond trusts whereby the evaluator will never assign a value to the trust's portfolio insurance is inconsistent with the policy and provisions of the Act and the rules thereunder. The insurance is an asset of the trust whose value must be determined "in good faith by the board of directors" or its equivalent.

Rule 22c-1(a) under the Act, which was adopted pursuant to the authority granted by Section 22(c) of the Act, 7/ provides that,

---

6/ A minor exception to this policy exists. With regard to accrued interest, at least one sponsor has stated that "the Sponsor will continue to calculate accrued interest in respect of such defaulted obligations so long as the insurance coverage in respect of said obligations remains in effect and the insured has not informed the Sponsor of a proposed default in its payments to the Trustee," letter of Wilkie, Farr & Gallagher, June 5, 1975.

7/ Section 22(c) of the Act provides that "the Commission may make rules . . . covering the same subject matter, and for the accomplishment of the same ends as are prescribed in subsection (a) of [Section 22]." The latter subsection provides, in part, that "a securities association registered under Section 15A of the Securities Exchange Act of 1934 may prescribe . . . a method . . . for computing" certain prices of redeemable securities "so that the price in each case will bear such relation to the current net asset value of such security computed as of such time as the rules may prescribe . . . for the purpose of eliminating or reducing so far as reasonably possible any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities. . . ."

> "No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."

Section 2(a)(41) of the Act and Rule 2a-4 thereunder set forth definitions of "value" and "current net asset value", respectively, and indicate how those terms are to be determined. Rule 2a-4 provides, in pertinent part, that:

> "The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:
>
> (1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and <u>other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company</u>" [emphasis added].

The prospective and absolute refusal ever to assign a value to the insurance feature of the trusts, i.e., the refusal to consider such insurance as an asset of the trust, or, the determination that the insurance has no value, would result in a violation of Rule 22c-1 under the Act should a redeeming unit holder not receive a price or a new investor not pay a price based on the current net asset value of the unit. Although as a matter of accounting principles no pertinent rules exist regarding insurance policies as assets, in our view, such policies do constitute assets whose value can be estimated.

Admittedly, it may not be simple to determine the value of the insurance assets. However, factors such as the market discount of an insured bond attributable to risk of default or to actual default on interest or principal payments, years to maturity of the bond, projected value of continued flow of interest income, ability of the insurer to meet potential obligations and the likelihood for sale of such bonds from the portfolio, should be considered in making such determination. Obviously, what weight is to be accorded the various criteria in any situation may pose difficulties. However, at this time, our objection is to the judgment that no value will ever be assigned to the insurance asset.

The following hypothetical situations which seem to warrant the assignment of value to the insurance also emphasize the potential abuses and manipulative practices which could result from the trusts' present procedures and which are the specific concerns of Section 22(a) of the Act. 8/

I. Two portfolio bond issues, representing 20% of the principal amount of a trust, default on payments of interest. The market price of those bonds, whose interest rate and maturity is comparable to bonds now priced at 100, declines to 50 and the discount is attributable to the default. The insurer receives the trust's demand for payment and makes prompt payment of the interest on the defaulting bonds. Assuming that the other 80% of the portfolio is valued at principal amount, i.e. $800, a redeeming investor would receive approximately $900 for his unit under present valuation procedure.9/ It is indisputable, however, that the insurance on the defaulted bonds in the portfolio confers a greater value on that part of the trust portfolio than the depressed market price. A similar situation could be posed in a case where such bonds did not default but were in serious danger of defaulting and the market price became severely depressed.

II. An extreme example can be posed. Assume that an entire bond portfolio of a trust has been in default of interest payments for several years during which time the insurer has made prompt payment. A unit holder offers his unit (representing $1,000 principal amount of bonds) for redemption a short time before all the bonds are due to mature. Based on a market value of $200 for those bonds, the unit holder would be offered $200 for his unit by the sponsor even though the insurer was ready, willing and able to make prompt payment of the bond principal in case of actual default. The sponsor could buy and hold the unit for just a short period before receiving the $1000 insurance payment.10/ The 500% appreciation in the value of the unit is attributable solely to the failure to assign any value to the insurance feature.

The present procedure also is patently fallacious, viewed from the perspective of yield. Using the above example and assuming a 6% return on the bonds during their period of default, the attribution of a $200 value to the units means they would yield an unrealistic annual return of 30%.

8/ See footnote 7.

9/ As described above, such price would differ to a small extent depending on whether the unit was repurchased in the secondary market or was redeemed by the trustee.

10/ Of course, issues of gross abuse and fraud by the sponsor would be raised by such conduct.

Discussion of the Position of the Trust Representatives

The staff has discussed at some length the insurance valuation matter with counsel for the various trusts and for MGIC Indemnity Corp.. Counsel have submitted several opinion letters regarding the adopted procedure.11/ On September 25, 1975, in a letter to all of the sponsors of the insured trusts or their counsel, the staff stated generally the Division position and requested that the trusts "inform us of /their/ intentions as to the valuation of the insurance feature as an asset of the trust" (copy attached). On October 31, 1975, a lengthy conference was held with representatives of most parties concerned along with the staff of this Division, Office of Chief Accountant and Division of Corporation Finance. All parties were invited to present their views and to submit additional letters or other materials as they saw fit. What follows summarizes the position of the trusts as well as our reaction to their arguments.

Counsel for the trust sponsors argue first that the Act itself does not require valuing of the insurance. One counsel likens the portfolio bond insurance to key-man life insurance where value is equal solely to the cash surrender value of the policy until the death of the insured. Where the policy is a term insurance policy, counsel states "generally accepted accounting principles would not permit value to be attributed to the policy."12/ Counsel carefully terms that situation only as "similar" and we agree. It is not controlling, however, because unlike accounting for ordinary corporations where assets are carried on a "cost" basis, accounting for investment companies is based on "value". Accordingly, if an investment company carried a key-man life insurance policy, it would not necessarily be carried at its cash value at all times.

It is suggested that the intent of the Act is to value assets "at a price which they could realistically be expected to bring if offered for sale in the market."13/ In support, counsel cites Section 2(a)(32) which defines a redeemable security as one where its holder is entitled to receive his approximate proportionate share of "current net assets, or the cash equivalent thereof." Counsel reads too much into this definitional section which merely acknowledges that redemption may be in cash or in kind; it is hardly support for counsel's position on the complex subject at hand.

11/ The opinion letters, copies of which are attached, are from Chapman & Cutler, dated June 11, 1974, June 17, 1975 October 6, 1975 and November 13, 1975; Wilkie, Farr & Gallagher, June 5, 1975; Davis, Polk & Wardwell, June 30, 1975; and Foley & Lardner, November 13, 1975.

12/ Letters of Chapman & Cutler, dated October 6, 1975 and November 13, 1975.

13/ Letter of Chapman & Cutler, dated June 11, 1974; similarly its letters of October 6, 1975 and November 13, 1975.

Counsel also cites Investment Company Act Release No. 5847 (October 21, 1969) concerning restricted securities in support of evaluating an asset at "the amount the owner might reasonably expect to receive for /it/ upon /its/ current sale." But the spirit and intent of the Commission release and of the Act are that the redeemable unit be priced at what it would bring on the market. It is the directive of the Act, particularly Section 2(a)(41) and Rule 2a-4 thereunder, that the directors of a fund place a value on such assets. In any event, even though the insurance feature is per se non-marketable, if the units were freely priced in the market when the insurer was paying interest on defaulted bonds, one would expect to receive a higher price than the one based solely on the aggregate prices of the bonds.

The major thrust of counsels' arguments against assigning value to insurance is based on the potential inability of the trusts to realize any proceeds of the insurance. First, counsel state that if any bond is sold prior to its due date, the insurance on it lapses. The sale of defaulted bonds could occur either to meet redemptions or as a result of the termination of the trust. The argument goes that a sale could result in a dilution of the remaining unitholders' interests to the extent that higher redemption prices were paid previous redeeming unitholders on the expectation that insurance against default would be realized.

Counsels' argument against valuing the insurance because of the possible sale of the bonds points up a central problem. While the insurance feature is used as a major selling point by the insured trusts, at the same time they question the value of the insurance because of its possible uncollectability. We discuss this point further below, at page 13 . However, concentrating here solely on the impact the possibility of uncollectability might have on valuation of the insurance, we have no objection to a procedure where such possibility is taken into account by the persons performing the evaluation function for the trust. While such procedure would not eliminate the potential for dilution to either redeeming or non-redeeming unitholders, it should reduce that potential. It should be noted, moreover, that this problem is not unique to this situation since directors must evaluate all assets which do not have market values. Some potential always exists for an inaccurate determination. The Act, as stated above, only requires that assets without a market value be valued "at fair value as determined in good faith."

The example set forth by trust counsel which requires the sale of a defaulted bond to meet a redemption demand, is somewhat misleading. A defaulted bond would presumably be sold from the trust portfolio only where the portfolio contained no bonds which had not defaulted and where the sponsor had abandoned the maintenance of the secondary market, thus eliminating the sponsor's repurchases and causing redemptions or where the sponsor redeemed units in its possession. First, it has been represented that no sponsor of an insured trust has as yet ever abandoned its secondary market activity. Second, the likelihood of a single default has been represented by the insurer, among others, to be remote, 14/ let alone defaults on all issues in a trust portfolio. Also, secondary market activity has been represented to be insubstantial, so that a rush of redemptions requiring substantial liquidation of a trust portfolio is unlikely. Certainly, in the absence of unusual and compelling circumstances the fiduciary duty of a trustee and sponsor would be to dispose of bonds whose market price was unimpaired by default or risk of default prior to disposing of bonds whose market price was reduced because of such factors and whose value to the trust was greater than market price because of the insurer's obligations to make payments.15/

Nevertheless, in the case where all remaining portfolio bonds are discounted because of threatened or actual default and no secondary market is being maintained, the staff has indicated to trust counsel that an order pursuant to Section 22(e)16/ of the Act to permit suspension of redemptions might be appropriate. Such orders pursuant to Section 22(e)(3) could essentially negate the dilution problem faced by the trusts when all or a substantial portion of portfolio bonds are in default. The necessity of selling those bonds, thus eliminating the value of the insurance on them, would be ended. While unitholders would lose their right to redeem their units, it seems likely that a secondary market for such units would emerge. In the latter case, not only would no hardship be placed on the unitholder, but he would probably be better off since such market would determine a truer unit value.

14/ Recent events, of course, belie this assertion.

15/ A grave problem of another type could arise where the sponsor continues to repurchase units from investors, the trusts place no value on the insurance, and where the market price has dropped substantially because of defaults. In such a situation the investor would get a fraction of the insured unit's value, while the sponsor would have paid a pittance for a security with a generous yield, thanks to the insurance. Further, if the trust retains the defaulted bonds, the sponsor, by holding the units, would reap a windfall at the bond's maturity. This scenario, while theoretically possible, would be discouraged, it is hoped, by the sponsor's realization that such conduct could not be tolerated. In addition, the prospectuses of some trusts presently advise shareholders to inquire about over-the-counter activity in units and current market price.

16/ Section 22(e) of the Act as here pertinent, provides that "no registered investment company shall suspend the right of redemption or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company . . . for redemption except for such . . . periods as the Commission by order may permit for the protection of security holders of the company.

Another possibility is to limit redemptions to the non-defaulted portion of the portfolio, i.e. partial redemption. A redeeming unitholder could receive a redemption or repurchase price based on market prices of the non-defaulted portion of the portfolio and a fixed interest in the actual proceeds of the bond and insurance when received by the trust. While this procedure may have merit, no trusts so far have submitted memoranda on this point, although invited to do so.17/ If a trust did express interest in this procedure, the staff would favor some relief under Section 22(e).18/

Besides referring to sales of bonds to meet redemptions, trust counsel support their argument that insurance values might never be realized, by stating that defaulted bonds may be sold when the trust is reduced to its voluntary or mandatory termination amount. Again, to the extent that redeeming unitholders had in the past received a repurchase or redemption price based on a net asset value which included a value for insurance, trust assets would have been diluted.

As stated above, this argument presupposes that the trust evaluators cannot take into account the possibility that the insurance will lapse because of sale. In this regard, it should be noted that at least one fund, The First Trust of Insured Municipal Bonds, has a specific provision that if the trust is terminated, and defaulted bonds remain in the portfolio, the trust may be continued as to those bonds.19/ Insofar as other automatic termination provisions do not provide for such treatment, a serious question is raised regarding the basic nature of the insurance features.20/

17/ Of course, the more difficult problem always lies with bonds which have not yet defaulted, but whose depressed prices reflect a fear of imminent default.

18/ In the past, the Commission has authorized similar relief. See, e. g. New York Hedge Fund Inc. Investment Company Act Release No. 8412 (July 3, 1974); Vanguard Fund, Inc., ICA Release No. 8413 (July 3, 1974); and The Sagittarius Fund, ICA Release No. 8543 (October 17, 1974).

19/ For example, the prospectus of Series 9 on page 20 states. "in connection with any liquidation of the Fund, it shall not be necessary for the Trustee to dispose of any Bond or Bonds in default because of non-payment of principal or interest by the issuer thereof, if retention of such Bond or Bonds, until due, shall be deemed to be in the best interests of unitholders."

20/ It would be even more desirable to require the trust to determine whether non-defaulted bonds with depressed market prices reflect a fear of default. If such a judgment is made, then the trust should be continued as to those bonds, in addition to the ones already in default.

The basic problem is that the trusts' arguments against valuing insurance, i.e., because the bonds may be sold, reveals how ephemeral the insurance can be. To name the trusts as "insured" and characterize them as "insured with respect to the prompt payment of interest and principal" /emphasis added/ is less than honest if for one reason or another the bonds may be sold, and if a mandatory or voluntary termination clause makes it unlikely that the trust will exist at the due date of the bonds, particularly the bonds likely to default as to principal. 21/ Also such representations are less than accurate to the extent that, as some sponsors have indicated, there is no certainty as to the ability of the insurer to meet all obligations.

There is no doubt that the insurance feature is heavily emphasized in selling the trust units. Disclosure of the major contingencies regarding the insurance feature only somewhat abates the problem since it is the very concept of insurance as it applies to the trusts which is at issue. We believe it is essential to alter the relevant trust provisions and to reduce as far as possible any apprehension regarding the insurer's financial abilities. The former change would seem to be achievable since at least one trust has an acceptable procedure with respect to bonds already defaulted. With regard to the ability of the insurer to meet its obligations, the trust sponsors have a duty to determine such ability prior to committing fund assets to pay the insurance premiums. 22/

Counsel also raise questions as to the method of valuation, i.e., made by whom and judged by what standards. It seems clear that the evaluator has the current responsibility but that the trust agreement could provide for the trustee or anyone else to assume the duty. As stated above, the standards are those in the Act and the mere fact that reasonable men might differ would not mean that a particular evaluation is necessarily unreasonable.

21/ Section 35(d) of the Act prohibits an investment company from using a name or title which the Commission by order declares to be deceptive or misleading. In addition, Section 11(a) of the Securities Act of 1933 provides a right of action to security holders with regard to registration statements which contain untrue statements of material facts or omissions of material facts.

22/ In any event, trust sponsors have chosen to buy insurance with trust money. To the extent that they argue that such insurance is worthless or that they allow the trustee to operate the trust in a manner which defeats the purpose of having such insurance, a serious problem would be raised under Section 36 of the Act.

Counsel argue that if we require the attribution of a value to the insurance, the original offering price of the units, for example, could be greater than it currently is, since the units with portfolio insurance are rated "AA" by S&P whereas the underlying bonds are usually rated "AA", "A", and "BBB". Accordingly, counsel argue that the value of the insurance could be deemed to equal the difference in principal required to produce the applicable monetary yield on an "AA" municipal bond and that required to produce that yield on an average bond in the portfolio which is more commonly "A" or "BBB". However, as stated above, the "AA" rating given the insured unit results, apparently, from the judgment that the quality of the insurer is rated as "AA". The quality of the underlying portfolio is not considered by S & P. In addition, S & P does not apparently consider the fact that the insurance on trust bonds will be cancelled on their disposition. Accordingly, it is our present view, that such valuation by trust sponsors may not be reasonable.

Counsel finally argue that any problems in the area of valuation can be and have been cured by appropriate prospectus disclosure. However, the issue here is not whether the valuation procedures being used can be or are being adequately disclosed, 23/ but whether the procedures being used meet the standard imposed by the Act.

23/ Disclosure on this point in current prospectuses of insured unit trusts is fairly extensive. Such disclosure has been developed with the assistance of staff comments and extends to certain key facts regarding the operation of the insurance guarantee and the business of the insurer. That disclosure includes language advising investors that in determining the public offering price of units and the value of units upon redemption or liquidation no value is attributed to the portfolio insurance; for an investor to receive any benefit from the portfolio insurance he must be the owner of the units at the time the trustee becomes entitled to receive payment from the insurer; and if it becomes necessary for the trustee to dispose of bonds in the trust's portfolio, such bonds will have to be sold at their uninsured market value since the portfolio insurance is only applicable to bonds as long as they remain in the trust's portfolio. In addition, recent prospectuses include a statement that a question has been raised by the staff as to the appropriateness of the valuation practices used. (See copy of such disclosure attached) The Division of Corporation Finance is prepared to request inclusion in such prospectuses of any additional information which the Commission believes should be included in them.

Recommendation

That the Commission authorize the staff to send the attached letter to the interested parties named therein. Sponsors, trustees, evaluators, and insurers would be informed thereby that, in summary, the Commission believes that the position of the Division is not an unreasonable interpretation of applicable law. It would inform sponsors and trustees that they should consider the value of the insurance in determining the unit price when selling, repurchasing and redeeming the units, and if they intend to continue advertising the insurance feature and referring to insurance in the trusts' names, the trust agreements and/or insurance policies should be amended to provide for protecting the insurance asset from loss because of forced sales of portfolio bonds with regard to which the insurance would have a significant value. In addition, the letter would state that the staff would consider favorably applications for prospective and/or partial relief, pursuant to Section 22(e) of the Act, under appropriate conditions.

ABrown - 50213
GOSheroff - 50233
SMendelsohn - 50243

Attachments

1. Draft letter to trust representatives.
2. Letter sent by Division on September 24, 1975.
3. Letters submitted by counsel to the trusts.
4. Pertinent parts of insured unit trust prospectus.

RE:

Dear Mr.

On September 24, 1975, this Division sent a letter to you concerning "when and to what extent, if any, municipal bond trusts whose portfolios are insured should be required to reflect the value of the insurance in computing net asset value." (copy attached). We received several comments and on October 31, 1975, a conference was held, to which all the addressees were invited, to discuss with us and representatives of other offices of the Commission the issues raised in that letter. Thereafter other comments were submitted taking issue with the stated position of the Division.

We have reviewed the opinions submitted and have brought this matter to the attention of the Commission. The Commission believes that the views of the Division as expressed in its letter of September 24, 1975 and in this letter are not unreasonable interpretations of the applicable law. Our view is that any trust which has obtained or will obtain an insurance policy guaranteeing prompt payment of interest and principal on the bonds in its portfolio, should consider that insurance as an asset of the trust and, therefore, should provide that the trust's evaluator or some other appointed person determine the value of the insurance for purposes of determining the sale, repurchase and redemption prices for units of the trust. We take this position pursuant to Section 22(c) of the Investment Company Act of 1940 ("Act") and Rule 22c-1 thereunder, which require that net asset value be used in determining such prices of open-end investment company securities. Section 2(a)(41) of the Act and Rule 2a-4 thereunder define "value" and "net asset value" respectively with regard to securities and assets for which market quotations are not readily available, as "fair value as determined in good faith by the board of directors" of the registered company. It is this standard with which the trusts must comply.

One of the arguments made by certain trust representatives is that because of the automatic termination provided for in such trusts, which necessitates the sale of all remaining portfolio bonds, there is a significant likelihood that the insurer will never make payment of principal on bonds in default. We agree with trust counsel that the value of the insurance to the trust thereby may be severely impaired. Moreover, we believe that it may be misleading under such circumstances to include any reference to the insurance policies in the names or advertising of the registered unit investment trusts. We have also noted, however, that in at least one trust agreement, special provision is made for the possible continuation of the trust where remaining portfolio bonds are in default of principal or interest at the time when the trust would otherwise have been liquidated. We would not object to trust names and advertising making reference to the insurance policies where such a trust agreement provision were in effect. We also believe that trust agreements should mandate that continuation of the trust be considered where depressed market prices of remaining bonds are attributable to fear of imminent default.

Finally, as we mentioned at the October 31, 1975 conference, the staff would be willing to consider applications, filed pursuant to Section 6(c) and 22(e) of the Act, which would request, prospectively, relief from the redemption requirements of the Act. In effect, procedures may be devised whereby significant valuation problems for evaluators can be averted while the interests of investors continue to be protected. Such requests could encompass partial exemption from the redemption requirement for the portion of the portfolio which was in default or imminent danger of default of principal or interest, or could encompass full exemption from this requirement at such time as a set percentage of the portfolio bonds was in default of principal or interest. We would not be receptive at this time, however, to a request for relief pursuant to Section 6(c) of the Act, from Section 22(c) and Rule 22c-1, to permit the trusts to operate as they presently do, as one trust counsel suggests.

In summary, therefore, with regard to the already issued series of such registered unit trusts, we request that all trust sponsors and evaluators conform to the stated valuation principles, and accordingly amend, as necessary, the procedures used in connection with redemptions and secondary market repurchases and sales. We further request that you report to us on all action taken in this matter, so that we may report to the Commission the progress made, within sixty days after the date of this letter.

In addition, we intend to ascertain whether new series of the presently registered unit trusts which have insurance contracts guaranteeing timely payment of interest and principal on their portfolios and any new such unit trusts provide for evaluations of the insurance feature when calculating their respective net asset values for purposes of sales, repurchases and redemptions. The Division of Corporation Finance intends to assist in devising appropriate disclosure concerning these matters.

Finally, we intend to monitor the names and advertising of all new series and all new trusts to ascertain whether the names and advertising of the trusts refer to the insurance in those situations where the trust agreements do not provide for continuance of the trust after its termination date where such continuance would be in the best interests of remaining unit holders.

Sincerely,

Sydney H. Mendelsohn
Assistant Director

Attachments