MEMO# 3673

April 6, 1992

# INSTITUTE COMMENT LETTER ON PROPOSED REGULATIONS ON THE INVESTMENT OF MUNICIPAL BOND PROCEEDS IN COMMINGLED FUNDS

April 6, 1992 TO: TAX COMMITTEE NO. 14-92 INSTITUTIONAL FUNDS COMMITTEE NO. 5-92 RE: INSTITUTE COMMENT LETTER ON PROPOSED REGULATIONS ON THE INVESTMENT OF MUNICIPAL BOND PROCEEDS IN COMMINGLED FUNDS ______________________________________________________ As you know, the Institute has been discussing with the Treasury Department regulations which would enable state and local governments to more easily invest proceeds of tax-exempt bonds in institutional money market funds. (See Institute Memoranda to Institutional Funds Committee No. 2-90, Marketing Committee No. 14-90, SEC Rules Committee No. 38-90 and Tax Committee No. 17-90, dated July 24, 1990; and to Institutional Funds Committee No. 3-91, dated June 13, 1991.) Typically, these bonds proceeds are invested by the issuer for a temporary period before being expended. Recently, the Treasury Department issued proposed regulations which include provisions relating to the ability of tax-exempt bond issuers to invest bond proceeds in commingled investment pools. Although not explicitly stated in the proposed regulations, it is assumed that such commingled pools are intended to include institutional money market funds. Because the issuers are required to rebate to the federal government any earnings on the bond proceeds that exceed the amount paid on the bonds, the Treasury Department has expressed a concern about "fee burning"; i.e., charging fees to a tax-exempt issuer higher than those charged to other investors for the same advice or product. Thus, the proposed regulations provide for caps on the expenses of any fund in which the proceeds of tax-exempt bonds are invested. The proposed caps are 25 basis points on the average daily balance of the issuer invested in the fund on amounts up to $10,000,000 and 12.5 basis points on the average daily balance in excess of that amount. If the fund's expenses exceeded these caps, the income of the issuer derived from the fund would have to be "grossed up" for purposes of calculating the amount of earnings to be rebated to the federal government, if any. In the attached comment letter, the Institute opposes certain aspects of the proposed regulations. Specifically, the letter states that the regulations are flawed in that: (1) RIC expenses are properly deducted from the RIC's income before its - 1 - income is distributed, and that those expenses should not be attributed to shareholders: (2) an investment in the shares of a corporation, such as a RIC, does not give the corporate shareholders an ownership interest in the corporation's underlying assets; (3) there is no indication in the legislative history to Internal Revenue Code section 148 that Congress intended the tax-exempt bond arbitrage rules to override the general treatment of RIC shareholders provided in the Code; and (4) no policy rationale exists which would justify extending the commingled fund rules to RICs. We will keep you informed of developments. David J. Mangefrida Jr. Assistant Counsel - Tax Attachment

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