The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 2893

June 27, 1991

SEC STAFF MODIFIES ITS POSITION ON LIQUIDITY OF MUNICIPAL LEASE SECURITIES

June 27, 1991 TO: SEC RULES MEMBERS NO. 37-91 RE: SEC STAFF MODIFIES ITS POSITION ON LIQUIDITY OF MUNICIPAL LEASE SECURITIES

_____ Last year, the SEC staff stated in its industry comment letter that it considers municipal lease securities to be illiquid because of the inefficiency of the market in which they traded. (See Memorandum to SEC Rules Members No. 4-90, dated January 19, 1990 and Memorandum to SEC Rules Committee No. 11-91, dated February 6, 1991.) Therefore, mutual funds had to treat these securities as illiquid for purposes of the ten percent limitation on the purchase of illiquid securities. The Institute requested the staff to reconsider its position since many municipal lease obligations are in fact liquid. In response, the staff issued the attached letter modifying its position, which recognizes that "in certain circumstances, it may be appropriate to view municipal lease obligations as liquid securities." In the letter, the staff states that a fund may make the determination to treat such securities as liquid under guidelines established by the board of directors. The staff suggests several factors that a fund should consider in making this determination such as: (1) the frequency of trades and quotes for the obligation; (2) the number of dealers willing to purchase or sell the security and the number of other potential buyers; (3) the willingness of dealers to undertake to make a market in the security; and (4) the nature of the marketplace trades. In addition, the staff stated that factors unique to municipal lease obligations should be considered in determining liquidity such as whether the marketability of the security will be maintained throughout the time the fund holds the security. This determination depends on factors related to the credit quality of the municipality and the essentiality to the municipality of the property covered by the lease. In this respect, the staff notes the factors that a rating agency generally considers when evaluating the credit quality of a municipal lease obligation. The staff warns that it may view as imprudent the purchase of an unrated municipal lease obligation unless the fund can perform an analysis of factors similar to those performed by the rating agencies and reasonably conclude that the obligation is liquid. Finally, the letter requires a fund that invests, or intends to invest, more than five percent of its net assets in municipal lease obligations that the board (or its delegate) determines to be liquid to disclose in the prospectus the factors considered by the board in making that determination. This disclosure may be added by a "sticker" to the prospectus under Rule 497 of the Securities Act. Amy B.R. Lancellotta Assistant General Counsel Attachment (in .pdf format)