The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 4466

January 29, 1993

SEC SANCTIONS WITH RESPECT TO MONEY MARKET FUND PURCHASE OF UNRATED SECURITIES

January 29, 1993 TO: BOARD OF GOVERNORS NO. 8-93 MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 2-93 SEC RULES MEMBERS NO. 15-93 COMPLIANCE COMMITTEE NO. 2-93 RE: SEC SANCTIONS WITH RESPECT TO MONEY MARKET FUND PURCHASE OF UNRATED SECURITIES _____ The Securities and Exchange Commission recently sanctioned an investment adviser and a former portfolio manager for willfully violating Section 34(b) of the Investment Company Act and aiding and abetting violations of Rule 22c-1 under the Act in connection with the purchase of approximately $177 million of unrated securities by a tax-exempt money market fund. The alleged violations were discovered during a routine SEC examination of the fund in November and December 1990. The SEC found that from July 18, 1989 to November 28, 1990, a series investment company used the amortized cost valuation method to value the portfolio of its tax-exempt money market fund, in reliance on Rule 2a-7 (as in effect at the time). During that period, the portfolio manager purchased for the fund (1) $81 million in unrated securities that were guaranteed by letters of credit issued by financial institutions that had not received ratings on their short-term debt, and (2) $96 million in synthetic securities that were guaranteed by a conditional letter of credit issued by a financial institution that had received a "high quality" rating on its short-term debt. The conditions for this letter of credit dictated that the guarantee would not be operative if any pool security went into default before a ratings downgrade or if certain tax events occurred, such as a denial of tax exempt status for any pool security. The SEC found that the investment company's board of directors has not made a minimal credit risk or comparable quality determination with respect to the unrated securities, nor had the board delegated that responsibility to the adviser. The SEC also found that neither the adviser nor the portfolio manager had concluded thatthe credit enhancement facility supporting the synthetic securities was conditional before determining that the synthetic securities were eligible for purchase by the money market fund. The SEC thus found that the investment company could not rely on Rule 2a-7 from July 18, 1989 to November 28, 1990 and therefore violated Rule 22c-1 by selling, redeeming or repurchasing securities issued by the money market fund without calculating its net asset value in a manner prescribed by the rule. The SEC found that the adviser and portfolio manager willfully aided and abetted that violation of Rule 22c-1. The SEC also found that the portfolio manager had made entries on the order tickets for the unrated debt securities that stated incorrectly that an NRSRO had rated the securities "high quality." According to the SEC, the adviser and the investment company's board used schedules and other documents that were derived from these order tickets to monitor the money market fund's portfolio. The adviser also relied on these

documents to compile the schedule of the money market fund's portfolio investments that was incorporated in its periodic reports. The reports for the period thus inaccurately stated that all portfolio securities had either been rated "high quality" or had been determined by the money market fund's board of directors to be of comparable quality. The SEC thus found that the adviser and portfolio manager willfully violated Section 34(b). Finally, the SEC found that, during the period in question, the adviser did not have in place a sufficient system to monitor compliance with the quality requirements of Rule 2a-7, or to sufficiently assure the accuracy of certain records and reports required to be maintained or filed with the Commission. Further, no operative instrument was in effect delegating to the adviser the board's responsibility to make minimal credit risk and comparable quality determinations for unrated securities. As a result, the adviser did not have, in accordance with Section 203(e) of the Investment Advisers Act, adequate procedures reasonably expected to prevent and deter the portfolio manager's aiding and abetting violations of Rule 22c-1 or his principal violations of Section 34(b). Without admitting or denying the allegations, the adviser consented to a censure and payment of a $50,000 civil penalty, and the portfolio manager consented to a censure and payment of a $5,000 civil penalty. The adviser agreed to certify that it had undertaken (or caused the investment company's board to undertake) to (1) engage an independent accounting firm to review the adviser and company's Rule 2a-7 compliance procedures, (2) adopt appropriate Rule 2a-7 compliance procedures, and (3) appoint a compliance committee to review all acquisitions of portfolio securities by the fund. The portfolio manager also agreed to an order to cease and desist from committing or causing any violation of Section 34(b) and Rule 22c-1. A copy of the SEC's order is attached. Craig S. Tyle Vice President - Securities Attachment

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