

**MEMO# 9476**

December 4, 1997

## **SEC ADOPTS TECHNICAL AMENDMENTS TO RULE 2A-7**

1 Release Nos. 33-7479; IC-22921 (December 2, 1997) (the "Release"). See Memorandum to Accounting/Treasurers Members No. 42-96, Primary Contacts - Money Market Funds No. 7-96, SEC Rules Members No. 77-96, Money Market Funds Advisory Committee No. 13-96, dated December 12, 1996, for a copy of the SECs proposing release. 2 Release Nos. 33-7275; IC-21837 (March 21, 1996) (the "1996 Amendments"). The Commission had suspended the compliance date of many of the 1996 Amendments pending the adoption of technical amendments to Rule 2a-7 to address the issues that arose regarding those amendments. See Memorandum to Accounting/Treasurers Members No. 5-96, Money Markets Funds Ad Hoc Committee No. 4-96, Money Market Members - One Per Complex No. 1-96, SEC Rules Members No. 14-96, dated March 25, 1996, for a copy of the 1996 Amendments. [9476] December 4, 1997 TO: ACCOUNTING/TREASURERS MEMBERS No. 52-97 PRIMARY CONTACTS - MONEY MARKET FUNDS No. 4-97 SEC RULES MEMBERS No. 88-97 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 6-97 RE: SEC ADOPTS TECHNICAL AMENDMENTS TO RULE 2a-7

The Securities and Exchange Commission has adopted technical amendments to Rule 2a-7 under the Investment Company Act of 1940, the rule regulating money market funds.<sup>1</sup> The amendments, among other things, revise terminology used in the rule to reflect common market usage and resolve certain interpretive issues under the rule, relating primarily to the amendments to the rule that were adopted in March 1996.<sup>2</sup> In addition, the Commission adopted several amendments to the advertising rules applicable to money market funds. The final amendments reflect many of the Institutes comments on the amendments as proposed. A copy of the Commissions release is attached. A summary of the significant aspects of the amendments to Rule 2a-7 and to the advertising rules applicable to money market funds is set forth below.

A. Guarantees

1. Definition of "Guarantee" - To clarify terminology used in Rule 2a-7, the rule has been amended to replace the terms "puts" and "unconditional puts" with a new term -- "guarantee" -- that includes a wide range of arrangements designed to unconditionally support the credit of the issuer of a security.

3 Rule 2a-7 has been amended to permit funds to disregard a demand feature or a guarantee that is not relied upon to satisfy the rules credit quality or maturity standards, or for liquidity, for all purposes under the rule.

2. Credit Substitution - Rule 2a-7 has been amended to permit a fund to rely solely on the credit quality of the issuer of a guarantee in determining whether a security subject to a guarantee meets the rule's credit quality standards. (The 1996 Amendments only permitted a fund to rely solely on the credit quality of the issuer of an unconditional demand feature.) Under the rule as amended, a security subject to a guarantee is not eligible for fund investment unless the guarantee (or the issuer of the guarantee) is rated and it meets the notice requirement in

the rule in the event of a change in the identity of the issuer of the guarantee. In addition, securities subject to guarantees issued by non-controlled persons are not subject to the rules issuer diversification standards. Guarantees, however, are subject to the guarantee and demand feature diversification standards in paragraphs (c)(4)(iii), (c)(4)(iv) and (c)(5) of the rule.

3. Rating Requirement for Guarantees - As noted above, Rule 2a-7 has been amended to require that all guarantees be rated. The rule provides an exception from this requirement for the following guarantees: (a) a guarantee issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the guarantee; (b) a guarantee with respect to a repurchase agreement that is collateralized fully; (c) a guarantee issued by the U.S. Government; and (d) a guarantee not relied upon for quality, maturity or liquidity purposes.<sup>3</sup> Conditional demand features, which are not within the definition of "guarantee" under the amended rule, are not subject to the rating requirement.

B. Diversification and Credit Quality Standards Applicable to Issuers

1. Repurchase Agreements - Rule 2a-7 allows a fund to "look through" a repurchase agreement (repo) to the underlying collateral and thereby ignore the counterparty in determining compliance with the diversification requirements when the obligation of the counterparty is "collateralized fully," as defined in the rule. The 1996 Amendments sought to define "collateralized fully" to limit the collateral to that which could be liquidated promptly in the event of bankruptcy of the counterparty. To address the confusion that arose under that definition, the Commission amended the definition of "collateralized fully" to omit references to specific types of acceptable collateral.

2. Refunded Securities - The 1996 Amendments permitted a fund to "look through" refunded securities to the escrowed Government securities in determining compliance with the rules issuer diversification requirements, provided that, among other things, an independent public accountant has certified that the escrowed securities, or any subsequent substitution of the escrowed securities, will satisfy all payments of principal, interest and applicable premiums on the refunded securities. The rule has been amended to provide that the accountants certification need not be obtained if, in connection with the placement of the Government securities into the escrow account, a refunded security has received a rating from an NRSRO in the highest category for debt obligations.

3. Government Guarantees - Rule 2a-7 has been amended to exclude guarantees issued by the U.S. Government from the guarantee and demand feature diversification standards under the rule. Thus, government guarantees are treated the same under the rule as securities issued directly by the U.S. Government.

C. Asset Backed Securities and Synthetic Securities (collectively "ABSs")

1. Rating Requirement - Under the 1996 Amendments, all ABSs were required to receive a rating from an NRSRO. The rule has been amended to exclude from the rating requirement ABSs substantially all of the qualifying assets of which consist of municipal securities. In addition, an ABS subject to a guarantee is not required to be rated.

2. Diversification Standards

a. Look Through to Secondary ABSs - Rule 2a-7 requires that funds treat the special purpose entity as the issuer of an ABS for purposes of the diversification requirements, except that a fund is required to "look through" the special purpose entity to any issuer of qualifying assets whose obligations constitute ten percent or more of the principal amount of the qualifying assets of the special purpose entity ("ten percent obligor"). For diversification purposes, a fund must treat these ten percent obligors as if they issued the portion of the ABS such obligations represent. The "look through" provision has been amended to clarify that funds are required to identify and treat as proportionate issuers of a primary ABS only ten percent obligors of the primary ABS and ten percent obligors of any secondary ABS. Thus, funds are not required to "look through" to the qualifying assets of any ten percent obligor of a "tertiary ABS" (i.e., a ten percent obligor of a secondary ABS that is itself a special purpose entity issuing ABSs) for purposes of compliance with the rules diversification standards. In addition, the rule has been

amended to exclude a "restricted special purpose entity" (i.e., one that does not issue its ABSs to anyone other than another specific ABS issuer) from treatment as a ten percent obligor under the rule.

b. Demand Features and Guarantees Securing Obligations of Ten Percent Obligor - The Commission has adopted an amendment to clarify that in the case of any ten percent obligors deemed to be issuers for purposes of the rules diversification standards, any demand features or guarantees supporting the obligations of the ten percent obligors are treated as being held by the fund and are subject to the demand feature and guarantee diversification standards under the rule.

c. Special Purpose Entity Cap - In the release proposing amendments to Rule 2a-7, the Commission explained that it was a possible for a large portion of a fund to be exposed to a single ABS as a result of its investing in a special purpose entity with one or more ten percent obligors. This could expose a fund to an undue amount of structural risk. Therefore, the Commission requested comment on whether to restrict fund investment in the obligations of a single special purpose entity. The Commission determined not to amend the rule in this manner, based on its concern that such a cap would add complexity to the rule without meaningfully limiting structural risks.

d. Sponsor-Provided Demand Features and Guarantees - Rule 2a-7 has been amended to allow a fund holding an ABS to include any sponsor-provided demand feature or guarantee in its twenty-five percent "demand feature" or "guarantee" basket.

e. First Loss Guarantees - The 1996 Amendments required funds to treat a first loss guarantor as a guarantor of the entire ABS. Rule 2a-7 has been amended to permit funds to treat a first loss guarantee the same as any other fractional guarantee when calculating compliance with the rules guarantee and demand feature diversification standards.

3. Periodic Determinations Regarding Ten Percent Obligor - The Commission has amended the requirement that a fund adopt written procedures requiring periodic determinations of the number of ten percent obligors deemed to be issuers of all or a portion of an ABS. Such procedures are not required with respect to any ABS that a fund's board of directors initially has determined will never have, or is unlikely to have, any ten percent obligors. Funds must maintain a record of this determination.

4. Swap Arrangements - The release proposing amendments to Rule 2a-7 noted that certain ABSs may consist of qualifying assets whose cash flow has been "swapped" to a financial institution (the "swap counterparty") that ultimately acts as the primary source of payment to funds holding the ABSs. The Commission had solicited comment regarding whether such a swap counterparty should be treated as the issuer of the ABSs for diversification purposes and on the appropriate treatment of swaps and similar arrangements under the rule. The Commission determined not to amend Rule 2a-7 at this time to address these types of arrangements, noting the difficulty of addressing these types of arrangements given that they are constantly evolving in the marketplace and that there are wide variations in the types of swaps used to structure ABS offerings. The Release states, however, that swaps and similar arrangements that fall within the rule's definition of a guarantee or demand feature should be treated as such for purposes of guarantee and demand feature diversification.

D. Investments in Other Money Market Funds The 1996 Amendments permitted a money market fund to treat an investment in another money market fund as a first tier security, but limited such investment to no more than five percent of the acquiring fund's assets. The rule included a narrow exception to the five percent limit for a fund investing substantially all of its assets in shares of another money market fund in reliance on Section 12(d)(1)(E) of the Investment Company Act. To allow funds to invest more than five percent but less than substantially all of their assets in shares of another money market fund, the rule has been amended to permit a fund, within the limitations of Section 12(d)(1) of the Investment Company Act, to invest in shares of another money market fund in excess of the rule's five percent diversification standards, provided that the acquiring fund's board of directors reasonably believes that the acquired fund is in compliance with Rule 2a-7.

4

Many of these requirements were adopted under the 1996 Amendments, but compliance with them was suspended by the Commission pending the adoption of technical amendments to the rule.

5 E. Amendments to the Advertising Rules

1. Calculation of Yield - The Commission has amended the money market fund yield formula to clarify that only investment income may be included in the yield of a money market fund.

2. Use of Total Return - To address a concern that investors may be confused by money market fund advertisements that include short-term total return instead of yield because they do not understand the difference between them, the Commission had proposed to require that total return quotations in advertisements and sales literature cover a period of at least one year, and that such quotations be accompanied by a quotation of current yield. Based on comments of the Institute and others opposing such a one year requirement, the Commission decided not to adopt it. Instead, the Commission has amended Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act to require that (a) money market fund quotations of total return be accompanied by quotations of current yield and that both quotations be placed next to each other and shown in the same print size, and (b) if there is a material difference between the quoted total return and the quoted yield, a statement be included that the yield quotation more closely reflects the current earnings of the fund than the total return quotation.

F. Effective Date; Compliance Date

The amendments to Rule 2a-7 and the forms and advertising rules applicable to money market funds will become effective on February 10, 1998. The Commission, however, has provided a six-month transition period for the amendments to the rule. This means that all funds must be in compliance with Rule 2a-7, as amended, by July 1, 1998, except with respect to "grandfathered securities," described below. Funds must comply with the amendments to the advertising rules and forms applicable to money market funds by February 10, 1998. To minimize disruption to funds and markets as a result of amendments to Rule 2a-7, the Commission has "grandfathered" certain securities first issued on or before February 10, 1998 that do not meet the following requirements of the amended rule:

1. The rating requirement for guarantees;
2. The notification requirement, which provides that, in order for a security subject to a guarantee or demand feature to be an eligible security, the fund must receive notice from the demand feature or guarantee provider (or other institution) if there is a substitution of the provider of the demand feature or guarantee;
3. The requirements for ABSs regarding maturity determinations and ratings;
4. The requirement that a demand feature and a guarantee include the ability to recover principal and any accrued interest; and
5. The requirement that in determining the eligibility of a security subject to a conditional demand feature the funds board make certain determinations regarding the conditional demand features exercisability.

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Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's Library Services Division at (202)326-8304, and ask for this memo's attachment number: 9476.