

MEMO# 2054

July 24, 1990

AUGUST 8, 1990 MEETING ON UTILIZATION OF FUNDS FOR INVESTMENT OF MUNICIPAL BOND PROCEEDS

- 1 - July 24, 1990 TO: INSTITUTIONAL FUNDS COMMITTEE NO. 2-90 MARKETING COMMITTEE NO. 14-90 SEC RULES COMMITTEE NO. 38-90 TAX COMMITTEE NO. 17-90 RE: AUGUST 8, 1990 MEETING ON UTILIZATION OF FUNDS FOR INVESTMENT OF MUNICIPAL BOND PROCEEDS _____ Consideration is being given to revising the Treasury Department's State and Local Government Series ("SLGS") program, which permits issuers of tax-exempt municipal bonds to invest temporarily in U.S. government securities and avoid calculating arbitrage under the restrictions of section 148 of the Internal Revenue Code. Specifically, these arbitrage restrictions prevent issuers of tax-exempt municipal bonds from earning a higher yield on their investments of the bond proceeds (before the proceeds are used for their intended purpose) than they pay as interest on the bonds themselves; any amounts earned in excess of this permitted yield must be rebated to the Federal government. The calculation of the permitted rate of earnings and of the rebate amount is exceptionally complex, and many municipalities, particularly the relatively small ones, have a great deal of difficulty complying with the law at a reasonable expense. Under the SLGS program, municipal issuers may purchase Treasury securities which pay the exact interest rate that the issuer is allowed to earn and which have the exact maturity date that the municipalities need. While there is no legal requirement that municipal issuers utilize the SLGS program, many issuers do so. The SLGS program is not, however, as flexible as many municipal issuers would like. Recently, the Institute received an inquiry as to whether we would be interested in crafting a proposal to permit the mutual fund industry to offer a money-market type product to municipal bond issuers. This product would pay the issuers the yield to which they are entitled under the Code and rebate the excess to the Federal government, thereby relieving the municipalities of the burden of calculating the rebate amount. In the past, two issues have been raised by Government officials - 2 - that must be considered. First is the issue of whether two entities, such as fund advisers, offering investment vehicles to municipal issuers could sell to each other lower-quality securities whose poor liquidity has made them difficult to price and sell; in these circumstances, questions might arise as to whether the sale would be a true arms-length transaction. Second is the issue of whether fund advisers might charge "excessive" management fees to these municipal proceeds funds, because those excessive fees would not affect the return to the municipalities but simply reduce the rebate to the Federal government. Other considerations, such as whether existing funds could be sold to these municipalities or whether new funds would need to be created, must be addressed. Any

other federal or state securities laws or regulations which might interfere with the offering of this new type of product must also be identified. A meeting to discuss this possible new type of mutual fund product will be held on August 8, 1990 at 10:00 a.m. at The Capital Hilton, 1001-16th Street, N.W. Washington, D.C., phone number (202) 393-1000 in the South America Room. Lunch will be served at the meeting. Please telephone Berlauder Barnes at (202) 955-3518 by August 3, 1990 if you will be attending. David J. Mangefrida, Jr. Assistant General Counsel Amy B. Rosenblum Assistant General Counsel

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