The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 2650

March 28, 1991

INSTITUTE LETTER TO SEC STAFF ON TAX-EXEMPT MONEY MARKET FUND PROPOSALS

March 28, 1991 TO: BOARD OF GOVERNORS NO. 21-91 MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 7-91 SEC RULES COMMITTEE NO. 18-91 MONEY MARKET FUNDS AD HOC COMMITTEE NO. 9-91 RE: INSTITUTE LETTER TO SEC STAFF ON TAX-EXEMPT MONEY MARKET FUND PROPOSALS ____ At the recent SEC meeting at which amendments to the rules regulating money market funds were adopted, Commissioner Roberts urged the staff of the Division of Investment Management to consider changes to the quality and diversification requirements applicable to tax-exempt money market funds, since the amendments to those requirements were applicable only to taxable money market funds. It is our understanding that the Division staff has, in fact, started looking into issues relating to tax-exempt funds. The Institute's ad hoc committee on money market funds has met a number of times over the past couple of months to consider proposals to modify the regulation of tax-exempt funds. The Institute recently submitted to the SEC staff the attached letter recommending modifications to the rules affecting tax-exempt money market funds, which reflects the proposals developed by the committee. Set forth below are the significant amendments proposed by the Institute. Diversification The Institute recommended that the diversification requirement applicable to taxable money market funds (i.e., no more than 5% of a fund's assets may be invested in any one issuer) be adopted for national tax-exempt funds. However, because of the more limited supply of tax-exempt securities in certain states and the dominance of only one or a few municipal issuers within a given state, the Institute recommended that single state tax-exempt funds not be required to meet the 5% diversification requirement proposed for national funds. Instead, the Institute recommended that additional disclosure be required in the prospectuses of those funds that do not meet the 5% diversification requirement. The Institute also recommended that the name of single state funds accurately reflect the fund's intention to concentrate its investment in securities of issuers domiciled in a particular state and that additional cover page disclosure be made as to the fund's intent to concentrate in such securities and that there may be additional risks of doing so. Quality The Institute recommended that the 5% limit on second tier securities applicable to taxable funds be adopted for both national and single state tax-exempt funds, provided that funds be permitted to treat split-rated securities as being of the same quality as the higher rating, so long as at least 50% of the agencies rating that security have assigned it the highest rating. Under the SEC's amendments (which apply to taxable and tax- exempt funds), a security that received different ratings from the rating agencies could be considered a top tier security (and, therefore, not subject to the 5% limit on second tier securities) only if two rating agencies rated it in the highest category. Thus, a split-rated security that was rated by only two agencies (e.g., A-1/P-2) would have to go in the 5% basket of second tier securities. As a result, tax-exempt funds could be precluded from purchasing a large number of securities since, historically, there have been only two rating agencies that have rated tax- exempt securities. Moreover, the recently adopted amendments could provide one rating agency with de facto veto power over tax-exempt funds' purchases of securities. The Institute also recommended that this change be made with respect to taxable funds to further investor protection and to provide for reasonable investment flexibility by avoiding a single NRSRO "veto". Miscellaneous The Institute recommended that Rule 2a-7 be amended to prohibit funds from purchasing conditional demand features used to shorten maturity of tax-exempt securities, unless the conditions are limited to those set forth in the letter. This proposal is intended to reduce the risk of a tax-exempt security losing its demand feature, which could result in the fund holding a long-term security, the value of which may significantly deviate from its amortized cost value. In addition, given the complexity of some of the tax-exempt securities that have recently come to market and the potential tax issues that may affect the tax-exempt status of these securities, the Institute recommended that the SEC caution funds about the additional tax-related risks to a stable net asset value that are present with respect to tax-exempt securities and remind boards of directors of tax-exempt money market funds of their obligations concerning the valuation of fund shares. We will keep you informed of developments. Amy B.R. Lancellotta Assistant General Counsel Attachment