MEMO# 7327

October 9, 1995

INVESTMENT ADVISER TO TAX-EXEMPT MONEY MARKET FUND SETTLES ADMINISTRATIVE ACTION CONCERNING INELIGIBLE SECURITIES

1 In the matter of Cardinal Management Corp., Admin. Proc. File No. 3-8848 (September 29, 1995). October 9, 1995 TO: MONEY MARKET FUNDS AD HOC COMMITTEE No. 14-95 SEC RULES MEMBERS No. 70-95 RE: INVESTMENT ADVISER TO TAX-EXEMPT MONEY MARKET FUND SETTLES ADMINISTRATIVE ACTION CONCERNING INELIGIBLE SECURITIES ____ An investment adviser to a tax-exempt money market fund recently settled an administrative action brought by the Securities and Exchange Commission which alleged that the adviser had caused the fund to (1) hold ineligible securities, (2) purchase securities of another investment company in violation of the funds investment policies, and (3) misrepresent and omit material facts concerning the purchase of the ineligible securities.1 As part of the settlement, the SEC censured the adviser and ordered it to pay a penalty of $35,000. According to the settlement order, between August 1991 and December 1992, the adviser caused the fund to hold eight Auction Rate Notes ("ARNs"). The ARNs had remaining maturities from twenty years to thirty-two years and each paid interest on the last day of successive 35-day periods following the date of original issue. The interest rate for each 35-day period was set on the basis of orders placed in an auction conducted by an agent of the issuer on the business day preceding the commencement of a new interest period. Under the auction process, bids were accepted from prospective purchasers and existing note holders (who indicated their desire either to continue to hold their notes or to sell their notes depending on the outcome of the auction). Neither the issuer nor any other party was required to redeem the notes or repay the principal amount at the periodic auctions. The SEC alleged that the ARNs failed to meet the maturity requirements for money market funds and were therefore ineligible securities. It concluded that the ARNs were not subject to a "demand feature" within the meaning of Rule 2a-7(d)(3), because the auction process for the notes does not entitle the holder to redeem the notes from the issuers or otherwise to receive the principal amount of the underlying securities. Accordingly, the ARNs were ineligible securities for a money market fund because they had maturities in excess of the 397 day limit set forth under Rule 2a-7(c)(2)(i). The SEC also alleged that during the period from August 1983 to July 1993 the adviser purchased securities of another tax-exempt investment company for the fund, which was in violation of the funds investment restrictions. The adviser used this other tax-exempt fund as a "sweep vehicle" to hold the funds daily open cash balances. Finally, the SEC found that the adviser had misrepresented and omitted to state material facts in its Form ADV filings, i.e., that it had purchased

ineligible securities and the securities of another tax-free fund, which was not consistent with its investment restrictions. Alexander C. Gavis Assistant Counsel Attachment 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 Information Resource Center at (202)326-8305 or (202)326-5903, and ask for this memo’s attachment number: 7327.
