

MEMO# 3330

December 9, 1991

SEC STAFF POSITION ON MONEY MARKET FUNDS PURCHASING INVERSE FLOATERS

December 9, 1991 TO: MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 32-91 MONEY MARKET FUNDS AD HOC COMMITTEE NO. 31-91 SEC RULES MEMBERS NO. 59-91 RE: SEC STAFF POSITION ON MONEY MARKET FUNDS PURCHASING INVERSE FLOATERS

The Director of the Division of Investment Management issued the attached letter expressing the staff's views on the purchase of instruments known as "inverse floaters" by money market funds. The staff views these instruments (which are described as instruments with floating or variable interest rates that move in the opposite direction of short-term interest rates and at an accelerated rate) as being inappropriate investments for funds seeking to maintain a stable net asset value. The staff believes that it is likely that the market value of inverse floaters will deviate from their amortized cost value as a result of their high volatility. In addition, the staff notes that an investment in these instruments amounts to leveraging the fund's portfolio, which is an inappropriate portfolio management technique for a fund seeking to maintain a stable net asset value. The staff stated that an investment in these instruments raises the following specific legal issues. First, the staff concluded that an investment in inverse floaters would "circumvent the provisions of rule 2a-7 governing the maximum maturity of individual securities and the average weighted portfolio maturity where a sufficient amount of a fund's assets are invested in these instruments." Therefore, the staff believes that an investment in these securities would constitute doing indirectly what the fund cannot do directly in violation of Section 48 of the Investment Company Act (which prohibits any person from doing indirectly any act which it would be unlawful to do directly under the provisions of the Act). In addition, the staff stated in footnote 2 of the letter that it would "arrive at the same conclusion regarding an instrument whose rate of interest magnifies the effect of interest rate changes directly with prevailing interest rates." Second, the letter states that since the average weighted maturity reported to investors would not accurately reflect the exposure of a fund that owns inverse floaters to interest rate changes, a fund owning these instruments may be materially misleading investors as to the risks associated with an investment in the fund when it reports its average weighted maturity. The staff concludes the letter by warning that if in the course of inspections they continue to find these instruments in fund portfolios, the Division will consider recommending to the Commission that an enforcement action be instituted against fund advisers and directors who have caused or permitted these securities to be included in fund portfolios. Amy B.R. Lancellotta Associate General Counsel Attachment

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.