

MEMO# 2540

February 13, 1991

SEC ADOPTION OF AMENDMENTS TO MONEY MARKET FUND RULES

THIS SUMMARY IS BASED ON MY NOTES FROM THE MEETING AND, THUS, MAY DIFFER SLIGHTLY FROM THE ADOPTED CHANGES. February 13, 1991 TO: MONEY MARKET FUNDS AD HOC COMMITTEE NO. 3-91 RE: SEC ADOPTION OF AMENDMENTS TO MONEY MARKET FUND RULES _____ At an open meeting today, the SEC adopted amendments to Rule 2a-7 and other rules applying to money market funds. Chairman Breeden stated in his introductory remarks that the Commission's proposal was important to protect the more than 20 million money market fund shareholders, especially at a time when investor confidence has seriously eroded as a result of the S&L crisis and bank failures. Set forth below is a brief summary of the significant changes that were adopted today. I will prepare a more detailed summary of the new requirements as soon as the release is available from the SEC.

Quality Ratings - A fund may purchase a security that has received the highest rating by any two rating agencies. If only one rating agency has rated the security, that rating is determinative.

Second Tier Paper - A fund may invest up to 5% of its assets in securities in second tier paper. In response to commercial paper issuers who were concerned by this limit, the SEC stated there is nothing to prevent other mutual funds from purchasing this paper (except that they can not call themselves money market funds). In addition, the SEC noted that money market funds today only have 1/2 of 1% of their assets invested in second tier paper. This translates into about \$2 billion of this paper; however, under the 5% limit they could hold up to \$20-25 billion. Thus, the impact in the marketplace should be negligible. In addition to the overall 5% limit of second tier paper, a fund is limited to the greater of 1% or \$1 million per issuer. This modification is intended to respond to concerns that funds may not be able to buy small amounts of this paper and that the 1% limit may have prohibited some funds from purchasing second tier paper.

Unrated Securities - Funds may buy unrated securities provided that the issuer does not have a similar security rated below eligible quality and does not have outstanding long-term debt rated below the top two ratings.

Split-Rated Securities - Split-rated securities that have received the highest rating by two agencies may be purchased by a fund. A security that has received the highest rating by only one agency may be purchased by a fund, but must be included in the 5% basket of second tier paper. It is interesting that under the SEC's proposal a fund could only hold up to 5% of its assets in split-rated paper and that under the adopted standard a fund could be 100% invested in split-rated securities, provided at least two agencies rate it the highest.

Maturity Dollar-Weighted Average - The dollar-weighted average portfolio maturity was reduced from 120 days to 90 days.

Single Instruments - The maturity of a single portfolio instrument can not exceed 13 months, except that a fund that uses mark-to-market valuation may purchase government securities with a maturity of up to 25 months.

Diversification A fund may not invest more than 5% of its assets in any one issuer, except that a fund may exceed this

limit with respect to an issuer of top rated paper for up to 3 business days. This allows funds to deal with unexpected cash flows. A fund may continue to invest up to 10% of its assets in securities subject to an unconditional put issued by any one institution.

Downgrades and Defaults If a portfolio security is downgraded below eligible quality or is in default, the fund must dispose of the security as soon as practicable unless the board determines that it is in the best interests of the fund and its shareholders not to do so. The rule will explicitly state that market conditions may be a factor that the board considers in making this determination. If a security is downgraded but is still of eligible quality, the board must make a prompt assessment of whether to continue to hold the security or sell it. If an adviser becomes aware that a rating agency has rated a security below the second highest rating, the board must make a prompt assessment of whether to continue to hold or sell the security.

Notification - If a fund is holding a security that is in default that accounts for 1/2 of 1% or more of the fund's assets, the fund must notify the SEC. The notification is only required where the default relates to the financial condition of the issuer.

Disclosure and Holding Out Requirements - The SEC adopted the cover page disclosure and holding out requirements as proposed.

Board Delegation of Duties - The rule will explicitly state that the board may delegate its duties to another party and will identify some of the specific duties that may be delegated (e.g, comparability determination of unrated securities, reassessment of a downgraded security).

Transition Period - There will be a 90 day transition period from the date of publication in the Federal Register, which they expect will be within a week or two.

Tax-Exempt Funds - The new diversification and quality requirements will not apply to tax-exempt money market funds. Marianne Smythe stated that the staff will be taking a look at tax-exempt money market funds and, in fact, was urged by Commissioner Roberts to do so.