The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 13715

July 11, 2001

SEC ADOPTS NEW RULE FOR REPURCHASE AGREEMENTS AND REFUNDED SECURITIES

[13715] July 11, 2001 TO: SEC RULES COMMITTEE No. 55-01 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 2-01 RE: SEC ADOPTS NEW RULE FOR REPURCHASE AGREEMENTS AND REFUNDED SECURITIES The SEC has issued a release adopting a new rule and related rule amendments under the Investment Company Act of 1940 that affect the ability of funds to invest in repurchase agreements and pre-refunded bonds under the Act.1 New Rule 5b-3 under the 1940 Act permits a fund to treat a repurchase agreement ("repo") as an acquisition of the underlying securities for purposes of Sections 5(b)(1)2 and 12(d)(3)3 of the Act. The rule also provides similar "look- through" treatment for purposes of Section 5(b)(1) in the case of an investment in state or municipal bonds, the payment of which has been fully funded by escrowed U.S. Government securities. The final rule was adopted largely as proposed and incorporates certain recommendations made by the Institute in its comment letter on the proposal.4 The Commission's final rule is attached, and it is summarized below. The final rule becomes effective on August 15, 2001. Qualifying Repurchase Agreements New Rule 5b-3(a) permits a fund to treat the acquisition of a repurchase agreement as an acquisition of the underlying securities if the obligation of the seller to repurchase the securities from the fund is "collateralized fully." Under the rule, a repo is "collateralized fully" if: 1 Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, SEC Rel. No. IC-25058 (July 5, 2001); 66 Fed. Reg. 36156 (July 11, 2001). The Commission originally proposed the rule and amendments in the fall of 1999. See Memorandum to Money Market Funds Advisory Committee No. 15-99 and SEC Rules Committee No. 73-99, dated September 30, 1999. 2 Section 5(b)(1) limits the amount that a diversified fund may invest in the securities of any one issuer (other than the U.S. Government), which may limit the amount of repos that a fund may enter into with any one counterparty. 3 Section 12(d)(3) generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter, and thus, arguably, may limit a fund's ability to enter into repos with many of the firms that act as counterparties. The final rule amends Rule 12d3-1, which provides an exemption from Section 12(d)(3), to eliminate the note appended to the rule that renders the rule unavailable for repos, thus permitting funds to rely on Rule 12d-3 even if the repo fails to meet the requirements for "look-through" treatment in Rule 5b-3. 4 See Memorandum to Money Market Funds Advisory Committee No. 18-99 and SEC Rules Committee No. 100-99, dated November 30, 1999. 2(i) the value of the underlying securities (reduced by the costs that the fund reasonably could expect to incur if the counterparty defaults) is, and at all times remains, at least equal to the agreed resale price; (ii) the fund has perfected its security interest in the collateral; (iii) the collateral is maintained in an account of the fund with its custodian or

a third party that qualifies as a custodian under the 1940 Act; (iv) the collateral consists entirely of: (A) cash items; (B) U.S. Government securities; (C) securities that at the time the repurchase agreement is entered into are rated in the highest category by the "Requisite NRSROs" (as defined in the rule); or (D) unrated securities that are of comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the fund's board of directors or its delegate; and (v) the repurchase agreement qualifies for an exclusion from any automatic stay of creditors' rights against the counterparty under applicable insolvency law in the event of the counterparty's insolvency. As recommended by the Institute, the final rule has eliminated the proposed requirement that the fund's board of directors or its delegate evaluate the creditworthiness of the counterparty to a repurchase agreement. The Commission determined that this is not necessary given the requirement that funds relying on the rule qualify for the Bankruptcy Code protection. Similarly, the rule does not to require funds to perfect their security interest in the collateral by obtaining "control" of the collateral. The Commission has determined, however, to maintain the ratings requirement regarding the credit quality of the collateral. In its view, such a requirement is necessary in order to limit a fund's exposure to the ability of the counterparty to maintain sufficient collateral. Treatment of Pre-Refunded Bonds New Rule 5b-3(b) permits a fund to treat an acquisition of a refunded security as an acquisition of the escrowed U.S. Government securities for purposes of Section 5(b)(1). The rule defines "refunded security" as a debt security the principal and interest payments of which are to be paid by U.S. Government securities that have been irrevocably placed in an escrow account and are to be pledged only to the payment of the debt security. In addition, the deposited securities must not be redeemable prior to their final maturity, and the escrow agreement must prohibit the substitution of the deposited securities unless the substituted securities are U.S. Government securities. Finally, an independent certified public accountant must certify to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the refunded securities, unless the refunded security has received the highest rating from an NRSRO. Barry E. Simmons Associate Counsel Attachment 3Attachment (in .pdf format)
