INVESTMENT COMPANY INSTITUTE

MEMO# 2839

June 13, 1991

PROPOSAL TO TREASURY DEPARTMENT ON SLGS-STYLE MONEY MARKET FUND FOR MUNICIPAL BOND ISSUERS

June 13, 1991 TO: INSTITUTIONAL FUNDS COMMITTEE NO. 3-91 RE: PROPOSAL TO TREASURY DEPARTMENT ON SLGS-STYLE MONEY MARKET FUND FOR MUNICIPAL BOND ISSUERS ____ As discussed at the last Institutional Funds Committee meeting on June 6, 1991, the Institute has been working with the Treasury Department to obtain the issuance of regulations which would make it simpler for municipal bond issuers to invest in money market funds the proceeds of their bond offerings not needed for the tax-exempt purpose for which the bonds were issued. Current regulations which require issuers to rebate to the federal government all arbitrage profits earned on the investment of municipal bond proceeds are too cumbersome to make investment in money market funds a viable option for many municipal issuers. The proposal made to Treasury would allow an issuer of municipal obligations to invest the proceeds in "self-rebating" shares of a money market fund whose assets would be restricted to government securities. The issuer would direct the fund to send to the federal government all earnings on the bond proceeds invested in the self-rebating money market fund shares above those earned at the yield paid by the issuer on the municipal bonds. This allows the issuer to (1) avoid receiving rebatable arbitrage profits and incurring the attendant accounting, legal and other expenses, and (2) comply with any yield restriction imposed by the Internal Revenue Code. One concern raised with a self-rebating arrangement is that it might give rise to "yield-burning" through payment of excessive fees to fund managers or through purchases of fund assets at above-market prices. The proposal contains two provisions designed to alleviate these concerns. The first proposal is based on the assumption that, although the municipal issuers are not sensitive to yield on their investments, the arms-length participation in a fund, or in sales to a fund of securities, by persons who are profit- maximizing will provide a market discipline over fees. Thus, under the proposal, a qualified fund must at all relevant times either (1) have sufficient assets which do not qualify for the - 1 - self-rebating provision or (2) acquire substantially all of its assets at prices which do not exceed the lowest of three bids from primary dealers for such securities. The first test would be satisfied if the shares of the fund other than the self-rebating shares exceed the lesser of 25% of the fund's total outstanding shares or $100,000,000 in net asset value as of the last day of the fund's preceeding fiscal year or on average over the first 30 days of the current fiscal year. If the fund fails this test, it can remain qualified if it purchases substantially all (i.e., 90%) of its assets acquired in that year at the lowest of at least three bid prices from primary dealers for that investment. The second provision to prevent yield burning would encourage issuers to invest in "institutional" funds rather than retail funds by proportionately reducing the amount of the payment to Treasury treated as a rebate of arbitrage profits for each year that the fund's total expense ratio exceeds a certain, as yet undetermined, amount. In other words, the municipalities would be forced to rebate an amount equal to the excess fees, in addition to the amounts rebated by the fund. As yet, no regulations have been issued in this area, and it is uncertain what form any such regulation may take. The Internal Revenue Service recently announced that it intended to issue regulations in proposed form only, rather than concurrently as proposed and temporary regulations, and to finalize the regulations and have them become effective after as short a comment period as possible. We will keep you informed of further developments. David J. Mangefrida, Jr. Assistant Counsel - Tax

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