The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

**MEMO# 11285**

September 30, 1999

# SEC RULE PROPOSAL REGARDING REPURCHASE AGREEMENTS AND REFUNDED SECURITIES

1 Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Rel. No. IC- 24050 (Dec. 23, 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, accordingly 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. Rule 12d3-1, which provides an exemption from Section 12(d)(3), would also be amended to eliminate the note which, as currently appended to the rule, renders the rule unavailable for repos that fail to meet the requirements for look-through treatment set forth in the Investment Company Act. [11285] September 30, 1999 TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 15-99 SEC RULES COMMITTEE No. 73-99 RE: SEC RULE PROPOSAL REGARDING REPURCHASE AGREEMENTS AND REFUNDED SECURITIES

_____ The SEC has proposed a new rule and related rule amendments under the Investment Company Act of 1940 that would codify and update staff positions to permit investment companies to "look through" counterparties to repurchase agreements and issuers of municipal bonds that have been "refunded" with U.S. Government securities and treat the underlying securities comprising the collateral as investments for certain purposes under the Act. The SEC's proposal is attached1 and it is summarized below. Comments on the SEC's proposal are due by November 23, 1999. If there are comments you would like the Institute to consider including in its comment letter, please provide them to Barry Simmons by phone at (202) 326-5923, by fax at (202) 326-5827, or by email at simmonbe@ici.org by Friday, October 15, 1999. Repurchase Agreements Proposed Rule 5b-3(a) under the Investment Company Act would permit a fund to treat the acquisition of a repurchase agreement (or "repo") as an acquisition of the underlying securities (rather than as a loan to the counterparty) for purposes of Sections 5(b)(1)2 and 12(d)(3)3 of the Act. This treatment is subject to two conditions. First, the obligation of the seller to repurchase the securities from the fund must be "collateralized 4 Similarly, the SEC proposed conforming amendments to Rule 2a-7 to require a money market fund to also evaluate a repo counterparty's creditworthiness in order to treat the acquisition of a repo as an acquisition of the underlying securities. 2 fully," as proposed to be defined in the rule. Second, the board of directors or its delegate must evaluate the creditworthiness of the counterparty.4 Rule 5b-3 would incorporate Rule 2a-7's definition of "collateralized fully" to require that (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 (i.e., price paid to the seller plus the accrued resale premium), (ii) the collateral for the repo consists entirely of cash items, U.S. Government securities, or other securities of a high quality, and (iii) the repo 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. The proposed rule would also require a fund to perfect its security interest in the repo collateral and maintain the collateral in an account with the fund's custodian or a third party that qualifies as a custodian under the Investment Company Act. Pre-Refunded Bonds Proposed Rule 5b-3(b) would permit a fund to treat an investment in a refunded security as an investment in the escrowed U.S. Government securities for purposes of the Section 5(b)(1) diversification requirements. The rule would define "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 escrowed securities must not be redeemable prior to their final maturity and the escrow agreement must prohibit the substitution of the escrowed securities, unless the substituted securities are also U.S. Government securities. Finally, an independent certified public accountant must have certified to the escrow agent that the escrowed securities will satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities. (This last condition would be waived, however, if the refunded security has received the highest rating from an NRSRO.) Barry E. Simmons Assistant Counsel Attachment

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