

MEMO# 7738

March 25, 1996

SEC ADOPTS AMENDMENTS TO MONEY MARKET FUND REGULATIONS

1 See Memorandum to Money Market Members - One Per Complex No. 11-93 and SEC Rules Members No. 102-93, dated December 27, 1993 and Memorandum to Money Market Funds Ad Hoc Committee No. 10-93, dated December 23, 1993. 2 Release Nos. 33-7275; IC-21837 (March 21, 1996). March 25, 1996 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 RE: SEC ADOPTS AMENDMENTS TO MONEY MARKET FUND REGULATIONS

_____ We are pleased to report that the Securities and Exchange Commission has adopted amendments to Rule 2a-7 under the Investment Company Act of 1940, and other rules and forms under that Act and the Securities Act of 1933 relating to money market funds.¹ While the amendments apply primarily to tax-exempt funds, a number of them apply to taxable funds as well. The Institute had urged the Commission to adopt diversification and credit quality standards for tax-exempt funds similar to those adopted for taxable funds in 1991. The changes to Rule 2a-7 reflect many of the Institutes comments on the amendments as proposed. Set forth below is a summary of the significant aspects of the amendments. A copy of the Commissions adopting release is attached.² In light of these recent amendments, the Institute is sponsoring a special one-day conference on money market fund regulation. The conference will be held on Friday, May 10, 1996 at the Stouffer Renaissance Mayflower Hotel in Washington, D.C. For more information about the conference, contact Susan Burgess at 202/326-5817.

I. Amendments Applicable to Tax-Exempt Money Market Funds

A. Issuer Diversification Requirements - Under the amendments, "national" tax-exempt funds (i.e., funds that do not limit their investments to securities exempt from the income taxes of a specific state) are limited to investing no more than five percent of their assets in securities of a single issuer (other than Government securities). Instead of exempting "single state" funds (i.e., funds that hold themselves out as primarily distributing income exempt from the income taxes of a specified state or locality) entirely from a diversification requirement, as originally proposed and supported by the Institute, the amendments require that these funds be diversified at the five percent level as to seventy-five percent of their assets; the remaining twenty-five percent of fund assets may be invested in securities of one or more issuers so long as they are first tier securities.

B. Credit Quality Requirements - The Commission did not adopt the proposal to limit single state investment to only first tier securities, which was strongly opposed by the Institute. Instead, the credit quality requirements proposed for national funds were extended to single state funds as well. Specifically, all tax-exempt funds are limited to investing five percent of their assets in second tier securities that are "conduit securities," as defined in the rule. Investment in such securities of any one issuer is limited

to the greater of one percent of fund assets or one million dollars. For purposes of calculating compliance with this requirement, as well as the diversification requirements described above, the issuer of the security is the non-governmental entity ultimately responsible for the payment of principal and interest.

II. Amendments to Rule 2a-7

Applicable to All Money Market Funds

A. Diversification and Quality Standards for Put Providers

22 1. Diversification Requirements

- The Commission has adopted, as proposed, a ten percent aggregate limit on a money fund's investment in securities subject to conditional and unconditional puts, and securities directly issued by, the same issuer. This limitation applies only with respect to seventy-five percent of a fund's assets. The remaining twenty-five percent of a fund's assets may be invested in securities subject to puts from, or directly issued by, one or more institutions, provided that they are first tier and are "puts issued by a non-controlled person," as defined in the rule. The rule has been amended to clarify that a fund is not required to aggregate an issuer-provided put (i.e., a put provided by the issuer of the underlying security) with the security subject to the put for purposes of determining compliance with the ten percent put diversification requirement.

2. Quality Standards

a. Rating Requirement

- Under the amendments, a demand feature (other than a standby commitment) will be deemed an eligible security under Rule 2a-7 only if it (or its issuer) has received a short-term rating from a nationally recognized statistical rating organization ("NRSRO").

b. Providers of Puts in Excess of Five Percent of Fund Assets

- The amendments prohibit a money fund from investing more than five percent of its assets in second tier puts from a single put provider.

3. Conditional Demand Features

- The proposed amendments would have specified the permissible conditions that could be included in a conditional demand feature for purposes of the rule. The Commission has determined that because put providers may use different, often broader, language than that proposed, it would instead be better to amend the rule to provide general guidance concerning the types of conditions that are appropriate for money fund investment. Specifically, the rule, as amended, provides that a security subject to a conditional demand feature is an eligible security only if the fund's board of directors (or its delegate) determines that there is "minimal risk" of occurrence of the conditions that would result in the demand feature not being exercisable. The fund's board (or its delegate) also must determine that: (a) the conditions limiting exercise can be monitored readily by the fund, or relate to the taxability, under federal, state or local law, of the interest payments on the security; or (b) the terms of the demand feature require that the fund receive notice of the occurrence of the condition and the opportunity to exercise the demand feature.

B. Other Issues Regarding Puts

1. Accrued Interest

- The definition of "put" in paragraph (a)(16) of the rule has been amended to specify that the put must enable the holder to receive not only the amortized cost of the securities, but also accrued interest.

2. Notice of Substitution of Put Provider

- To ensure that funds are aware of the identity of their put providers at all times, Rule 2a-7 was amended to condition the eligibility of a security subject to a demand feature upon there being arrangements in place to notify the fund holding the security in the event that there is a change in the identity of the issuer of a demand feature.

C. Other Diversification and Quality Standards

1. Exclusion of Securities Subject to Certain Demand Features

- The issuer diversification requirements under the rule have been amended to exclude securities that are subject to an "unconditional demand feature issued by a non-controlled person," as defined in the rule. These securities will be subject only to the rule's put diversification requirements. (Conduit securities subject to such demand features are exempt from the second tier securities limitation applicable to tax-exempt funds and are subject only to the rule's put diversification requirements.)

2. Repurchase Agreements

- The Commission has adopted, as proposed, amendments to permit a fund to treat a repurchase agreement as collateralized fully, thereby allowing it to "look through" the repo to the underlying collateral for diversification purposes, only if it is

collateralized by securities that would qualify the repo for preferential treatment under the Federal Deposit Insurance Act or the Federal Bankruptcy Code.

3. Pre-Refunded Bonds - Rule 2a-7 has been amended to allow funds to "look through" pre-refunded bonds for diversification purposes so long as the underlying securities are Government securities and the escrow arrangement satisfies certain conditions designed to assure that the bankruptcy of the issuer of the pre-refunded bond would not affect payments on the bonds from the escrow account. The Commission did not adopt the proposal to limit fund investment in pre-refunded bonds issued by the same issuer to twenty-five percent of its assets.

33 D. Asset Backed Securities The Commission has amended Rule 2a-7 to clarify the diversification, credit quality and maturity determination standards applicable to synthetic and "asset backed securities (ABSs)," as defined under the rule.

1. Diversification - The "special purpose entity" issuing the security generally will be treated as the issuer for purposes of the diversification requirements under the rule; however, any entity whose obligations constitute ten percent or more of the principal amount of the qualifying assets backing the ABS will be deemed to be the issuer of the portion of the ABS such obligations represent.

2. Credit Quality - The rule requires that funds purchase only rated ABSs, but does not specify whether the rating received must be short-term or long-term.

3. Maturity - Commenters expressed concern that using the "scheduled" maturity date of certain ABSs, as proposed, could allow funds to determine the maturity of such ABSs by relying on the date on which principal is scheduled, but not necessarily required, to be repaid. In response, the Commission amended the definition of "demand feature" to include a feature of an ABS permitting the fund unconditionally to receive principal and interest within thirteen months of making demand. The maturity of an ABS with a final maturity in excess of 397 days may be determined by reference to a demand feature only if the ABS also meets the definition of a floating or variable rate security.

E. Variable and Floating Rate Securities Several changes were adopted to the provisions in Rule 2a-7 dealing with variable and floating rate securities. Among other things, the rule was amended to permit funds to determine the maturity of floating rate securities with final maturities of 397 days or less by referring to the next readjustment of the interest rate. The rule was also amended to clarify that adjustable rate Government securities are treated the same way as other adjustable rate securities under the rule (i.e., the maturity of the security may only be determined by reference to the interest readjustment date if, upon readjustment, the security can reasonably be expected to have a market value that approximates par value).

F. Board Approval Rule 2a-7 has been amended to eliminate the requirement that the board of directors of a taxable fund approve or ratify purchases of unrated securities and securities that are rated by only one NRSRO.

III. Amendments to Other Rules and Forms

A. Recordkeeping The Commission has amended Rule 31a-1 under the Investment Company Act to require money funds to maintain in their portfolio investment records information identifying: (1) each security by its legal name; (2) any liquidity or credit enhancements associated with each security; and (3) any coupons, accruals, maturities, puts, calls or any other information necessary to identify, value and account for each security.

B. Disclosure Requirements The Commission adopted several new disclosure requirements regarding money market funds. Among other things, the Commission has amended Form N-1A to require a single state tax-exempt money fund to include a prominent statement in its prospectus that the fund is concentrated in securities issued by the state or entities within the state and that therefore investment in the fund may be riskier than an investment in other types of money market funds. Single state funds that do not meet the five percent diversification requirement with respect to one hundred percent of their assets must include a prominent statement on the cover page of its prospectus that the fund may invest a significant percentage of its assets in a single issuer, and that therefore investment in the fund may be riskier than investment in other types of money market funds. In addition,

Rule 134 under the Securities Act has been amended to require "tombstone" advertisements to include a statement that an investment in a money fund is not insured or guaranteed by the U.S. Government and that there can be no assurance that the fund will maintain a stable net asset value. C. Exemptive Rule Governing Purchases of Certain Portfolio Securities by Affiliated Persons The Commission has adopted a new rule under the Investment Company Act, Rule 17a-9, to permit (but not require) an affiliate of a fund to purchase from the fund securities that are no longer eligible securities under Rule 2a-7 at the higher of their amortized cost values (including accrued interest) or market values, without having to obtain a Commission order. IV. Effective Dates Funds may begin complying with the amendments upon publication of the adopting release in the Federal Register. Beginning October 3, 1996, money funds must comply with the amendments except with respect to certain securities that the Commission has "grandfathered" (see pp. 73 and 74 of the attached release). The new disclosure requirements generally become effective June 3, 1996 (see p. 74). Amy B.R. Lancellotta Associate Counsel Attachment

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