

**MEMO# 8453**

December 12, 1996

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

1 Release Nos. 33-7371; IC-22383 (Dec. 10, 1996). 2 See Memorandum to Accounting/Treasurers Members No. 5-96, Money Market 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. 1 Resent due to pages 71 & 72 missing December 12, 1996 TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 13-96 SEC RULES COMMITTEE No. 129-96 RE: SEC PROPOSES TECHNICAL AMENDMENTS TO RULE 2a-7

The Securities and Exchange Commission has proposed technical amendments to Rule 2a-7 under the Investment Company Act of 1940, the rule regulating money market funds.<sup>1</sup> These amendments are designed to address a number of questions that have arisen under the amendments to the rule adopted by the Commission last March (the "March Amendments")<sup>2</sup> and to make certain technical corrections to the rule. In addition, the Commission has proposed several amendments to the advertising rules applicable to money market funds. Comments on the proposed amendments are due to the Commission by January 24, 1997. A meeting has been scheduled for January 8, 1997 to discuss the proposed amendments. The meeting will be held in the ICI Mutual's conference room, located on the 11th floor of our office building, and will begin at 10:00 a.m. Please contact Michael Branch at 202/326-5816 by December 31, 1996 to let him know whether you will be attending the meeting. If you are not planning to attend the meeting, please provide me with your comments on the proposed amendments by January 10, 1997. My direct number is 202/326-5824, the fax number is 202/326-5827 and my e-mail address is amy@ici.com. A summary of the significant aspects of the proposed amendments is set forth below.

**A. Guarantees Definition of "Guarantee"** - To address confusion in the industry regarding the types of unconditional credit support that are appropriate for purposes of the credit quality requirements under Rule 2a-7, the Commission has proposed to revise the rule's terminology by replacing references to "puts" and "unconditional puts" with a new term "guarantee," which would be defined to include a wide-range of arrangements designed to unconditionally support the credit of the issuer of a security.

**Credit Substitution** - The Commission has proposed to expand the rule's credit quality standards to permit a fund to rely solely on the credit quality of the issuer of a guarantee (as opposed to being able to rely only on the credit quality of the issuer of an unconditional demand feature, as currently permitted under the rule) in determining the credit quality of the security, so long as the guarantee is rated by an NRSRO and arrangements are in place for a fund holding a security subject to a guarantee to be given notice in the event of a change in the identity of the issuer of the guarantee. Funds also would be permitted to exclude from the issuer diversification requirements securities subject to a "guarantee issued by a non-controlled person," as defined in the rule.

**Rating Requirements for Guarantees** - In addition to

extending the rating requirement to guarantees, as noted above, the Commission has proposed to modify this requirement in the following respects: (a) conditional demand features would be exempted from the rating requirement; (b) any rating from an NRSRO (rather than only a short-term rating) would satisfy the rating requirement; and (c) a guarantee issued by a person that is controlled by, controls, or is under common control with the issuer of the security would be excepted from the rating requirement.

**Demand Features and Guarantees Not Relied Upon** - The rule would be amended to provide that a demand feature or guarantee that is not relied upon to satisfy the rule's credit quality or diversification requirements, or for liquidity, is not subject to any of the rule's requirements.

**B. Repurchase Agreements; Refunded Securities** 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 March Amendments specified the types of securities that would be appropriate collateral for these purposes. To address the confusion that has arisen under this provision, the Commission has proposed to omit references to specific types of acceptable collateral. The March Amendments permit a fund to "look through" refunded securities to the escrowed securities in determining compliance with the rule's issuer diversification requirements, provided that, among other things, an independent public accountant has certified that the escrowed Government securities, or any subsequent substitution of the escrowed securities, will satisfy all payments of principal, interest and applicable premiums on the refunded securities. The Commission has proposed to revise the rule to provide that the accountant's certification need not be obtained if, in connection with the placement of Government securities into the escrow account, the refunded securities have received a rating from an NRSRO in the highest category for debt obligations.

**C. Asset Backed Securities and Synthetic Securities (collectively "ABSs") Rating Requirement** - The Commission has proposed to modify the requirement that all ABSs be rated to exempt any ABS substantially all the qualifying assets of which consist of the obligations of one or more municipal issuers. In addition, an ABS subject to a guarantee (which generally would be required to be rated under the rule), would itself not be required to be rated.

**Diversification Requirements** - Under the March Amendments, the special purpose entity is treated as the issuer of the ABS for purposes of the rule's 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. For diversification purposes, a fund is required to treat these ten percent obligors as if they issued the portion of the ABS such obligations represent. The proposed amendments would clarify that a ten percent obligor that is also the issuer of other ABSs ("secondary ABSs") would be deemed to have issued a portion of the assets of the primary ABS that such secondary ABSs represent. For purposes of identifying ten percent obligors, the proposed amendments would provide that a fund should continue down the chain of ten percent obligors until a special purpose entity with no ten percent obligors is reached. Finally, the proposed amendments would clarify that in the case of the obligations of a ten percent obligor that are treated as being held directly by the fund, any demand features and guarantees supporting the obligations would be treated as being held by the fund and should be subject to the rule's demand feature and guarantee diversification tests. The Commission has solicited comment regarding how ABSs that consist of qualifying assets whose cash flow has been "swapped" to a financial institution that ultimately acts as the primary source of payment to funds holding the ABSs should be treated under the rule, particularly with respect to the diversification requirements.

**Demand Features and Guarantees** - The Commission has proposed to revise the rule to permit a fund holding an ABS to include any sponsor-provided demand feature

or guarantee in the twenty-five percent "put" basket. D. Advertising Rules Calculation of Yield - The Commission has proposed to amend the money market fund yield formula to clarify that income included in yield is limited to investment income. Use of Total Return - The Commission has proposed amendments to Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act to require that total return used in advertisements and sales literature cover a period of at least one year. In addition, the Commission is proposing to require that quotations of total return in advertisements and sales literature be accompanied by a quotation of current yield, computed in accordance with Commission rules, and set forth with equal prominence. E. Money Market Funds with Debit Cards The Commission has become aware of a fund sponsor that established a program linking a money market fund with a debit card available for use by the fund's shareholders. Under the program, rebates earned by the fund on credit card transactions entered into by the fund's shareholders are distributed to the shareholders in the form of income. Because this type of income is not investment income, its inclusion in the money market fund's standardized yield is not permitted. The Commission has solicited comment on an appropriate method for disclosing, in connection with performance information, these rebate amounts and other types of arrangements involving non-investment income. For example, should a fund be able to advertise a separate rate of return (as a percentage) for the rebate feature covering the same period of time as the standardized yield? F. Transition Period Comment is requested on an appropriate effective date for these amendments and whether the release adopting the amendments should provide for a transition period of comparable length to that of the March Amendments (i.e., six months). \* \* \* Amy B.R. Lancellotta Associate Counsel Attachment