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SEC PROPOSES AMENDMENTS TO TAX-EXEMPT MONEY MARKET FUND REGULATION

December 23, 1993 TO: MONEY MARKET FUNDS AD HOC COMMITTEE NO. 10-93 SEC RULES COMMITTEE NO. 113-93 RE: SEC PROPOSES AMENDMENTS TO TAX-EXEMPT MONEY MARKET FUND REGULATION _____ The

The Securities and Exchange Commission has proposed amendments to rules and forms under the Securities Act of 1933 and the Investment Company Act of 1940 that govern money market funds. The proposed amendments would impose certain quality and diversification requirements on tax-exempt money market funds under Rule 2a-7, impose additional disclosure requirements on tax-exempt money market funds, and make certain other changes to the rules and forms applicable to all money market funds. The Institute has been urging the Commission since 1991 when it adopted tighter diversification and quality standards for taxable funds to adopt similar requirements for tax-exempt funds. A copy of the Commission's release is attached. Set forth below is a summary of the significant aspects of the proposed amendments.

A. Tax-Exempt Money Market Funds: Diversification and Quality Requirements

1. Issuer Diversification Requirements - Rule 2a-7 currently requires taxable funds to limit investments in a single issuer to five percent of fund assets. The proposal would amend Rule 2a-7 to apply the five percent diversification test to "national funds" (i.e., tax-exempt money market funds that do not limit their investments to securities exempt from the income taxes of a specific state). With respect to "single state funds" (i.e., tax-exempt money market funds that hold themselves out as primarily distributing income exempt from the income taxes of a specified state or locality), the Commission has proposed to exempt them from the five percent diversification test and instead limit their portfolio instruments to first tier securities, as defined under the Rule. To facilitate compliance with the five percent diversification test, the Commission has proposed to allow funds to "look through" pre-refunded bonds to the escrowed Government securities for purposes of the diversification test. A fund, however, would be limited to investing no more than twenty-five percent of its assets in pre-refunded bonds of the same issuer.

2. Quality Limitations on Portfolio Securities - As stated above, the proposal would preclude single state funds from purchasing second tier securities. The proposal would not require national funds to limit their investments in second tier securities (as taxable funds currently are required to do), except with respect to the purchase of conduit securities, as defined under the Rule. Under the proposal, a tax-exempt fund would be precluded from investing more than five percent of its assets in second tier conduit securities, with investment in the second tier conduit securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars.

2B. Puts and Demand Features

- The Commission has proposed amendments regarding puts and demand features that

would apply to both taxable and tax-exempt money market funds.

1. **Diversification Requirements** - Currently, Rule 2a-7 permits a fund to invest in unconditional puts from a single institution guaranteeing up to ten percent of the fund's assets, but limits investments in securities subject to conditional puts to five percent of the fund's assets. Under the proposed amendments, the ten percent limit would be applicable to all puts. For these purposes, conditional and unconditional puts from a single issuer would be aggregated to determine whether the ten percent limit has been reached.
2. **Twenty-Five Percent Put Basket** - The proposed amendments would eliminate the twenty-five percent basket for puts currently available to tax-exempt funds.
3. **Multiple Layered Puts and Guarantees** - In cases where more than one institution has provided a put or guarantee, the proposal would require that for the put diversification requirements under Rule 2a-7, each put provider or guarantor be deemed to have guaranteed the entire principal amount of the security, notwithstanding that the security is subject to puts from other institutions.
4. **Quality Limitations on Put Providers** - The proposed amendments would limit funds to investing in puts (other than standby commitments) that are rated, or provided by institutions that are rated, by NRSROs. In addition, when a fund invests more than five percent of its assets in securities supported by a put from a single put provider (whether conditional or unconditional), the put must be provided by an institution that has received the highest rating with respect to its short-term debt obligations from the requisite NRSROs, as defined under the Rule. The proposed amendments also would require a fund that invests more than forty percent of its assets in securities subject to puts to disclose in its prospectus that the credit quality of the portfolio is linked closely to the credit quality of banks and other financial institutions.
5. **Conditional Puts** - In the release, the Commission expressed concern about the inability of a fund to exercise a demand feature because of the occurrence of a condition attached to the demand feature. Based on this concern, the Commission has proposed amendments that would limit the permissible conditions with respect to conditional puts to the following:
 - a. default in the payment of principal or interest on the underlying security;
 - b. the bankruptcy, insolvency, or receivership of the issuer or a guarantor of the underlying security;
 - c. the downgrading of the underlying security or a guarantor by more than two full rating categories; and
 - d. in the case of a tax-exempt security, a determination by the Internal Revenue Service of taxability with respect to the interest on the security.
- C. **Asset Backed and Synthetic Securities** - Amendments have been proposed concerning the eligibility under Rule 2a-7 of synthetic and other asset backed securities, as defined under the Rule. Among other things, the proposed amendments would permit money market funds to invest only in such securities that have a short-term rating and, when the final maturity of the security exceeds 397 days, a long-term debt rating from a NRSRO.

3D. **General Review, Information, and Notice Requirements** - The Commission has proposed amendments to Rule 2a-7 to require money market funds to adopt written procedures concerning ongoing reviews of the credit risks of any security (other than a Government security) for which maturity is determined by reference to a demand feature. In cases where a security is subject to an unconditional demand feature, the proposed amendments would require that, in certain circumstances (such as a significant adverse change in the credit quality of the provider of the demand feature or the impending expiration of the demand feature), funds obtain sufficient information about the issuers of such securities to permit them to value the securities without the demand feature. The release states that the information funds should consider obtaining would include financial statements, notices concerning unscheduled draws on any reserve fund or credit enhancement established to assure timely payment of interest or principal on the security, and notice of any events of default. If a fund is not able to obtain current information about the financial condition of these issuers, the fund would be required to dispose of the security as soon as practicable by sale or by exercise of the demand feature.

E. Maturity Determinations; Floating Rate and Variable Rate Securities - Rule 2a-7 currently provides that the maturity of a floating rate security subject to a demand feature is the period remaining until principal can be recovered through demand. The Commission has proposed amending the Rule to permit funds to determine the maturity of floating rate securities with final maturities of 397 days or less by referring to the interest rate reset date. The proposed amendments also would provide that the maturities of variable rate securities with final maturities of less than 397 days would be measured by reference to the earlier of the date on which the interest rate next readjusts and the date on which principal can be recovered on demand.

F. Repurchase Agreements - The proposed amendments would limit the types of collateral that could be used by funds for purposes of "looking through" a repurchase agreement to the underlying collateral for diversification purposes under Rule 2a-7. The proposed amendments would permit repurchase agreements to be treated as fully collateralized only if, among other things, they are collateralized by securities that would qualify the repurchase agreement for preferential treatment, as specified under the Rule.

G. Investments in Other Money Market Funds - The proposed amendments codify staff positions regarding the permissibility of money market fund investment in other money market funds.

H. Board Approval of Certain Securities - The proposed amendments would 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.

I. Recordkeeping - Under the proposed amendments, a fund would be required to maintain a written record of the determination that a portfolio instrument presents minimal credit risks and to maintain a record of the NRSRO ratings (if any) used to determine the status of the security under the Rule. In addition, the Commission has proposed an amendment to Rule 31a-1 under the Investment Company Act to require money market funds to maintain in their portfolio investment records information identifying: (1) each security by its legal name; (2) any liquidity and 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.

J. Disclosure

41. Single State Funds - The proposed amendments would require a single state tax-exempt fund to disclose in its prospectus that: (1) its investments are geographically concentrated; (2) for a single state fund that does not meet the five percent diversification test, that the fund may invest a significant percentage of its assets in the securities of a single issuer; and (3) that an investment in the fund therefore may be riskier than an investment in other types of money market funds.

2. Advertising - The proposed amendments would require tombstone advertisements under Rule 134 of the Securities Act include the statement currently required in fund prospectuses and certain advertisements that an investment in a money market 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.

K. Proposed Exemptive Rule For Purchases of Certain Portfolio Instruments By Affiliated Persons - The Commission has proposed new Rule 17a-9 under the Investment Company Act to exempt certain purchases of portfolio securities from a money market fund by an affiliated person of the fund. Specifically, the proposed exemption would apply when (1) the security is no longer an eligible security under Rule 2a-7, (2) the purchase price is paid in cash, and (3) the purchase price is equal to the greater of the amortized cost of the security or its market price (in each case, including accrued interest).

L. Transition Period - If the proposed amendments are adopted, the Commission expects to make them effective ninety days after publication in the Federal Register.

M. Comment Period - Comments are due to the SEC on the proposed amendments by April 6, 1994. * * *

5The Institute has tentatively scheduled a meeting to discuss the proposed amendments on February 8, 1994. We will provide you with information concerning the location and time of the meeting shortly.

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