



# SEC VALUATION AND LIQUIDITY GUIDANCE FOR REGISTERED INVESTMENT COMPANIES

## COMPENDIUM

VOLUME 2

**SEC VALUATION AND LIQUIDITY GUIDANCE FOR REGISTERED  
INVESTMENT COMPANIES**



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Compendium

Volume 2

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding of, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

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# RULE 2a-7

## RULE 2a-7 MONEY MARKET FUNDS

### (a) Definitions.

(1) Acquisition (or Acquire) means any purchase or subsequent rollover (but does not include the failure to exercise a Demand feature).

(2) Amortized cost method of valuation means the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(3) Asset backed security means a fixed income security (other than a Government security) issued by a Special purpose entity (as defined in this paragraph), substantially all of the assets of which consist of Qualifying assets (as defined in this paragraph). Special purpose entity means a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from Qualifying assets, but does not include a registered investment company. Qualifying assets means financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(4) Business day means any day, other than Saturday, Sunday, or any customary business holiday.

(5) Collateralized fully means "Collateralized fully" as defined in Rule 5b-3(c)(1).

(6) Conditional demand feature means a Demand feature that is not an Unconditional demand feature. A Conditional demand feature is not a Guarantee.

(7) Conduit security means a security issued by a Municipal issuer (as defined in this paragraph) involving an arrangement or agreement entered into, directly or indirectly, with a person other than a Municipal issuer, which arrangement or agreement provides for or secures repayment of the security. Municipal issuer means a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality of a state or territory of the United States. A Conduit security does not include a security that is:

(i) Fully and unconditionally guaranteed by a Municipal issuer; or

(ii) Payable from the general revenues of the Municipal issuer or other Municipal issuers (other than those revenues derived from an agreement or arrangement with a person who is not a Municipal issuer that provides for or secures repayment of the security issued by the Municipal issuer); or

(iii) Related to a project owned and operated by a Municipal issuer; or

(iv) Related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a Municipal issuer.

(8) Demand feature means:

(i) A feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise. A Demand feature must be exercisable either:



- (A) At any time on no more than 30 calendar days' notice; or
- (B) At specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice; or
- (ii) A feature permitting the holder of an Asset backed security unconditionally to receive principal and interest within 397 calendar days of making demand.
- (9) Demand feature issued by a Non-Controlled person means a Demand feature issued by:
  - (i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand feature (control means "control" as defined in Section 2(a)(9) of the Investment Company Act of 1940; or
  - (ii) A sponsor of a Special purpose entity with respect to an Asset backed security.
- (10) Eligible security means:
  - (i) A Rated security with a remaining maturity of 397 calendar days or less that has received a rating from the Requisite NRSROs in one of the two highest short-term rating categories (within which there may be sub-categories or gradations indicating relative standing); or
  - (ii) An Unrated security that is of comparable quality to a security meeting the requirements for a Rated security in paragraph (a)(10)(i) of this rule, as determined by the money market fund's board of directors; Provided, however, that:
    - (A) A security that at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less and that is an Unrated security is not an Eligible security if the security has received a long-term rating from any NRSRO that is not within the NRSRO's three highest long-term ratings categories (within which there may be sub-categories or gradations indicating relative standing), unless the security has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories;
    - (B) An Asset backed security (other than an Asset backed security substantially all of whose Qualifying assets consist of obligations of one or more Municipal issuers, as that term is defined in paragraph (a)(7) of this rule) shall not be an Eligible security unless it has received a rating from an NRSRO.
  - (iii) In addition, in the case of a security that is subject to a Demand feature or Guarantee:
    - (A) The Guarantee has received a rating from an NRSRO or the Guarantee is issued by a guarantor that has received a rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee, unless:
      - (1) The Guarantee is issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the Guarantee (other than a sponsor of a Special purpose entity with respect to an Asset backed security);
      - (2) The security subject to the Guarantee is a repurchase agreement that is Collateralized fully; or
      - (3) The Guarantee is itself a Government security; and
    - (B) The issuer of the Demand feature or Guarantee, or another institution, has undertaken promptly to notify the holder of the security in the event the Demand feature or Guarantee is substituted with another Demand feature or Guarantee (if such substitution is permissible under the terms of the Demand feature or Guarantee).
- (11) Event of insolvency means "Event of insolvency" as defined in Rule 5b-3(c)(2).
- (12) First Tier Security means any Eligible security that:

- (i) Is a Rated security that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); or
- (ii) Is an Unrated security that is of comparable quality to a security meeting the requirements for a Rated security in paragraph (a)(12)(i) of this rule, as determined by the fund's board of directors; or
- (iii) Is a security issued by a registered investment company that is a money market fund; or
- (iv) Is a Government security.

(13) Floating rate security means a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and that, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(14) Government security means any "Government security" as defined in Section 2(a)(16) of the Act.

(15) Guarantee means an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the Guarantee (if required), the principal amount of the Underlying security plus accrued interest when due or upon default, or, in the case of an Unconditional demand feature, an obligation that entitles the holder to receive upon exercise the approximate amortized cost of the Underlying security or securities, plus accrued interest, if any. A Guarantee includes a letter of credit, financial guaranty (bond) insurance, and an Unconditional demand feature (other than an Unconditional demand feature provided by the issuer of the security).

(16) Guarantee issued by a non-controlled person means a Guarantee issued by:

- (i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Guarantee (control means "control" as defined in Section 2(a)(9) of the Act; or
- (ii) A sponsor of a Special purpose entity with respect to an Asset backed security.

(17) NRSRO means any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi) (E), (F) and (H) of Rule 15c3-1 under the Securities Exchange Act of 1934, that is not an "affiliated person," as defined in Section 2(a)(3)(C) of the Act, of the issuer of, or any insurer or provider of credit support for, the security.

(18) Penny-rounding method of pricing means the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(19) Rated security means a security that meets the requirements of paragraphs (a)(19)(i) or (ii) of this rule, in each case subject to paragraph (a)(19)(iii) of this rule:

- (i) The security has received a short-term rating from an NRSRO, or has been issued by an issuer that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security; or
- (ii) The security is subject to a Guarantee that has received a short-term rating from an NRSRO, or a Guarantee issued by a guarantor that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the Guarantee; but
- (iii) A security is not a Rated security if it is subject to an external credit support agreement (including an arrangement by which the security has become a Refunded security ) that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement as provided in paragraph (a)(19)(i) of this rule, or the credit support agreement with respect to the security has received a short-term rating as provided in paragraph (a)(19)(ii) of this rule.

(20) Refunded security means "Refunded security" as defined in Rule 5b-3(c)(4).

(21) Requisite NRSROs means:

- (i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or
- (ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund acquires the security, that NRSRO.

(22) Second Tier Security means any Eligible security that is not a First Tier Security. Second Tier Conduit security means any Conduit security that is an Eligible security that is not a First Tier Security.

(23) Single state fund means a Tax Exempt Fund that holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and, where applicable, subdivisions thereof.

(24) Tax Exempt Fund means any money market fund that holds itself out as distributing income exempt from regular federal income tax.

(25) Total assets means, with respect to a money market fund using the Amortized cost method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.

(26) Unconditional demand feature means a Demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the Underlying security or securities.

(27) United States Dollar-Denominated means, with reference to a security, that all principal and interest payments on such security are payable to security holders in United States dollars under all circumstances and that the interest rate of, the principal amount to be repaid, and the timing of payments related to such security do not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars.

(28) Unrated security means a security that is not a Rated security.

(29) Variable rate security means a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(b) Holding Out and Use of Names and Titles.

(1) It shall be an untrue statement of material fact within the meaning of Section 34(b) of the Act for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act, to hold itself out to investors as a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of this rule.

(2) It shall constitute the use of a materially deceptive or misleading name or title within the meaning of Section 35(d) of the Act for a registered investment company to adopt the term “money market” as part of its name or title or the name or title of any redeemable securities of which it is the issuer, or to adopt a name that suggests that it is a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this rule.

(3) For purposes of this paragraph, a name that suggests that a registered investment company is a money market fund or the equivalent thereof shall include one that uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) Share Price Calculations. The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund” or “fund”), notwithstanding the

requirements of Section 2(a)(41) of the Act and of Rule 2a-4 and Rule 22c-1 thereunder, may be computed by use of the Amortized cost method or the Penny-rounding method; Provided, however, that:

(1) Board Findings. The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized cost method or the Penny-rounding method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.

(2) Portfolio Maturity. The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; Provided, however, that the money market fund will not:

(i) Except as provided in paragraph (c)(2)(ii) of this rule, acquire any instrument with a remaining maturity of greater than 397 calendar days; or

(ii) In the case of a money market fund not using the Amortized cost method, Acquire a Government security with a remaining maturity of greater than 762 calendar days; or

(iii) Maintain a dollar-weighted average portfolio maturity that exceeds ninety days.

(3) Portfolio Quality.

(i) General. The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO) and that are at the time of Acquisition Eligible securities.

(ii) Second Tier Securities. Immediately after the Acquisition of any Second Tier Security:

(A) Taxable Funds. A money market fund that is not a Tax Exempt Fund shall not have invested more than five percent of its Total assets in securities that are Second Tier Securities; and

(B) Tax Exempt Funds. A money market fund that is a Tax Exempt Fund shall not have invested more than five percent of its Total assets in Conduit securities that are Second Tier Conduit securities.

(iii) Securities Subject to Guarantees. A security that is subject to a Guarantee may be determined to be an Eligible security or a First Tier Security based solely on whether the Guarantee is an Eligible security or First Tier Security, as the case may be.

(iv) Securities Subject to Conditional demand features. A security that is subject to a Conditional demand feature ("Underlying security") may be determined to be an Eligible security or a First Tier Security only if:

(A) The Conditional demand feature is an Eligible security or First Tier Security, as the case may be;

(B) At the time of the Acquisition of the Underlying security, the money market fund's board of directors has determined that there is minimal risk that the circumstances that would result in the Conditional demand feature not being exercisable will occur; and

(1) The conditions limiting exercise either 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

(2) The terms of the Conditional demand feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand feature in accordance with its terms; and

(C) The Underlying security or any Guarantee of such security (or the debt securities of the issuer of the Underlying security or Guarantee that are comparable in priority and security with the Underlying security or Guarantee) has

received either a short term rating or a long-term rating, as the case may be, from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund's board of directors to a security that has received a rating from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories, as the case may be.

(4) Portfolio Diversification.

(i) Issuer Diversification. The money market fund shall be diversified with respect to issuers of securities Acquired by the fund as provided in paragraphs (c)(4)(i) and (c)(4)(ii) of this rule, other than with respect to Government securities and securities subject to a Guarantee issued by a non-controlled person.

(A) Taxable and National Funds. Immediately after the Acquisition of any security, a money market fund other than a Single state fund shall not have invested more than five percent of its Total assets in securities issued by the issuer of the security; Provided, however, that such a fund may invest up to twenty-five percent of its Total assets in the First Tier Securities of a single issuer for a period of up to three Business days after the Acquisition thereof; Provided, further, that the fund may not invest in the securities of more than one issuer in accordance with the foregoing proviso in this paragraph at any time.

(B) Single state funds. With respect to seventy-five percent of its Total assets, immediately after the Acquisition of any security, a Single state fund shall not have invested more than five percent of its Total assets in securities issued by the issuer of the security; Provided, however, that a Single state fund shall not invest more than five percent of its Total assets in securities issued by the issuer of the security unless the securities are First Tier Securities.

(C) Second Tier Securities.

(1) Taxable Funds. Immediately after the Acquisition of any Second Tier Security, a money market fund that is not a Tax Exempt Fund shall not have invested more than the greater of one percent of its Total assets or one million dollars in securities issued by that issuer that are Second Tier Securities.

(2) Tax Exempt Funds. Immediately after the Acquisition of any Second Tier Conduit security, a money market fund that is a Tax Exempt Fund shall not have invested more than the greater of one percent of its Total assets or one million dollars in securities issued by that issuer that are Second Tier Conduit securities.

(ii) Issuer Diversification Calculations. For purposes of making calculations under paragraph (c)(4)(i) of this rule:

(A) Repurchase agreements. The Acquisition of a repurchase agreement may be deemed to be an Acquisition of the Underlying securities, provided the obligation of the seller to repurchase the securities from the money market fund is Collateralized fully.

(B) Refunded securities. The Acquisition of a Refunded security shall be deemed to be an Acquisition of the escrowed Government securities.

(C) Conduit securities. A Conduit security shall be deemed to be issued by the person (other than the Municipal issuer) ultimately responsible for payments of interest and principal on the security.

(D) Asset backed securities.

(1) General. An Asset backed security Acquired by a fund ("Primary ABS") shall be deemed to be issued by the Special purpose entity that issued the Asset backed security, Provided, however:

(i) Holdings of Primary ABS. Any person whose obligations constitute ten percent or more of the principal amount of the Qualifying assets of the Primary ABS ("Ten Percent Obligor") shall be deemed to be an issuer of the portion of the Primary ABS such obligations represent; and

(ii) Holdings of Secondary ABS. If a Ten Percent Obligor of a Primary ABS is itself a Special purpose entity issuing Asset backed securities (“Secondary ABS”), any Ten Percent Obligor of such Secondary ABS also shall be deemed to be an issuer of the portion of the Primary ABS that such Ten Percent Obligor represents.

(2) Restricted special purpose entities. A Ten Percent Obligor with respect to a Primary or Secondary ABS shall not be deemed to have issued any portion of the assets of a Primary ABS as provided in paragraph (c)(4)(ii)(D)(1) of this rule if that Ten Percent Obligor is itself a Special purpose entity issuing Asset backed securities (“Restricted Special purpose entity”), and the securities that it issues (other than securities issued to a company that controls, or is controlled by or under common control with, the Restricted Special purpose entity and which is not itself a Special purpose entity issuing Asset backed securities) are held by only one other Special purpose entity.

(3) Demand features and Guarantees. In the case of a Ten Percent Obligor deemed to be an issuer, the fund shall satisfy the diversification requirements of paragraph (c)(4)(iii) of this rule with respect to any Demand feature or Guarantee to which the Ten Percent Obligor’s obligations are subject.

(E) Shares of Other Money Market Funds. A money market fund that acquires shares issued by another money market fund in an amount that would otherwise be prohibited by paragraph (c)(4)(i) of this rule shall nonetheless be deemed in compliance with this section if the board of directors of the Acquiring money market fund reasonably believes that the fund in which it has invested is in compliance with this section.

(iii) Diversification Rules for Demand features and Guarantees. The money market fund shall be diversified with respect to Demand features and Guarantees Acquired by the fund as provided in paragraphs (c)(4)(iii) and (c)(4)(iv) of this rule, other than with respect to a Demand feature issued by the same institution that issued the Underlying security, or with respect to a Guarantee or Demand feature that is itself a Government security.

(A) General. Immediately after the Acquisition of any Demand feature or Guarantee or security subject to a Demand feature or Guarantee, a money market fund, with respect to seventy-five percent of its Total assets, shall not have invested more than ten percent of its Total assets in securities issued by or subject to Demand features or Guarantees from the institution that issued the Demand feature or Guarantee, subject to paragraphs (c)(4)(iii)(B) and (C) of this rule.

(B) Second Tier Demand features or Guarantees. Immediately after the Acquisition of any Demand feature or Guarantee (or a security after giving effect to the Demand feature or Guarantee) that is a Second Tier Security, a money market fund shall not have invested more than five percent of its Total assets in securities issued by or subject to Demand features or Guarantees from the institution that issued the Demand feature or Guarantee.

(C) Demand features or Guarantees Issued by Non-Controlled Persons. Immediately after the Acquisition of any security subject to a Demand feature or Guarantee, a money market fund shall not have invested more than ten percent of its Total assets in securities issued by, or subject to Demand features or Guarantees from the institution that issued the Demand feature or Guarantee, unless, with respect to any security subject to Demand features or Guarantees from that institution (other than securities issued by such institution), the Demand feature or Guarantee is a Demand feature or Guarantee issued by a non-controlled person.

(iv) Demand feature and Guarantee Diversification Calculations.

(A) Fractional Demand features or Guarantees. In the case of a security subject to a Demand feature or Guarantee from an institution by which the institution guarantees a specified portion of the value of the security, the institution shall be deemed to guarantee the specified portion thereof.

(B) Layered Demand features or Guarantees. In the case of a security subject to Demand features or Guarantees from multiple institutions that have not limited the extent of their obligations as described in paragraph (c)(4)(iv)(A) of this rule, each institution shall be deemed to have provided the Demand feature or Guarantee with respect to the entire principal amount of the security.

(v) Diversification Safe Harbor. A money market fund that satisfies the applicable diversification requirements of paragraphs (c)(4) and (c)(5) of this rule shall be deemed to have satisfied the diversification requirements of Section 5(b)(1) of the Act and the rules adopted thereunder.

(5) Demand features and Guarantees Not Relied Upon. If the fund's board of directors has determined that the fund is not relying on a Demand feature or Guarantee to determine the quality (pursuant to paragraph (c)(3) of this rule), or maturity (pursuant to paragraph (d) of this rule), or liquidity of a portfolio security, and maintains a record of this determination (pursuant to paragraphs (c)(9)(ii) and (c)(10)(vi) of this rule), then the fund may disregard such Demand feature or Guarantee for all purposes of this rule.

(6) Downgrades, Defaults and Other Events.

(i) Downgrades.

(A) General. Upon the occurrence of either of the events specified in paragraphs (c)(6)(i)(A)(1) and (2) of this rule with respect to a portfolio security, the board of directors of the money market fund shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders:

(1) A portfolio security of a money market fund ceases to be a First Tier Security (either because it no longer has the highest rating from the Requisite NRSROs or, in the case of an Unrated security, the board of directors of the money market fund determines that it is no longer of comparable quality to a First Tier Security); and

(2) The money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated security or Second Tier Security held by the money market fund has, since the security was Acquired by the fund, been given a rating by any NRSRO below the NRSRO's second highest short-term rating category.

(B) Securities to Be Disposed of. The reassessments required by paragraph (c)(6)(i)(A) of this rule shall not be required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five Business days of the specified event and, in the case of events specified in paragraph (c)(6)(i)(A)(2) of this rule, the board is subsequently notified of the adviser's actions.

(C) Special Rule for Certain Securities Subject to Demand features. In the event that after giving effect to a rating downgrade, more than five percent of the fund's Total assets are invested in securities issued by or subject to Demand features from a single institution that are Second Tier Securities, the fund shall reduce its investment in securities issued by or subject to Demand features from that institution to no more than five percent of its Total assets by exercising the Demand features at the next succeeding exercise date(s), absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund.

(ii) Defaults and Other Events. Upon the occurrence of any of the events specified in paragraphs (c)(6)(ii)(A) through (D) of this rule with respect to a portfolio security, the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand feature or otherwise, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security):

(A) The default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(B) A portfolio security ceases to be an Eligible security;

(C) A portfolio security has been determined to no longer present minimal credit risks; or

(D) An Event of insolvency occurs with respect to the issuer of a portfolio security or the provider of any Demand feature or Guarantee.

(iii) Notice to the Commission. In the event of a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an Event of insolvency with respect to the issuer of the security or any Demand feature or Guarantee to which it is subject, where immediately before default the securities

(or the securities subject to the Demand feature or Guarantee) accounted for ½ of 1 percent or more of a money market fund's Total assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically, or by means of a facsimile transmission or electronic mail, followed by letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management.

(iv) Defaults for Purposes of Paragraphs (c)(6)(ii) and (iii). For purposes of paragraphs (c)(6)(ii) and (iii) of this rule, an instrument subject to a Demand feature or Guarantee shall not be deemed to be in default (and an Event of insolvency with respect to the security shall not be deemed to have occurred) if:

(A) In the case of an instrument subject to a Demand feature, the Demand feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest; or

(B) The provider of the Guarantee is continuing, without protest, to make payments as due on the instrument.

(7) Required Procedures: Amortized cost method. In the case of a money market fund using the Amortized cost method:

(i) General. In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) Specific Procedures. Included within the procedures adopted by the board of directors shall be the following:

(A) Shadow Pricing. Written procedures shall provide:

(1) That the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions;

(2) For the periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and

(3) For the maintenance of records of the determination of deviation and the board's review thereof.

(B) Prompt Consideration of Deviation. In the event such deviation from the money market fund's amortized cost price per share exceeds ½ of 1 percent, the board of directors shall promptly consider what action, if any, should be initiated by the board of directors.

(C) Material Dilution or Unfair Results. Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(8) Required Procedures: Penny-rounding method. In the case of a money market fund using the Penny-rounding method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.



(9) Specific Procedures: Amortized Cost and Penny-rounding methods. Included within the procedures adopted by the board of directors for money market funds using either the Amortized Cost or Penny-Rounding. Methods shall be the following:

(i) Securities for Which Maturity Is Determined by Reference to Demand Features. In the case of a security for which maturity is determined by reference to a Demand feature, written procedures shall require ongoing review of the security's continued minimal credit risks, and that review must be based on, among other things, financial data for the most recent fiscal year of the issuer of the Demand feature and, in the case of a security subject to a Conditional demand feature, the issuer of the security whose financial condition must be monitored under paragraph (c)(3)(iv) of this rule, whether such data is publicly available or provided under the terms of the security's governing documentation.

(ii) Securities Subject to Demand features or Guarantees. In the case of a security subject to one or more Demand features or Guarantees that the fund's board of directors has determined that the fund is not relying on to determine the quality (pursuant to paragraph (c)(3) of this rule), maturity (pursuant to paragraph (d) of this rule) or liquidity of the security subject to the Demand feature or Guarantee, written procedures shall require periodic evaluation of such determination.

(iii) Adjustable Rate Securities Without Demand Features. In the case of a Variable Rate or Floating rate security that is not subject to a Demand feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this rule, written procedures shall require periodic review of whether the interest rate formula, upon readjustment of its interest rate, can reasonably be expected to cause the security to have a market value that approximates its amortized cost value.

(iv) Asset backed securities. In the case of an Asset backed security, written procedures shall require the fund to periodically determine the number of Ten Percent Obligors (as that term is used in paragraph (c)(4)(ii)(D) of this rule) deemed to be the issuers of all or a portion of the Asset backed security for purposes of paragraph (c)(4)(ii)(D) of this rule; provided, however, written procedures need not require periodic determinations with respect to any Asset backed security that a fund's board of directors has determined, at the time of Acquisition, will not have, or is unlikely to have, Ten Percent Obligors that are deemed to be issuers of all or a portion of that Asset backed security for purposes of paragraph (c)(4)(ii)(D) of this rule, and maintains a record of this determination.

(10) Record Keeping and Reporting.

(i) Written Procedures. For a period of not less than six years following the replacement of such procedures with new procedures (the first two years in an easily accessible place), a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(6) through (c)(9) and (e) of this rule shall be maintained and preserved.

(ii) Board Considerations and Actions. For a period of not less than six years (the first two years in an easily accessible place) a written record shall be maintained and preserved of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth in this section, to be included in the minutes of the board of directors' meetings.

(iii) Credit Risk Analysis. For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks and the NRSRO ratings (if any) used to determine the status of the security as an Eligible security, First Tier Security or Second Tier Security shall be maintained and preserved in an easily accessible place.

(iv) Determinations With Respect to Adjustable Rate Securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(9)(iii) of this rule (that a Variable Rate or Floating rate security that is not subject to a Demand feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this rule can reasonably be expected, upon readjustment of its interest rate at all times during the life of the instrument, to have a market value that approximates its amortized cost).

(v) Determinations with Respect to Asset backed securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determinations required by paragraph (c)(9)(iv) of this rule (the number of Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this rule) deemed to be the issuers of all or a portion of the Asset backed security for purposes of paragraph (c)(4)(ii)(D) of this rule). The written record shall include:

(A) The identities of the Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this rule), the percentage of the Qualifying assets constituted by the securities of each Ten Percent Obligor and the percentage of the fund's Total assets that are invested in securities of each Ten Percent Obligor; and

(B) Any determination that an Asset backed security will not have, or is unlikely to have, Ten Percent Obligor deemed to be issuers of all or a portion of that Asset backed security for purposes of paragraph (c)(4)(ii)(D) of this rule.

(vi) Evaluations with Respect to Securities Subject to Demand features or Guarantees. For a period of not less than three years from the date when the evaluation was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the evaluation required by paragraph (c)(9)(ii) (regarding securities subject to one or more Demand features or Guarantees) of this rule.

(vii) Inspection of Records. The documents preserved pursuant to this paragraph (c)(10) shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act. If any action was taken under paragraphs (c)(6)(ii) (with respect to defaulted securities and event of insolvency) or (c)(7)(ii) (with respect to a deviation from the fund's share price of more than ½ of 1 percent) of this rule, the money market fund will file an exhibit to the Form NSAR filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible securities.

(d) Maturity of Portfolio Securities. For purposes of this rule, the maturity of a portfolio security shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, except as provided in paragraphs (d)(1) through (d)(8) of this rule:

(1) Adjustable Rate Government Securities. A Government security that is a Variable rate security where the variable rate of interest is readjusted no less frequently than every 762 calendar days shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate. A Government security that is a Floating rate security shall be deemed to have a remaining maturity of one day.

(2) Short-term variable rate securities. A Variable rate security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity equal to the earlier of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(3) Long-term Variable rate securities. A Variable rate security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand feature, shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) Short-Term Floating rate securities. A Floating rate security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity of one day.

(5) Long-term floating rate securities. A Floating rate security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand feature, shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(6) Repurchase agreements. A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the Underlying securities is scheduled to occur, or, where the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.

(7) Portfolio lending agreements. A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(8) Money market fund securities. An investment in a money market fund shall be treated as having a maturity equal to the period of time within which the Acquired money market fund is required to make payment upon redemption, unless the Acquired money market fund has agreed in writing to provide redemption proceeds to the investing money market fund within a shorter time period, in which case the maturity of such investment shall be deemed to be the shorter period.

(e) Delegation. The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this rule (other than the determinations required by paragraphs (c)(1) (board findings); (c)(6)(i)(C) (rule for certain securities subject to second tier Demand features); (c)(6)(ii) (defaults and other events); (c)(7)(i) (general required procedures: Amortized cost method); (c)(7)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), and (C) (material dilution or unfair results); and (c)(8) (required procedures: Penny-rounding method) of this rule) provided:

(1) Written Guidelines. The Board shall establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this rule) and procedures under which the delegate makes such determinations:

(2) Oversight. The Board shall take any measures reasonably necessary (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security or Event of insolvency with respect to the issuer of the security or any Guarantee to which it is subject that requires notification of the Commission under paragraph (c)(6)(iii) of this rule) to assure that the guidelines and procedures are being followed.

# RELEASES

## ACCOUNTING SERIES RELEASE NO. 219 VALUATION OF DEBT INSTRUMENTS BY MONEY MARKET FUNDS AND CERTAIN OTHER OPEN-END INVESTMENT COMPANIES

Release Nos. IC-9786; ASR-219

May 31, 1977

AGENCY: Securities and Exchange Commission.

ACTION: Rule Interpretation.

SUMMARY: The Commission has issued an interpretation of a rule adopted under the Investment Company Act of 1940 (the "Act") indicating, generally, that it shall be considered inappropriate under the provisions of the rule for "money market" funds and certain other open-end investment companies to determine the fair value of debt portfolio securities on an amortized cost basis, except in the case of securities with remaining maturities of 60 days or less. There has been considerable confusion and uncertainty as to the appropriate methods to be utilized by "money market" funds in valuing their portfolio securities. This interpretation should help insure that shares of such companies are sold and redeemed at prices reflecting the fair value of the underlying portfolio securities.

EFFECTIVE DATE: Immediately.

FOR FURTHER INFORMATION CONTACT: Kenneth S. Gerstein, Esq., Division of Investment Management, Securities and Exchange Commission, Washington, D.C. 20549 (202-755-0233).

SUPPLEMENTARY INFORMATION: On April 28, 1975, there was published for public comment notice of a position the Commission proposed to take regarding the standardization of procedures utilized by registered investment companies, including "money market" funds, for the valuation of short-term debt instruments in their portfolios.<sup>1</sup> The proposed valuation position would have suggested "marking to market" as the most appropriate method for valuing any short-term debt securities held by registered investment companies and would have expressed the belief that it would be desirable for such companies to discontinue the "amortized cost" method of valuation.<sup>2</sup>

Among the public comments with respect to the proposed position on valuation of short-term debt instruments were those suggesting that: (1) the benefits of "marking to market" valuation were small compared to the attendant costs of such valuation method; (2) many "money market" fund shareholders desire a valuation method that would achieve a constant asset value; and (3) the Commission lacks the authority to preclude the use of amortized cost valuation. Other commentators suggested that only "money market" funds be required to "mark to market."

Nevertheless, after consideration and analysis of the comments received with respect to the proposal, the Commission, for the reasons discussed below, has issued this interpretation setting forth its views as to the appropriateness of certain methods utilized by "money market" funds and certain other registered open-end management investment companies to

<sup>1</sup> Investment Company Act of 1940 Release No. 8757, April 15, 1975.

<sup>2</sup> *Id.* The release also indicated the Commission's tentative view that money market funds might be permitted to portray return by means of a quotation such as "yield to average life." In Investment Company Act Release No. 8816 (June 12, 1975) notice was given of proposed guidelines with respect to standardizing money market fund yield quotations. Such guidelines would have permitted the use of "yield to average life" quotations. The Commission is still considering these matters.

determine the fair value of debt securities in their portfolios. The interpretation that the Commission has issued differs in some respects from the proposed position and is discussed in detail below. The Commission expects companies to comply with this interpretation at the earliest possible date consistent with their obligations to avoid disruption of their operations, but in any event not later than November 30, 1977.

The Commission recognizes that, in the absence of the interpretation it has determined today to issue, there has been considerable confusion and uncertainty as to the appropriate methods to be utilized by “money market” funds in valuing their portfolio securities. This interpretation should help remove the uncertainty and further the objectives of enabling investors in such funds to: (1) purchase and redeem their shares at prices appropriately reflecting the current value of fund portfolio securities; (2) be properly credited for any unrealized appreciation or depreciation in such portfolio securities; and (3) be provided with meaningful and comparable information with which to appraise investment returns and the current earning ability of “money market” funds.

*Interpretation with Respect to Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies.*

The Commission is aware that many investment companies, including some “money market” funds, value short-term debt instruments in their portfolios on an amortized cost basis. Under this method of valuation, investment companies initially value such instruments at their cost on the date of purchase and, if the instrument was purchased at a discount, thereafter assume a constant proportional increase in value until maturity.<sup>3</sup> However, during the period a debt security is held, changes in the market rate of interest and other factors may affect the price at which that security could be sold. As a general principle, the longer the remaining maturity of an outstanding debt security, the more that price will be affected by such interest rate changes.

The Commission is concerned that the use of the amortized cost method in valuing portfolio securities of registered investment companies may result in over-valuation or undervaluation of the portfolios of such companies, relative to the value of the portfolios determined with reference to current market factors.

In the case of registered open-end management investment companies (“mutual funds” or “funds”), this would mean investors purchasing or redeeming shares could pay or receive more or less than the actual value of their proportionate shares of the funds’ current net assets. The effect of such sales or redemptions may therefore result in inappropriate dilution of the assets and returns of existing shareholders.<sup>4</sup>

Although inappropriate valuation of securities could cause these effects in various types of funds, the position taken herein is addressed specifically to the case of: (1) “money market” funds, and (2) other open-end investment companies that hold a significant amount of debt securities, such that the use of the amortized cost method in valuing any portion or type of these debt securities could have a material impact on such funds, net asset values per share. Generally, the Commission would consider the use of a particular valuation method to have a material impact if the use of that method, as opposed to another method, might cause a change of at least one cent in a net asset value per share of \$10.00.<sup>5</sup> The

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<sup>3</sup> In simplified terms, for instruments purchased at a discount, the difference between the cost of such an instrument at purchase and its maturity value is divided by the number of days to maturity and that amount is accrued daily as an increase in the value of the instrument each day. More precisely, amortized cost valuation may be described as cost, adjusted for amortization of premium, or for accretion of discount.

<sup>4</sup> For example, redemptions of shares in a fund which has overvalued its portfolio or sales of shares in a fund which has undervalued its portfolio could result in the dilution of the assets and returns of other investors in the fund. The extent of such dilutive effects would be dependent upon several factors, including the extent of the overvaluation or undervaluation, and the proportion of fund shares sold or redeemed at such times.

<sup>5</sup> Although one cent differences in net asset values per share of \$10.00 might appear to be insignificant, the effects of such differences can be material to the decisions of investors when translated into differences in rates of return. Moreover, the inequitable effects of amortized cost valuation can occur in the case of any open-end investment company where a significant proportion of a company’s portfolio consists of debt securities valued at amortized cost. The extent of such inequitable effects will, of course, depend upon changes in interest rates and the level of a company’s sales and redemptions of shares.

interpretation explained below will be applicable to both “money market” funds and these other open-end investment companies.<sup>6</sup>

Generally, “money market” funds are open-end investment companies which invest primarily in short-term debt instruments. They provide a vehicle to permit investors to take advantage of what at times may be the higher short-term interest rates earned on large investments. Through a pooling of money these funds enable the purchase of larger denomination instruments than could normally be bought by the individual small investor. These funds have also attracted investments from corporation, bank trust departments, and other institutional investors. Another characteristic of money market funds is the short-term investment perspective of many shareholders. Although the portfolio composition of “money market” funds is variable both in terms of the types of securities purchased and their maturities, the portfolios of such funds typically include U.S. government and government agency issues, certificates of deposit, banker’s acceptances, and commercial paper.

Section 22(c) [15 U.S.C. 80a-22(c)] of the Act [15 U.S.C. 80a-1 *et seq.*], by reference to Section 22(a) [15 U.S.C. 80a-22(a)] of the Act, authorizes the Commission to adopt rules prescribing, inter alia, methods for computing the minimum purchase price and maximum redemption price of redeemable securities issued by a registered investment company:

\*\*\* for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of . . . purchase, redemption, or sale which is unfair to holders of such other outstanding securities . . . .

Section 2(a) (41) [15 U.S.C. 80a-2(a) (41)] of the Act defines “value”, as here relevant, to mean:

(B) . . . (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the [registered investment company’s] board of directors . . . .

Rule 2a-4 [17 CFR 270.2a-4] promulgated under the Act provides, in part, that the “current net asset value” of a redeemable security issued by a registered investment company used in computing its price, for the purposes of distribution and redemption, means:

\*\*\* an amount which reflects calculations . . . made substantially in accordance with the following, with estimates used where necessary or appropriate:

(1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities . . . shall be valued at fair value and determined in good faith by the board of directors. . . .

Now that both the Commission and the money market fund industry have had the benefit of experience with this relatively new investment product, and to help insure that shares of such funds are sold and redeemed at prices reflecting the current market or fair value of such funds’ portfolio securities, the Commission has concluded that it shall prospectively consider it inconsistent with the provisions of Rule 2a-4 for a money market fund to determine the fair value of debt securities which mature at a date more than 60 days subsequent to the valuation date on an amortized cost basis.

Although debt securities with remaining maturities in excess of 60 days should not be valued at amortized cost, the Commission will not object if the board of directors of a money market fund, in good faith, determines that the fair value of debt securities originally purchased with remaining maturities of 60 days or less shall be their amortized cost value, unless the particular circumstances dictate otherwise.<sup>7</sup> Nor will the Commission object if, under similar circumstances, the fair value of debt securities originally purchased with maturities of in excess of 60 days, but which

<sup>6</sup> See, generally, Accounting Series Release No. 118 (December 23, 1970) [35 FR 19986], “Accounting for Investment Securities by Registered Investment Companies,” and Investment Company Act of 1940 Release No. 7221 (June 29, 1972) [37 FR 12790], “Guidelines for the Preparation of Form N-8B-1, “as they relate to the valuation of portfolio securities by open-end investment companies.

<sup>7</sup> The fair value of securities with remaining maturities of 60 days or less may not always be accurately reflected through the use of amortized cost valuation, due to an impairment of the creditworthiness of an issuer, or other factors. In such situations, it would appear to be incumbent upon the directors of a fund to recognize such factors and take them into account in determining “fair value.”

currently have maturities of 60 days or less, is determined by using amortized cost valuation for the 60 days prior to maturity, such amortization being based upon the market or fair value of the securities on the 61st day prior to maturity.<sup>8</sup>

The Commission believes that money market funds and those other companies to which this interpretation is applicable should value debt securities with greater than 60 days remaining to maturity based upon current market quotations if readily available or, if such quotations are not readily available, in such a manner as to take into account any unrealized appreciation or depreciation due to changes in interest rates and other factors which would influence the current fair values of such securities.<sup>9</sup> These methods are sometimes referred to as “marking to market.” In determining “fair value” by reference to current interest rates and other factors, the board of directors of a money market fund may, of course, utilize whatever method it determines in good faith to be most appropriate.<sup>10</sup> The method utilized could be based in part, for example, upon quotations by dealers or issuers for securities of similar type, quality and maturity.

Except in the circumstances delineated above, the Commission believes that, in view of the experience which has now been gained with respect to the characteristics of money market funds, the use of the amortized cost method of valuation by a money market fund cannot in the future represent a “good faith” effort to determine the “fair value” of portfolio securities for purposes of Rule 2a-4; such valuation fails to consider the impact of market factors subsequent to the date a debt security is purchased on the value of such security. Moreover, the probability that amortized cost valuation will not approximate “fair value” is progressively greater for securities of increasingly longer maturities. The Commission believes that the use of amortized cost valuation by money market funds in valuing securities with remaining maturities in excess of 60 days is not an appropriate estimate of market value or “fair value” and further that, because alternative valuation procedures which consider market factors are available, use of amortized cost valuation under such circumstances as an estimate is not necessary. This standard should help insure that fund shares are sold and redeemed at prices reflecting the appropriate proportionate share of funds’ current net assets, and minimize the potential for dilution of the assets and returns of existing shareholders.

The Commission is also of the view that money market fund shareholders should be accurately credited with the effects of any unrealized appreciation or depreciation that may occur when the value of a fund’s portfolio fluctuates. If such effects are not reflected in either a fund’s net asset value or its distributions to shareholders, as a practical matter the result would be a situation analogous to that which would exist if amortized cost valuation were used, and similar dilutive effects could occur. Such may be the case, for example, where a money market fund “marks to market,” but declares a daily dividend of accrued interest income and reflects any remaining unrealized appreciation or depreciation in a “floating” net asset value of \$1.00 nominal value per share, rounded to the nearest cent. Under these circumstances, unrealized capital changes, which could materially affect the value of such fund’s portfolio, would ordinarily not be of sufficient magnitude to cause the net asset value to change by one cent. The effects of unrealized appreciation and depreciation, in the case of a fund with a “floating” \$1.00 net asset value per share, would generally appear in the third and fourth decimal places, and when rounded to the third decimal place (i.e., tenths of one cent) would still not have a one cent impact on the net asset value. Moreover, if such a one cent change should occur, dilution may also result, since a relatively small change in net asset value would cause a larger change in the computed net asset value per share due to rounding. For example, if in the type of fund described above the net asset value was calculated accurately to three decimal places, were a change in net asset value from \$1.004 to \$1.006 to occur, such change of \$.002 would cause the net asset value, when rounded to the nearest cent, to change by one full cent.

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<sup>8</sup> A fund also may use amortized cost valuation for a period less than 60 days prior to maturity, in which case the principles indicated above would also be applicable.

<sup>9</sup> In Accounting Series Release No. 118, note 6, *supra*, the Commission stated that:

As a general principle, the current ‘fair value’ of an issue of securities being valued by the Board of Directors would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale.

In that release, the Commission notes various factors that might be considered in arriving at “fair value”, which factors included: yield to maturity with respect to debt issues . . . an evaluation of the forces which influence the market in which these securities are purchased and sold . . . [and the] price and extent of public trading in similar securities of the issuer or comparable companies, and other relevant matters.

<sup>10</sup> See note 6 *supra*.

To alleviate these results and insure that shareholders are more properly credited for capital appreciation or depreciation, the Commission believes that any money market fund which reflects capital changes in its net asset value per share should calculate, and utilize for purposes of sales and redemptions, a current net asset value per share with an accuracy of one-tenth of one percent (equivalent to the nearest one cent on a net asset value of \$10.00).<sup>11</sup> Any less precise calculation by such a fund might have the effect of masking the impact of changing values of portfolio securities and therefore might not "reflect" the fund's calculations pertaining to its portfolio valuation as required by Rule 2a-4.<sup>12</sup>

Boards of directors of money market funds and those other funds referred to above should consider and re-evaluate current fund pricing practices in light of the positions expressed herein. In this regard, the Commission recognizes that such consideration may result in decisions by some funds to make various modification of their valuation and distribution practices. To avoid any sudden changes in net asset values some funds might wish to effect a gradual transition to new valuation methods. Moreover, some time may be necessary to take the action necessary to adopt new dividend policies or other measures designed to implement the views expressed herein. Therefore, to allow adequate time for planning and effecting orderly transitions, the Commission, as noted above, expects companies to comply with this interpretation by no later than November 30, 1977.

By the Commission.

George A. Fitzsimmons  
Secretary  
May 31, 1977

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<sup>11</sup> Such calculation is applicable only with respect to those money market funds which do not include in their distributions to shareholders all capital changes. If such a fund had a net asset value of \$10.00 per share, it would be appropriate to calculate its current net asset value accurately to one tenth of a cent, rounded to the nearest one cent. If such a fund had a net asset value per share of \$1.00 it would be appropriate to calculate its current net asset value accurately to the nearest one hundredth of one cent, rounded to the nearest one tenth of one cent.

<sup>12</sup> See note 5, *supra*.



## PROPOSAL REGARDING VALUATION OF DEBT INSTRUMENTS AND COMPUTATION OF CURRENT PRICE PER SHARE BY CERTAIN OPEN-END INVESTMENT COMPANIES (MONEY MARKET FUNDS)

Release No. IC-12206

February 1, 1982

ACTION: Proposed rule.

SUMMARY: The Commission today is releasing for public comment a proposed rule regarding the valuation of debt instruments, the calculation of current net asset value per share and the computation of current price per share by certain registered open-end investment companies, commonly referred to as "money market funds." The proposed rule would permit such investment companies, subject to enumerated conditions either: (1) to value portfolio instruments by use of the amortized cost valuation method; or (2) to compute current price per share by rounding the net asset value per share to the nearest one cent, based on a share value of one dollar. The rule would obviate the necessity for money market funds to apply for, and the Commission to issue, individual orders of exemption to permit use of those valuation or pricing methods.

DATE: Comments must be received by April 5, 1982.

ADDRESSES: Interested persons wishing to submit their views and comments on the proposed rule should file four copies thereof with George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C., 20549. All submissions should refer to File No. S7-920 and will be made available for public inspection at the Commission's Public Reference Section, Room 6101, 1100 L Street, N.W., Washington, D.C., 20549.

FOR FURTHER INFORMATION CONTACT: Arthur J. Brown, Chief Investment Company Act Study (202) 272-2048 or Cathy G. Douglas, Special Counsel, (202) 272-2024, Division of Investment Management, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is publishing for public comment proposed Rule 2a-7 under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] ("Act") which would allow, subject to specified conditions, certain open-end investment companies, known as "money market funds," to compute their current price per share for purposes of distribution, redemption and repurchase by using either: (1) the "amortized cost" method of valuation to value their portfolio instruments for purposes of calculating their current net asset value per share; or (2) the "penny-rounding" method of computing their current price per share. Under the amortized cost method of valuation, money market funds may calculate their current net asset value for use in computing the current price of their redeemable securities by valuing all portfolio securities and assets, regardless of whether market quotations are readily available, at the acquisition cost as adjusted for amortization of premium or accumulation of discount rather than at current market value as would be required by Rule 2a-4 [17 CFR 270.2a-4].

Under the penny-rounding method of computation, money market funds calculate their current net asset value in conformance with Rule 2a-4 by valuing portfolio securities for which market quotations are readily available at current market value, and other securities and assets at fair value as determined in good faith by the board of directors. However, they may then compute the current price of their redeemable securities by rounding the net asset value per share to the nearest one cent on a share value of one dollar.

The proposed rule provides that to use either of the above valuation or pricing methods a money market fund must comply with certain conditions. Those conditions basically: (1) limit the types of investments that the money market fund can make to short-term, high quality debt instruments; (2) impose on the board of directors (trustees in the case of a trust; hereinafter referred to as "board of directors" or "board") of the money market fund a special obligation to ensure that a stable price per share of one dollar is maintained; and (3) require that the board of directors of the money market funds, in good faith, determines that the valuation or pricing method selected pursuant to this rule will reflect fairly the value of each shareholder's interest in the money market fund and that the money market fund will discontinue its use of such method if such method ceases to reflect fairly each shareholder's interest. In addition, a money market fund using the amortized cost method of valuation must monitor the deviation between the price of its portfolio instruments and the

net asset value of such shares calculated using values for portfolio instruments based upon current market factors. If such deviation exceeds ½ of one percent of the price per share or if the amount of deviation may result in material dilution or other unfair results to shareholders, the proposed rule would impose specific obligations on the board of directors to respond to the situation. Likewise, a money market fund using the penny-rounding method to compute its price per share may have to monitor in a similar fashion the valuation of those portfolio instruments (with remaining maturities of sixty days or less)<sup>1</sup> that are valued at amortized cost in order to assess the fairness of that valuation method.

The proposed rule generally codifies the standards that have developed for granting the applications filed by money market funds for exemption from the pricing and valuation provisions of the Act. As described more fully below, the rule expands slightly the scope of the exemption to permit the purchase of additional instruments. In addition, the rule has been fashioned to outline more clearly the obligations of money market funds and their boards of directors when relying on the exemption. In this regard, the rule is not intended to expand the responsibilities and liabilities imposed upon directors beyond those imposed under the exemptive orders.

## Background

Section 2(a)(41) of the Act [15 U.S.C. 80a-2(a)(41)], in conjunction with Rules 2a-4 and 22c-1 under the Act [17 CFR 270.2a-4 and 270.22c-1], requires a registered investment company to calculate its current net asset value per share, for purposes of distribution, redemption, and repurchase, by valuing (1) its portfolio securities with respect to which market quotations are readily available at current market value, and (2) its other securities and assets at their fair value as determined, in good faith, by the board of directors. Such “fair value” has been interpreted to mean the value that would be received upon the current sale of a security or asset. (Investment Company Act Release Nos. 5847 (October 21, 1969), 35 FR 19989 (December 31, 1970) and 6295 (December 23, 1970), 35 FR 19986 (December 31, 1970)). On May 31, 1977, the Commission issued an interpretive release (Investment Company Act Release No. 9786 (“Release 9786”), 42 FR 28999 (June 7, 1977)), expressing the view that money market funds, defined as open-end investment companies which invest primarily in short-term debt instruments, and other open-end investment companies that hold a significant amount of debt securities should: (1) determine the fair value of short-term debt portfolio securities for which market quotations are not readily available with reference generally to current market factors; and (2) calculate their price per share to an accuracy of within .1%, or \$.01 based on a share value of \$10.00. Release 9786 indicated further that, because the amortized cost method of valuation would not take market factors into account, the use of that method under all but very limited circumstances would be inconsistent with the provisions of Rule 2a-4 under the Act.

Subsequent to the issuance of Release 9786, several applications were filed by money market funds requesting orders of exemption from the appropriate provisions of the Act and the rules thereunder, which applications, if granted, would have permitted the use of amortized cost valuation under certain specified conditions and circumstances. In response to requests for a hearing on the applications, the Commission issued an order for a consolidated hearing on such applications. (Investment Company Act Release No. 10201 (April 12, 1978), 43 FR 16830 (April 20, 1978).)

Prior to the commencement of the evidentiary portion of the administrative proceeding, certain of the applicants and the Division of Investment Management reached a partial agreement regarding the manner of valuing assets and pricing shares. As a result of that agreement, a number of the applicants amended their respective applications. Based on the amended applications, the Commission granted an order, Investment Company Act Release No. 10451 (October 26, 1978), 43 FR 51485 (November 3, 1978), which, subject to certain conditions, permitted those applicants to compute their current price per share by rounding the net asset value per share to the nearest one cent of a share price of \$1.00 (“penny-rounding”, however, the fair value of the portfolio securities used to determine net asset value was to be assessed in compliance with the views expressed in Release 9786, which required debt securities with more than 60 days remaining until maturity to be valued based on market factors.) The conditions of the penny-rounding orders, in general, required: (1) a special undertaking by the board of directors of each applicant to supervise operations of the money market fund in such a manner as to assure, to the extent reasonably practicable, that the share price would not deviate from \$1.00; (2) that the dollar weighted average portfolio maturity of the applicant’s portfolio would not be in excess of 120 days and no instrument with a maturity of greater than one year would be purchased; and (3) that purchase of portfolio instruments would be limited to those high quality instruments that were specified in each application.

<sup>1</sup> See footnote 36, *infra*.

Numerous other money market funds subsequently filed applications seeking orders of exemption for penny-rounding subject to conditions which are in substantial conformity with the above mentioned conditions, and the Division has granted the requested orders pursuant to its delegated authority.<sup>2</sup>

The applicants that continued to seek permission to use the amortized cost method of valuation participated in the evidentiary portion of the above administrative hearing, which commenced on November 20, 1978, and concluded on March 26, 1979. Following such proceedings, most applicants submitted Offers of Settlement (“Offers”) which provided for the use of the amortized cost method of valuation subject to certain conditions. On August 8, 1979, the Commission issued an order (Investment Company Act Release No. 10824) granting exemptive relief to enable those applicants to use the amortized cost method of valuation, subject to the conditions specified in the Offers, and cancelling as to them the administrative hearing.<sup>3</sup>

The conditions in that order included the same conditions set forth in the original penny-rounding exemptive orders with the following modifications. The obligation imposed upon the board of directors was modified to require that the board undertake to establish procedures reasonably designed, taking into account current market conditions and the fund’s investment objectives, to stabilize the fund’s net asset value per share at one dollar. The quality of the instruments which could be purchased was changed to the general standard of those instruments which the board determines present minimal credit risks, and which are of high quality as determined by any major rating service or, if unrated, of comparable quality. In addition, the amortized cost exemptive order included three new conditions which basically: (1) set forth the minimal procedures that a board must adopt to stabilize the fund’s net asset value per share at one dollar, which included monitoring the deviation between the net asset value per share using amortized cost values for portfolio instruments and the net asset value per share using market values for those instruments, as well as setting forth when the board would be required to take action to stabilize the fund’s net asset value per share; (2) required the fund to maintain a record of the procedures established by the board and any actions taken pursuant to those procedures; and (3) required the fund to file quarterly, as an attachment to Form N-1Q [17 CFR 274.106], a statement as to whether any action had been taken pursuant to those procedures.

Subsequently, more than 90 money market funds have requested, and the Division pursuant to delegated authority has granted, exemptive relief to permit the use of amortized cost valuation, subject to substantially the same conditions as those contained in the original order settling the hearing. Certain minor changes were made in subsequent orders to reflect technical corrections. In addition, subsequent orders permitting amortized cost valuation as well as penny-rounding were issued based upon applications that reflected a broader range of permissible portfolio investments. Those orders were designed to permit money market funds to utilize newly developed or newly available money market instruments, which were not included explicitly in the original applications and orders, and to remove some of the restrictions on the existing types of instruments.<sup>4</sup>

Most money market funds have sought exemptive relief to enable them to employ either penny-rounding or the amortized cost method of valuation in order to facilitate their ability to provide: (1) a steady flow of investment income at an interest rate comparable to those available by direct investment in money market instruments and (2) a stable share price. Each of the procedures, if properly utilized, has been determined by the Commission under the exemptive standard set forth in Section 6(c) of the Act [15 U.S.C. 80a-6(c)] to be appropriate in the public interest and consistent with the protection of investors and the policy and provisions of the Act. Accordingly, the Commission has determined to release for public comment proposed Rule 2a-7, which would generally codify the exemptive relief granted permitting money market funds to employ either penny-rounding or the amortized cost method of valuation to achieve a stable price per share.

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<sup>2</sup> The changes in the subsequent orders were related primarily to eliminating the condition that the funds would purchase only those specified portfolio instruments of the specified quality set forth in the application and substituting therefor an overall requirement that the portfolio instruments purchased present minimal credit risks and be of high quality as determined by any major rating service, or, if not rated, of comparable quality.

<sup>3</sup> The proceeding was dismissed as to the only remaining applicant, First Multifund for Daily Income, Inc., by the Commission on May 2, 1980 (Investment Company Act Release No. 11152). The Court of Appeals for the District of Columbia upheld that decision on June 16, 1981 (*First Multifund for Daily Income, Inc. v. SEC*, No. 80-1568, (D.C. Cir. 1981)).

<sup>4</sup> For example, many of the original applications limited the funds’ investments in the securities of banks to those banks with assets or capital exceeding a set amount.

## Discussion

The Commission believes that the proposed rule would obviate the need for certain investment companies to file exemptive applications for relief that is routinely granted. The proposed rule would also allow the investment company to select the manner of computing its price per share which it believes best serves the interests of its shareholders while imposing such conditions as would render the use of such method appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. The rule would further benefit shareholders by facilitating the ability of certain investment companies to fulfill their shareholders' investment objectives.

Under proposed Rule 2a-7, investment companies that have investment portfolios consisting entirely of U.S. dollar-denominated short-term debt obligations ("money market funds") may use either penny-rounding or the amortized cost valuation method for purposes of computing their price per share, provided that they comply with the conditions enumerated in the rule.<sup>5</sup> Those conditions are designed to ensure that any money market fund that adopts one of the procedures under discussion in an effort to maintain a stable price per share will be able to maintain that stable price per share. The rule also provides, under both methods, for the computation of a share price that will represent fairly the current net asset per share value of the investment company, thus reducing any possibility of dilution of shareholders' interests or other unfair results.<sup>6</sup>

### Permissible Portfolio Investments

The rule, like the previously granted exemptive orders, is designed to limit the permissible portfolio investments of a money market fund seeking to use either penny-rounding or the amortized cost valuation method to maintain a stable price per share to those instruments that have a low level of volatility<sup>7</sup> and thus will provide a greater assurance that the money market fund will continue to be able to maintain a stable price per share that fairly reflects the current net asset value per share of the fund. Accordingly, money market funds relying on the rule may purchase only those portfolio instruments which meet the quality and maturity requirements of the rule.<sup>8</sup> The proposed rule, however, would not prohibit a money market fund from holding cash reserves. It should be noted that the proposed rule does not speak to the acquisition or valuation of puts or stand-by commitments by a money market fund wishing to use the subject valuation methods. The Commission is currently considering applications for exemptive orders to permit money market funds using either the amortized cost valuation method or penny-rounding to acquire puts or stand-by commitments. The Commission has granted exemptive orders to permit the acquisition of puts, but only under limited circumstances and subject to certain conditions.<sup>9</sup> At some future time the proposed rule may be amended to include a resolution of the issues concerning the acquisition of puts.

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<sup>5</sup> Under the proposed rule, a money market fund that elects to use one of the permitted methods for determining its price per share is not foreclosed from switching to another method. So long as the enumerated conditions for the particular method are fulfilled, a fund may rely on the exemptions provided in paragraphs (a)(2) or (3). However, the proposed rule would not allow a fund to rely on both exemptions at the same time. Therefore, if a fund is using the amortized cost valuation method to calculate its net asset value per share when computing its price, it may not then round its per share net asset value to the nearest cent on a share value of one dollar. Such a fund may round its per share net asset value only to the extent that such rounding would not be deemed to be material, which the Commission believes to be one-tenth of one cent on a share value of one dollar.

<sup>6</sup> If shares are sold based on a net asset value which turns out to be either understated or overstated in comparison to the amount at which portfolio instruments could have been sold, then either the interests of existing shareholders or new investors will have been diluted.

<sup>7</sup> There are basically two types of risks which cause fluctuations in the value of money market fund portfolio instruments: the market risk, which primarily results from fluctuations in the prevailing interest rate, and the credit risk. In general, instruments with shorter periods remaining until maturity and which are of higher quality have reduced market and credit risks and thus tend to fluctuate less in value over time than instruments with longer remaining maturities or of lesser quality.

<sup>8</sup> The applications for exemptive relief have routinely set forth the specific types and quality of instruments in which the money market funds could invest. The instruments consisted exclusively of debt obligations, including such instruments as treasury bills and notes and other government issued or guaranteed debt securities, certificates of deposit and time deposits from domestic banks and thrift institutions and from foreign banks, bankers' acceptances of domestic and foreign banks, commercial paper, corporate bonds and notes and repurchase agreements on other debt obligations. While the rule does not set out the various types of debt instruments in which a money market fund relying on the rule may invest, the proposed rule does require that all portfolio instruments mature in one year or less and be of high quality.

<sup>9</sup> See, e.g., Investment Company Act Release No. 11867, July 21, 1981.

### Maturity of Portfolio Instruments

A money market fund would be able to rely on the rule only if its entire investment portfolio consisted of instruments with a remaining maturity of one year or less. As prescribed in the proposed rule, which is generally a codification of positions taken by the Commission regarding the conditions contained in the exemptive orders, the maturity of an instrument generally is deemed to be its stated maturity, with a special exception provided for certain variable and floating rate paper. Accordingly, an instrument is deemed to satisfy the requirement of having a remaining maturity of one year or less for purposes of the rule if, on the date of purchase<sup>10</sup> by the money market fund: (i) the instrument, regardless of the length of maturity when originally issued, currently has no more than 365 days remaining until the principal amount owed is due to be paid or, when originally issued, the principal amount owed or the instrument was to be paid in not more than 375 days<sup>11</sup>; (ii) where the instrument has a variable rate of interest<sup>12</sup> and is issued or guaranteed by the United States government or any agency thereof, it has no more than 365 days remaining until the next readjustment or renegotiation of the interest rate to be paid regardless of the stated maturity of the instrument and the board of directors has determined that when the rate will be readjusted it will cause the instrument to have a current market value which approximates its par value<sup>13</sup>; (iii) the instrument (a) has a demand feature which allows the fund unconditionally to obtain the amount due from the issuer upon notice of seven days or less,<sup>14</sup> (b) has either a floating rate of interest<sup>15</sup> or a variable rate of interest that is readjusted no less frequently than once per year,<sup>16</sup> where, in the case of a variable rate instrument, the board of directors has determined that whenever a new rate will be established it will cause the instrument to have a current market value which approximates its par value and in the case of a floating rate instrument the board has determined that such floating rate feature will ensure that the market value of such instrument will always approximate its par value, and (c) will be reevaluated by the board at least quarterly to ensure that the instrument is of high quality;<sup>17</sup> or (iv) where the instrument is a repurchase agreement or an agreement upon which

<sup>10</sup> The date of purchase is regarded as the date on which the fund's interest in the instrument is subject to market action. Thus, for securities purchased under normal settlement procedures, the length of maturity would be calculated starting on the trade date. For instruments such as "when issued" securities (securities purchased for delivery beyond the normal settlement date), if the commitment to purchase the instrument includes either a set price or yield, then the maturity will be calculated based upon the commitment date.

<sup>11</sup> This part of the definition has been extended beyond the usual definition of one year (365 days) to encompass securities, particularly government securities such as project notes, which are denominated as and intended to be "one year" notes but which occasionally are issued with maturities slightly longer than 365 days. [See Investment Company Act Release No. 11679, March 11, 1981.] This part of the definition is not meant to encompass securities which were originally issued and intended to be longer than "one year" instruments. Those instruments could be purchased by a money market fund relying on this rule only after they have 365 or fewer days remaining until maturity.

<sup>12</sup> Variable rate instruments are those instruments whose terms provide for automatic establishment of a new interest rate on set dates.

<sup>13</sup> See Investment Company Act Release No. 11679 (March 11, 1981) and application of Government Investors Trust (File No. 812-4859) filed April 9, 1981. This definition, which goes beyond a codification of orders issued, was expanded based upon the Commission's understanding that the volatility of such instruments would not be greater than the volatility of fixed interest rate instruments having a maturity equal to the readjustment period of the U.S. government guaranteed variable rate notes. However, the Commission's position is based entirely upon experience with Small Business Administration guaranteed debentures ("SBA notes") which are the only instruments currently falling within this category so far as the Commission is aware. Accordingly, the board of directors of a money market fund considering investment in any such instrument other than a SBA note should, as a part of their overall duty to supervise the operations of the fund to ensure stability, determine that it can expect the volatility of such notes not to differ materially from the volatility of fixed rate notes of the same quality. Moreover, the Commission will consider amendment of this or any other provision of the rule if market experience indicates that it is inappropriate to the rule's overall purposes.

<sup>14</sup> In theory, the existence of a demand feature alone should be sufficient to enable a fund to maintain a stable net asset value per share because the holder could receive the principal amount of the instrument in a short period of time regardless of market and credit worthiness changes. However, the Commission has insufficient evidence that (1) funds will exercise such a demand feature whenever interest rates increase or the creditworthiness of the issuer is reduced and (2) there is a market for such instruments and even if there is, whether it always evaluates the instrument at a price approximating its par value.

<sup>15</sup> Floating rate instruments are those instruments whose terms provide for automatic adjustments of their interest rates whenever some set interest rate changes.

<sup>16</sup> See application of Municipal Fund for Temporary Investment, (File No. 812-4970) filed September 15, 1981; and letter from Gerald Osheroff, Associate Director, Division of Investment Management to Joel T. Marcovsky, Merrill Lynch Asset Management, Inc., dated December 10, 1981.

<sup>17</sup> If the instrument were ever deemed to be of less than high quality, the fund either would have to sell the instrument or exercise the demand feature, whichever is more beneficial to the fund.

portfolio instruments are lent (“portfolio instrument lending agreement”)<sup>18</sup> regardless of the maturity of the security serving as collateral for the agreement, the agreement is to be effected within 365 days or less.<sup>19</sup>

### Maturity of the Portfolio

In addition to requirements regarding the maturity of individual portfolio investments, the rule would impose restrictions on the dollar-weighted average maturity of the entire portfolio. Paragraphs (a)(2)(iii) and (a)(3)(ii) of the proposed rule provide that the money market fund must maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable price per share. This provision imposes an obligation on the directors of the fund, as a part of their fiduciary duties, to ascertain that the fund is maintaining an average portfolio maturity that, given the then current market conditions, will permit it to maintain a stable price per share. During periods of greater volatility in the market, the board of directors should be aware of the greater difficulty in maintaining a stable price per share and should take steps to ensure that they are providing adequate oversight to the money market fund. In addition, the rule provides that in no event shall the fund maintain a dollar-weighted average portfolio maturity that exceeds 120 days. Should the disposition of a portfolio instrument or some market action cause the dollar-weighted average portfolio maturity to exceed 120 days, the board of directors is obligated to cause the fund to invest its available cash in such a manner as to reduce its dollar-weighted average portfolio maturity to 120 days or less as soon as reasonably practicable.

For purposes of computing the average portfolio maturity, instruments generally will be deemed to have a maturity equal to the period remaining until the date of maturity of the instrument noted on the face of the instrument. Certain variable or floating interest rate instruments, which are deemed to have a remaining maturity of one year or less for purposes of the rule,<sup>20</sup> may be treated as having a maturity other than that noted on the face of the instrument. Any such variable rate instruments that have demand features may be deemed to have a maturity equal to the longer of the period remaining until the next rate readjustment or the period remaining until the principal amount can be recovered.<sup>21</sup> Any such variable rate instruments that do not have a demand feature may be treated as having a maturity equal to the period remaining until the next calculation of the interest rate rather than the period remaining until the principal amount is due. Any such floating interest rate instruments with a demand feature that meet the conditions enumerated in the prior section of this release may be treated as having a maturity equal to the period remaining until the principal amount due on the instrument can be recovered through demand.<sup>22</sup> Repurchase agreements and portfolio instrument lending agreements

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<sup>18</sup> Repurchase agreements may be regarded as securities issued by the entity promising to repurchase the underlying security at a later date. (See Securities Act Release No. 6351 (September 25, 1981), *46 FR 48637* (October 2, 1981) and Investment Company Act Release No. 10666 (April 18, 1979), *44 FR 25128* (April 27, 1979).) Therefore, a money market fund is generally prohibited by the provisions of Section 12(d)(3) of the Act [*15 U.S.C. 80a-12(d)(3)*] from acquiring a repurchase agreement issued by a broker or dealer unless it structures the repurchase arrangement in accordance with the manner described in the Investment Company Act release, which is designed to ensure that the investment company’s investment, including accrued interest earned, is fully collateralized. The same analysis may apply to portfolio instrument lending agreements.

<sup>19</sup> Money market funds investing in, or seeking to invest in, an instrument with a maturity not falling within one of the above-described categories would not be able to rely upon the rule, as proposed, to permit the use of either penny-rounding or the amortized cost valuation method. Individual applications for exemptive relief to permit investment in other types of instruments may of course be filed.

<sup>20</sup> See the discussion on Maturity of Portfolio Instruments, which sets forth the conditions that must be fulfilled in order for the maturity to be deemed a period other than until the maturity date noted on the face of the instrument.

<sup>21</sup> Because certain of such variable rate demand instruments may not be readily marketable, the demand notice period may be the shortest period during which the holder may practically expect to bear the market risk associated with the instrument.

<sup>22</sup> If the board determined that a demand instrument, either floating or variable rate, were no longer of high quality, the fund could not base its maturity on the period remaining until recalculation of the interest rate or on the demand period, but, as noted at footnote 17, *supra*, would have to exercise the demand feature or sell the instrument, whichever is more beneficial to the fund.

shall be treated as having a maturity equal to the period remaining until the agreement is due to be executed.<sup>23</sup> Finally, although variable rate instruments with neither a U.S. government guarantee nor a demand feature may be purchased only if the period until the maturity date set on the face of the instrument is one year or less, the rule will permit, for purposes of determining the dollar-weighted average maturity of the entire portfolio under the rule, such instruments to be treated as having a maturity equal to the period remaining until the next readjustment of the interest rate, provided that the board determines that the new rate will cause the instrument to have a current market rate which approximates its par value.<sup>24</sup>

### Quality of Portfolio Instruments

In addition to the above limitations on the maturity of the portfolio of a money market fund seeking to rely on the proposed rule, paragraphs (a)(2)(iv) and (a)(3)(iii) of the proposed rule contain conditions relating to the quality of portfolio instruments. The rule provides that each portfolio instrument must be denominated in United States dollars and must also be an instrument which: (1) the board has determined presents minimal credit risks to the fund; and (2) is rated “high quality” by a major rating service or, if the security is unrated, is determined by the board to be of comparable quality.

The board of directors may fulfill its obligation to determine that the fund purchase only portfolio instruments which present minimal credit risks in a number of ways. For example, the board could set forth a list of “approved instruments” in which the fund could invest, such list including only those instruments which the board had evaluated and determined presented minimal credit risks.<sup>25</sup> The board could also approve guidelines for the investment adviser regarding what factors would be necessary in order to deem a particular instrument as presenting minimal credit risks. The investment adviser would then evaluate the particular instruments proposed for investment and make only conforming investments. In either case, on a periodic basis the board should secure from the investment adviser and review both a listing of all instruments acquired and a representation that the fund had invested in only those approved instruments. The board, of course, could revise the list of approved instruments or the investment factors to be used by the investment adviser.

In order to fulfill the rule’s requirement that the instruments be rated “high quality,” the instruments, if rated, must have been given a rating by a major financial rating service such as Standard & Poor’s Corporation, Moody’s Investors Services or Fitch Investors Service that falls within the rating service’s definition of “high quality.”<sup>26</sup> Even if the board of directors believes that the rating service incorrectly rated the instrument or that because of changed circumstances the instrument

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<sup>23</sup> Although repurchase agreements (“repos”) will be treated as having a maturity based upon the length of the agreement and not the maturity of the instruments which serve as collateral, the board of directors should be aware of the risks involved with the purchase of repos that are collateralized by securities with remaining maturities of greater than one year. If the issuer of the repo should default, the security serving as collateral would become a part of the money market fund’s portfolio. Securities with longer maturities generally have greater volatility and thus would expose the fund to a greater risk of an unstable price per share. Moreover, the security would not satisfy the provisions defining permissible portfolio instruments. Therefore, the Commission would take the position that such a security should be disposed of as soon as possible. The same analysis would apply to transactions where the money market fund loans portfolio securities and securities having maturities of greater than one year are received as collateral for the loan. If the borrower defaults, the fund would be left with securities which would not meet the provisions of the rule.

<sup>24</sup> This provision reflects a slight expansion of the relief given through exemptive orders, which required periods of renegotiation to be 30 days or less and the remaining maturity of the instrument to be 180 days or less. (Investment Company Act Release No. 11679, March 11, 1981.)

<sup>25</sup> The Commission envisions that the investment adviser would provide the board with the data to evaluate the instruments and make its assessment.

<sup>26</sup> Using bonds as an example, Standard & Poor’s, Fitch and Moody’s define “high quality” for bonds to be those instruments which receive an AAA or AA (Aaa or Aa) rating. Therefore, a money market fund seeking to rely on this rule could invest only in bonds which were rated AA (Aa) or better.

is now of higher quality, this provision of the rule precludes a money market fund which is relying on the rule from investing in any rated instrument which does not have a “high quality” rating.<sup>27</sup>

If an instrument has received no rating from a major rating service, then, assuming that the board has found that it presents minimal credit risks to the fund, it would be a permissible investment under the rule, provided that the board also finds that the instrument is of “comparable quality” to that of instruments that are rated “high quality.”<sup>28</sup> In making this finding the board of directors may establish guidelines for determining high quality and delegate to the investment adviser the responsibility of investigating the creditworthiness of the issuer and presenting its findings to the board for its approval.<sup>29</sup>

### Liquidity of the Portfolio

While the proposed rule does not limit a money market fund’s portfolio investments solely to negotiable and marketable instruments, money market funds, like all open-end management investment companies, are subject to limitations on restricted or illiquid securities. In Investment Company Act Release No. 5847 (October 21, 1969) (“Release 5847”) the Commission set forth its view that, because an open-end company has an obligation to value its portfolio correctly and to satisfy all redemption requests within the statutorily prescribed period, it must limit its acquisition of restricted securities and other securities not having readily available market quotations to the extent necessary to ensure that it can fulfill its obligations. In addition, the Commission took the position that, in light of those obligations, in no event should the percentage of such securities exceed ten percent of the company’s net assets. Therefore, money market funds relying on the rule, like any other open-end management companies, must limit their portfolio investments in illiquid instruments<sup>30</sup> to not more than ten percent of their net assets.<sup>31</sup> However, because of the nature of money market funds, the difficulties that could arise in conjunction with the purchase of illiquid instruments by such funds might be even greater than for other types of open-end management investment companies. Therefore, the board of directors of a money market fund relying on the rule may have a fiduciary obligation to limit further the acquisition of illiquid portfolio investments.

While the Act requires only that an investment company make payment of the proceeds of redemption within seven days,<sup>32</sup> most money market funds promise investors that they will receive proceeds much sooner, often on the same day that the request for redemption is received by the fund. In addition, most money market funds, because they are primarily vehicles for short-term investments, experience a greater and perhaps less predictable volume of redemption transactions than other investment companies. Thus, a money market fund must have sufficient liquidity to meet redemption requests on a more immediate basis. By purchasing or otherwise acquiring illiquid instruments, a money market fund exposes itself to a risk that it will be unable to satisfy redemption requests promptly.

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<sup>27</sup> However, a rated instrument that is subject to some external agreement (such as a letter of credit from a bank), where such external agreement was not considered when the instrument was given its rating, for purposes of this rule, will be considered an unrated security. The Commission believes that agreements such as letters of credit can significantly affect the credit risk associated with an instrument. Therefore, since the security may have significant aspects which are not included in the rating, it is appropriate to consider a security subject to an external agreement, as an unrated security, and thus permit the board to determine whether the instrument, taking into account the external agreements, is of comparable quality. If the board were to consider an external agreement as a basis for judging the quality of an underlying security, that external agreement would have to be unconditional and have terms coextensive with those of the underlying security. Moreover, the instrument could not be judged to be of better quality than that of comparable debt securities of the issuer of the external agreement. It should be noted, however, that if the rating service included the external agreement in its calculation of the rating, the instrument will be regarded as a rated instrument, regardless of the board’s concurrence with the rating.

<sup>28</sup> As noted above, provided that certain conditions are met, third party agreements may be analyzed in evaluating whether an instrument is of sufficient quality.

<sup>29</sup> Like the procedures discussed above regarding the board’s fulfilling its obligation to determine that the fund purchase only portfolio instruments which present minimal credit risks, the rule would permit the board to approve the purchase before it is made or, if appropriate guidelines are set, after the purchase is made.

<sup>30</sup> Illiquid instruments, in this context, would encompass any instrument which cannot be disposed of promptly and in the usual course of business without taking a reduced price. This would include repurchase agreements for greater than seven days, non-negotiable instruments, and instruments for which no market exists.

<sup>31</sup> In the event that changes in the portfolio or other events cause the investments in illiquid instruments to exceed ten percent of the fund’s net assets, the fund must take steps to bring the aggregate amount of illiquid instruments back within the prescribed limitations as soon as reasonably practicable. However, this requirement generally would not force the fund to liquidate any portfolio instrument where the fund would suffer a loss on the sale of that instrument.

<sup>32</sup> Section 22(e) of the Act [15 U.S.C. 80a-22(e)].



In addition, as set forth in Release 5847, the management of the investment company's portfolio could also be affected by the purchase of illiquid instruments. If the investment company found that it would have to sell portfolio instruments in order to satisfy redemptions, it might sell marketable securities which it would otherwise wish to retain in order to avoid selling non-negotiable instruments or other illiquid instruments through some alternative means, since the sale of such non-negotiable or illiquid securities would necessitate the money market fund's accepting a reduced price. The judgment as to which securities would be retained would no longer be based upon comparative investment merit. Therefore, the board of directors has a particular responsibility to ensure that when a money market fund purchases or acquires illiquid instruments, such instruments will not impair the proper management of the fund.

Finally, the purchase of illiquid instruments can complicate the valuation of a money market fund's shares and can result in the dilution of shareholders' interests. If illiquid instruments which were valued at amortized cost were disposed of at a reduced price, then, in retrospect, the net asset value of the money market fund would have been overstated. Similarly, if illiquid instruments were valued at a discounted value (to compensate for the possibility that they may have to be disposed of prior to maturity), but were held to maturity and thus yielded their full value, the net asset value of the money market fund would have been understated. Regardless of the types of instruments purchased, the board of directors of a money market fund is under the same obligation to ensure that the price per share correctly reflects the current net asset value per share of the fund. Therefore, when a fund purchases illiquid instruments, the board of directors has a fiduciary duty to see that the fund is operated in such a manner that the purchase of such instruments does not materially affect the valuation of the fund's shares.

#### **Obligation of the Board to Maintain Stable Price**

A money market fund that describes itself in its prospectus as having or seeking to maintain a stable price per share through portfolio management and use of a special pricing or asset valuation method has an obligation to the shareholders to continue the chosen method so long as it is consistent with the provisions of the Act, until shareholders are notified of a change in policy. The Commission believes that where a money market fund adopts either the valuation or pricing method under the proposed rule to enhance its ability to maintain a stable price it has a heightened responsibility to shareholders to maintain that stable price. Accordingly, under paragraphs (a)(2)(i) and (a)(3)(i) of the proposed rule, the board of directors of a money market fund wishing to use either penny-rounding or the amortized cost valuation method has a particular obligation to assure that the fund is managed in such a way that a stable price will be maintained.

For a fund seeking to use the amortized cost valuation method, the board of directors has a responsibility to establish procedures reasonably designed to stabilize the fund's price per share. For a fund seeking to use the penny-rounding method, the board of directors has a responsibility, through its supervision of the fund's operations and delegation of special responsibilities to the investment adviser, to assure, to the extent reasonably practicable, that the money market fund's price per share remains stabilized at one dollar.<sup>33</sup>

Testimony by witnesses from the investment company industry presented at the hearings on the original applications for amortized cost valuation alleged that with the limitations on quality and length of maturity provided, short of extraordinarily adverse conditions in the market, a money market fund that is properly managed should be able to maintain a stable price per share.<sup>34</sup> The orders granting exemptive relief and this rule, which codifies those orders, are premised on that representation. Therefore, there is a strong presumption that if a money market fund relying on this rule is unable to maintain a stable net asset value per share, and this is not due to highly unusual conditions affecting the money markets in general, the board of directors has not fulfilled its obligation to ensure that the fund is properly managed.

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<sup>33</sup> The proposed rule mandates that the board act in some specific ways to fulfill its responsibility to ensure a stable price: having the fund maintain an appropriate dollar-weighted average maturity and permitting the fund to invest only in instruments which present a minimal credit risk and are of high quality. Thus, for example, it appears that the board of directors should, absent extenuating circumstances, cause the money market fund to dispose of any security as soon as practicable, should the quality of that instrument fall below "high quality." See also footnote 17, *supra*.

<sup>34</sup> Proceedings before the Securities and Exchange Commission in the Matter of InterCapital Liquid Asset Fund, Inc., et al., 3-5431, December 20, 1978 at 1414.

### Monitoring the Fairness of the Valuation or Pricing Method

In addition to the restrictions on the types of portfolio investments that may be made, the provisions of the proposed rule impose obligations on the board of directors to assess the fairness of the valuation or pricing method and take appropriate steps to ensure that shareholders always receive their true proportionate interest in the money market fund. Paragraph (a)(1) of the proposed rule provides that the board of directors of each money market fund relying on the rule must determine that, absent unusual circumstances, the valuation or pricing method selected will fairly reflect the value of each shareholder's interest in the fund. That finding must be made prior to the implementation of the selected method, and the board must continue thereafter to believe that the method is fair.<sup>35</sup> Moreover, the minutes should reflect the findings and include the factors that were considered by the board and the board's analysis of those factors in reaching its conclusion. There would be an obligation on the board to discontinue the use of the selected valuation or pricing method if it ceased to reflect fairly each shareholder's interest. In such case, the fund's current price and net asset value per share would ordinarily have to be determined in conformance with the provisions of Section 2(a)(41) of the Act and Rules 2a-4 and 22c-1 thereunder.

In addition to the general obligation to assess the fairness of the valuation or pricing system, paragraph (a)(2)(ii) of the proposed rule requires the board of a money market fund relying on this rule and using the amortized cost method of valuation to adopt procedures to monitor the deviation between the per share net asset value based on the market value of the portfolio ("market-based value") and the price per share computed from a net asset value per share calculated using the amortized cost valuation of the portfolio and to maintain a record of such review. The rule does not prescribe specific intervals for such monitoring; however, the board must select intervals that are reasonable in light of current market conditions. During periods of high market volatility, this requirement may necessitate that the deviation between such market-based value and price be monitored on a daily basis. During periods of lower volatility, it may be reasonable to monitor such deviation less frequently. The reviews should be frequent enough so that the board may become aware of changes in the market-based per share net asset value before they become material. In determining the market-based value of the portfolio for purposes of computing the amount of deviation, all portfolio instruments, regardless of their length of maturity, should be valued based upon market factors and not their amortized cost value.<sup>36</sup>

In the fund's determination of the market-based value of each instrument, the Commission will not object if the fund, with the approval of its board, uses actual quotations or estimates of market value reflecting current market conditions chosen by the board in the exercise of its discretion to be appropriate indicators of value, or if the fund uses values obtained from yield data relating to classes of money market instruments by reputable sources, provided that certain minimum conditions are met. Any pricing system based on yield data for selected instruments used by a fund must be based upon market quotations for sufficient numbers and types of instruments to be a representative sample of each class of instrument held in the portfolio, both in terms of the types of instruments as well as the differing quality of the instruments. Moreover, the fund must periodically check the accuracy of the system. If the fund uses an outside service to provide this type of pricing for its portfolio instruments, it may not delegate to the provider of the service the ultimate responsibility to check the accuracy of the system.

The rule does not include a specific requirement that a money market fund using the penny-rounding method monitor the market-based value of its shares because such market-based valuation generally is itself the basis for the calculation of the per share net asset value upon which the price per share is computed. However, where a penny-rounding money market fund uses the amortized cost method to value portfolio instruments with remaining maturities of 60 days or less,<sup>37</sup> monitoring the deviation between the net asset value per share calculated using the market based value of all its

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<sup>35</sup> This requirement was not explicitly listed as a condition of the prior exemptive orders; however, the obligation existed as a result of: (1) the general obligation of a board to value portfolio instruments at fair value, which would cause the net asset value per share to fairly reflect each shareholder's interest, and (2) the specific condition of the orders that required the board to take action to eliminate any potential for dilution or unfair results by taking corrective actions, which might include ceasing to use the amortized cost valuation method.

<sup>36</sup> Release 9786 set forth the Commission's position that it would not object to a board of directors determining, in good faith, that it was appropriate for a money market fund to value securities with less than 60 days remaining until maturity at amortized cost, unless the particular circumstances dictate otherwise. The impact of that release was to obviate the necessity of exemptive relief for such valuation; that release, however, does not affect the monitoring procedures under this proposed rule.

<sup>37</sup> See footnote 36, *supra*.

portfolio instruments and its price per share may be necessary in order for the board to fulfill its responsibility to oversee the use of the penny-rounding method. If the price per share obtained through penny-rounding does not fairly represent each shareholder's interest in the fund, the board is obligated to use another pricing system which does fairly reflect each shareholder's interest. Particularly in a volatile market if a penny-rounding fund were to use amortized cost valuation for a material portion of its portfolio, monitoring of actual market values would be necessary in order for the board to make a determination regarding the current fairness of prices obtained under the penny-rounding method. Moreover, the board's obligation to assure that the money market fund is maintaining an appropriate dollar-weighted average maturity to ensure stability may require that the per share net asset value based upon the market value of all the fund's portfolio instruments be monitored in order for the board to make a reasonable determination whether the maturity must be changed to ensure stability. The money market fund should retain a written record of any monitoring and the frequency of such monitoring should be appropriate in light of current market conditions.

### **Obligation of the Board to Take Action to Stabilize Net Asset Value Per Share**

Pursuant to paragraph (a)(2)(i) of the proposed rule, the board of directors of a money market fund using the amortized cost method must establish procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to stabilize the fund's per share net asset value at one dollar. While the proposed rule does not mandate the specific content of the procedures other than as set forth in paragraph (a)(2)(ii), described below, the procedures must be in writing (paragraph (a)(2)(v)) and should provide for action on the part of the investment adviser or the board of directors to ensure that the per share net asset value remains stable. Examples of types of procedures that boards may wish to consider adopting are: (1) "early warning systems" whereby the board establishes a procedure requiring the investment adviser to inform the board, and the board to meet and consider what action is appropriate to take, whenever the per share net asset value of the fund, based upon market based valuations, falls below or rises above some predesignated level; and (2) procedures which require the investment adviser to modify its portfolio purchases in specified ways as market conditions change. Although the rule gives the board of directors some discretion regarding what types of procedures they wish to establish to ensure stability, the procedures adopted must satisfy the board's responsibilities undertaken in connection with selecting the valuation method.

Paragraph (a)(2)(ii) of the proposed rule prescribes the minimum procedures that the board must adopt. These procedures include an obligation that, in the event that the deviation between market-based net asset value per share and amortized cost price exceeds  $\frac{1}{2}$  of 1 percent, the board of directors will promptly consider what action, if any, should be initiated by the board.<sup>38</sup> In fulfillment of that obligation, the Commission takes the position that it is inappropriate, and will not satisfy the condition, for the board of directors to determine that it need not take any action to stabilize the per share net asset value on the basis that the amount of deviation will be reduced over time by anticipated changes in the market or by the maturing of portfolio instruments. The Commission bases its position on the fact that the board has, by undertaking to establish procedures to stabilize the net asset value per share, obligated itself to take affirmative action to ensure stability. Because no one can know, with assurance, what will happen in the market in the future, or at what point the fund might experience a large increase in redemptions, the Commission believes that a decision not to take any action to reduce the deviation, based upon a belief that market action or maturation of portfolio instruments will reduce the deviation, is not an action reasonably designed to ensure stability.

The board is required additionally to take such action as it deems appropriate whenever it believes that the amount of deviation may result in material dilution or other unfair results to investors or existing shareholders.<sup>39</sup> The rule neither specifies what actions the board must take, nor lists, as orders of exemption have, possible courses of action. However,

<sup>38</sup> In determining whether the deviation exceeds  $\frac{1}{2}$  of 1 percent, the market-based per share net asset value must be calculated to the nearest one-hundredth of a cent on a share value of one dollar with no rounding. Therefore, where a fund has an amortized cost price of \$1.00, a market-based net asset value per share of .99500 would not be considered as exceeding the  $\frac{1}{2}$  of 1 percent mark but a value of .99499 could not be rounded up and thus the deviation would be considered to exceed this benchmark.

<sup>39</sup> It should be noted that this requirement of the rule does not depend upon a determination that the deviation will result in material dilution, only that it may. Because the Commission deems a deviation of  $\frac{1}{2}$  of 1 percent to be a material amount, under all but highly unusual circumstances, the Commission would find that a deviation exceeding  $\frac{1}{2}$  of 1 percent may result in material dilution or other unfair results to shareholders. Thus, it is unlikely that a board of directors could, in conformance with the provisions of the rule, make a finding that no action was necessary when the deviation reached that level. Moreover, a board may find that the possibility of material dilution exists when the deviation is less than  $\frac{1}{2}$  of 1 percent. In such an event, the board would also be obligated to take corrective action.

there are a variety of methods to reduce the deviation, including: adjusting dividends; selling portfolio instruments prior to maturity to realize capital gains or losses or to shorten the average portfolio maturity of the money market fund; or redeeming shares in kind.<sup>40</sup>

In any event, as provided in paragraph (a)(1) of the proposed rule, if the board were ever to determine that the deviation was such that it could no longer conclude that the amortized cost price fairly reflected the value of each shareholder's interest in the fund, because of the possibility of dilution or other unfair results, it would have to discontinue use of the amortized cost method of valuation and calculate its price per share in accordance with the provisions of the Act and rules thereunder.<sup>41</sup> It should be noted, however, that the board of directors must undertake, as a fiduciary duty, the responsibility of establishing procedures designed to preclude the necessity for such a switch in valuation methods.

Although the proposed rule does not prescribe the specific actions that the board of directors of a fund using the penny-rounding method must take at a given time to assure that the price per share does not fluctuate, the rule explicitly imposes an obligation on the board to operate the fund in such a manner and, therefore, take action, to preclude a change in the price per share. As the net asset value per share begins to move away from one dollar, the board should consider, among other things, altering the average portfolio maturity or the quality of instruments purchased to stabilize the current price per share at one dollar.

With the penny-rounding method, if the net asset value<sup>42</sup> ever fell below .9950 or rose above 1.0050, the fund would have to change its price per share to .99 or 1.01, respectively, or would have to cease to use the penny-rounding method and calculate its price to at least a tenth of a cent. However, under the conditions of the proposed rule, a fund may have to so adjust its price under another circumstance. As noted in Release 9786, a fund using penny-rounding may, if the board deems it appropriate, value portfolio securities with less than 60 days until maturity at amortized cost. If the deviation between the amortized cost value of those securities and their current market value were such that the per share net asset value of all the fund's portfolio, rounded to the nearest cent, did not fairly reflect each shareholder's interest in the fund, then pursuant to paragraph (a)(1) of the rule the fund would have to cease to price its shares at one dollar.

#### **Record of Actions Taken to Stabilize Price**

Under paragraph (a)(2)(v) of the proposed rule a money market fund using the amortized cost method must maintain a written record that documents the board's compliance with its obligation to consider and take action where mandated. The rule provides that the documentation, which should include a discussion of all instances where the board considered whether action should be taken and what actions were initiated, must be included in the minutes of the board of directors' meetings and must be preserved for six years. Such documentation must also be made available for inspection by the staff of the Commission. In addition, pursuant to paragraph (a)(2)(vi), if any action is taken pursuant to paragraph (a)(2)(ii)(B) of the rule the board of directors shall cause the fund to file quarterly, as an attachment to Form N-1Q, a statement describing with specificity the circumstances surrounding the action and the nature of action taken. This provision of the proposed rule is a slight departure from the existing orders in that it requires funds to make a filing only if some action was taken.<sup>43</sup> The Commission believes that the modified filing requirement, in conjunction with the board's monitoring, will provide adequate controls over the use of the amortized cost valuation method and is in accord with the purposes of new provisions regarding the filing of N-1Q's and the reduced paperwork burdens thereof.<sup>44</sup>

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<sup>40</sup> The Commission is not proposing to codify such examples in order to avoid any implication that other actions would be inappropriate.

<sup>41</sup> Even without this provision of the rule, the board of directors has an obligation to discontinue a pricing method that does not fairly reflect the value of the fund's securities. As set forth in Release 9786, Section 2(a)(41) requires the board of directors to value the fund's assets at fair value as determined in good faith.

<sup>42</sup> The net asset value must be calculated using market-based values for all instruments other than those with less than 60 days until maturity, which generally may be valued at amortized cost, unless particular circumstances dictate otherwise. See footnote 36, *supra*.

<sup>43</sup> The existing orders require a quarterly filing stating whether or not any action was taken. In order to eliminate differential treatment, the Division will not recommend that the Commission take any action against a fund if it continued to rely on its individual exemptive order but followed the N-1Q reporting requirement contained in the rule.

<sup>44</sup> See Securities Act Release No. 6366 (December 16, 1981), 46 FR 62246 (December 23, 1981).

### Text of Proposed Rule

It is proposed that Part 270 of Chapter II of Title 17 of the Code of Federal Regulations be amended by adding new section § 270.2a-7, as follows:

### Part 270—Rules and Regulations, Investment Company Act of 1940

§ 270.2a-7. Use of the amortized cost valuation and penny-rounding methods by certain money market funds.

(a) The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by a registered investment company (hereinafter referred to as a money market fund), notwithstanding the requirements of Section 2(a)(41) of the Investment Company Act of 1940 [15 U.S.C. 80a-2(a)(41)] and of Rule 2a-4 [17 CFR 270.2a-4] and Rule 22c-1 [17 CFR 270.22c-1] thereunder, may be computed either by use of the amortized cost method of valuation or by use of the penny-rounding method of pricing Provided, That:

(1) The board of directors of the money market fund (trustees in the case of a trust) determines, in good faith based upon a full consideration of all material factors, that, absent unusual circumstances, the valuation or pricing method selected will fairly reflect the value of each shareholder's interest in the money market fund and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the value of each shareholder's interest; and either

(2) In the case of a money market fund using the amortized cost method of valuation:

(i) In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors (trustees) undertakes—as a particular responsibility within the overall duty of care owed to its shareholders—to establish procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase at one dollar;

(ii) Included within the procedures to be adopted by the board of directors (trustees) shall be the following:

(A) Review by the board of directors (trustees), as it deems appropriate and at such intervals as are reasonable in light of current market conditions, to determine the extent of deviation, if any, of the current net asset value per share as determined by using available market quotations from the money market fund's amortized cost price per share, and maintenance of records of such review,

(B) In the event such deviation from the money market fund's amortized cost price per share exceeds ½ of 1 percent, a requirement that the board of directors (trustees) will promptly consider what action, if any, should be initiated by the board of directors (trustees), and

(C) Where the board of directors (trustees) believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders it shall take such action as it deems appropriate to eliminate or reduce to the extent reasonably practical such dilution or unfair results;

(iii) The money market fund will maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share; Provided, however, That the money market fund will not (A) purchase any instrument with a remaining maturity of greater than one year, or (B) maintain a dollar-weighted average portfolio maturity which exceeds 120 days;

(iv) The money market fund will limit its portfolio investments, including repurchase agreements, to those United States dollar-denominated instruments which the board of directors (trustees) determines present minimal credit risks and which are of "high quality" as determined by any major rating service, or in the case of any instrument that is not rated, of comparable quality as determined by the board of directors (trustees);

(v) The money market fund will record, maintain, and preserve permanently in an easily accessible place a written copy of the procedures (and any modifications thereto) described in paragraph (a)(2)(i) above and the money market fund will record, maintain, and preserve for a period of not less than six years (the first two years in an easily accessible place) a written record of the board of directors' (trustees') considerations and actions taken in connection with the discharge of its responsibilities, as set forth above, to be included in the minutes of the board of directors' (trustees') meetings. The documents preserved pursuant to this condition shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act [15 U.S.C. 80a-30(b)] as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act [15 U.S.C. 80a-30(a)]; and

(vi) If any action was taken pursuant to paragraph (a)(2)(ii)(C) above, the money market fund will file a statement describing with specificity the nature and circumstances of such action within 30 days after the close of each calendar quarter during which such action was taken; or

(3) In the case of a money market fund using the penny-rounding method of pricing:

(i) in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors (trustees) undertakes—as a particular responsibility within the overall duty of care owed to its shareholders—to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one cent, will not deviate from one dollar;

(ii) The money market fund will maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable price per share; Provided, however, That the money market fund will not (A) purchase any instrument with a remaining maturity of more than one year, or (B) maintain a dollar-weighted average portfolio maturity which exceeds 120 days; and

(iii) The money market fund will limit its portfolio investments, including repurchase agreements, to those United States dollar-denominated instruments which the board of directors (trustees) determines present minimal credit risks, and which are of "high quality" as determined by any major rating service, or, in the case of any instrument that is not rated, of comparable quality as determined by the board of directors (trustees).

(b) Definitions.

(1) The "amortized cost method of valuation" is the method of calculating an investment company's current net asset value whereby portfolio securities are valued by reference to the fund's acquisition cost as adjusted for amortization of premium or accumulation of discount rather than by reference to their value based on current market factors.

(2) The "penny-rounding method of pricing" is the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one cent based on a share value of one dollar.

(3) The maturity of an instrument shall be deemed to be the period remaining until the date noted on the face of the instrument as the date on which the principal amount owed must be paid, except that:

(i) If the board of directors (trustees) has determined that whenever a new interest rate on a variable or floating rate instrument is established it will then cause the instrument to have a current market value which approximates its par value, (A) an instrument that is issued or guaranteed by the United States government or any agency thereof which has a variable rate of interest readjusted no less frequently than annually may be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate; (B) an instrument which has a demand feature that entitles the holder to receive the principal amount of such instrument upon no more than seven days' notice and which has a variable rate of interest may be deemed to have a maturity equal to the longer of the period remaining until the interest rate will be readjusted or the period remaining until the principal amount owed can be recovered through demand, Provided That the board of directors (trustees) determines no less frequently than quarterly that the instrument is of high quality; (C) an instrument which has a variable rate of interest may be deemed to have a maturity equal to the period remaining

until the next readjustment of the interest rate, Provided That the period remaining until the date noted on the face of the instrument as the date on which the principal amount owed must be paid is one year or less; (D) an instrument which has a demand feature that entitles the holder to receive the principal amount of such instrument upon no more than seven days' notice and which has a floating rate of interest may be deemed to have a maturity equal to the period of time remaining until the principal amount owed can be recovered through demand, Provided That the floating interest rate is adjusted concurrently with any change in an identified market interest rate to which it is pegged and the board of directors (trustees) determines (1) that such floating rate feature will ensure that the market value of such instrument will always approximate its par value, and (2) no less frequently than quarterly that the instrument is of high quality; and

(ii) A repurchase agreement or portfolio instrument lending agreement may be treated as having a maturity equal to the period remaining until the agreement is to be executed.

(4) "One year" shall mean 365 days except in the case of an instrument that was originally issued as a one year instrument but had up to 375 days until maturity one year shall mean 375 days.

STATUTORY BASIS: Proposed Rule 2a-7 is promulgated pursuant to the provisions of Sections 6(c) [15 U.S.C. 80a-6(c)], 22(c) [15 U.S.C. 80a-22(c)] and 38(a) [15 U.S.C. 80a-37(a)] of the Act.

By the Commission.  
George A. Fitzsimmons  
Secretary  
February 1, 1982

## ADOPTION OF REQUIREMENTS REGARDING VALUATION OF DEBT INSTRUMENTS AND COMPUTATION OF CURRENT PRICE PER SHARE BY CERTAIN OPEN-END INVESTMENT COMPANIES (MONEY MARKET FUNDS)

Release No. IC-13380

July 11, 1983

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting a rule regarding the valuation of debt instruments, the calculation of current net asset value per share and the computation of current price per share by certain registered open-end investment companies, commonly referred to as “money market funds.” The rule permits such investment companies, subject to enumerated conditions, either: (1) To value portfolio securities by use of the amortized cost valuation method; or (2) to compute current price per share by rounding the net asset value per share to the nearest one cent, based on a share value of one dollar. Previously, the Commission granted individual orders of exemption to permit use of those valuation or pricing methods. The rule obviates the need for most, if not all, of such applications.

EFFECTIVE DATE: July 18, 1983.

FOR FURTHER INFORMATION CONTACT: H. R. Hallock, Jr., Special Counsel (202-272-3030), or Gene A. Gohlke, Chief Financial Analyst (202-272-2024), Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission is adopting Rule 2a-7 [17 CFR 270.2a-7] under the Investment Company Act of 1940 (“Act”) [15 U.S.C. 80a-1 *et seq.*] to permit, subject to specified conditions, certain open-end investment companies, known as “money market funds,” to compute their current price per share for purposes of distribution, redemption and repurchase by using either: (1) The “amortized cost” method of valuation to value their portfolio instruments for purposes of calculating their current net asset value per share; or (2) the “penny-rounding” method of computing their current price per share.

Under the amortized cost method of valuation, money market funds may calculate their current net asset value for use in computing the current price of their redeemable securities by valuing all portfolio securities and assets, regardless of whether market quotations are readily available, at the acquisition cost as adjusted for amortization of premium or accretion of discount rather than at current market value as would be required by Rule 2a-4 under the Act. [17 CFR 270.2a-4].

Under the penny-rounding method of computation, money market funds calculate their current net asset value in conformance with Rule 2a-4 by valuing portfolio securities for which market quotations are readily available at current market value, and other securities and assets at fair value as determined in good faith by the board of directors. However, they may then compute the current price of their redeemable securities by rounding the net asset value per share to the nearest one cent on a share value of one dollar.

Rule 2a-7 provides that in order to use either of the above valuation or pricing methods a money market fund must comply with certain conditions. Those conditions basically: (1) Limit the types of investments that the money market fund can make to short-term, high quality debt instruments; (2) impose on the board of directors (trustees in the case of a trust; hereinafter referred to as “board of directors” or “board”) of the money market fund a special obligation to ensure that a stable price per share is maintained; and (3) require that the board of directors of the money market fund, in good faith, determine that it is in the best interests of the fund and its shareholders to maintain a stable net asset value or price per share and that the money market fund will discontinue its use of either method if such method ceases to reflect fairly the market-based net asset value per share. In addition, a money market fund using the amortized cost method of valuation must monitor the deviation between the price of its shares computed from a net asset value per share calculated using amortized cost values for its portfolio instruments and the net asset value of such shares calculated using values for portfolio instruments based upon current market factors. If such deviation exceeds ½ of one percent of the price per share



or if the amount of deviation may result in material dilution or other unfair results to shareholders, the rule imposes specific obligations on the board of directors to respond to the situation. Likewise, a money market fund using the penny-rounding method to compute its price per share may have to monitor in a similar fashion the valuation of those portfolio instruments with remaining maturities of sixty days or less<sup>1</sup> that are valued at amortized cost in order to assess the fairness of that valuation method.

The reasons for proposing Rule 2a-7 and the administrative history of the rule are discussed thoroughly in Investment Company Act Release No. 12206 (February 1, 1982) (“Release 12206”), 47 FR 5428 (February 5, 1982). In brief, the rule generally codifies the standards that were developed for granting the applications filed by money market funds for exemption from the pricing and valuation provisions of the Act, with a slight expansion of the types of instruments permitted for purchase. Persons interested in a more detailed discussion of the genesis of the rule should refer to that release.

Rule 2a-7 is designed to obviate the need for individual money market funds to file applications for exemptive orders to permit the use of either penny-rounding or amortized cost methods. In addition, the Commission recognizes that money market funds with existing exemptive orders may wish to rely on the rule rather than their individual orders. The Commission has no objection to money market funds ceasing to rely on their individual exemptive orders and using instead Rule 2a-7 as the basis for their pricing or valuation method, provided that the board of directors of any such money market fund approves the change and the fund makes any necessary disclosure to shareholders. In addition Rule 2a-7 is designed to clarify the obligations of money market funds and their boards of directors when using either the amortized cost or penny-rounding method. As stated in the release proposing Rule 2a-7, the rule is not intended to expand the responsibilities and liabilities imposed upon directors beyond those imposed under the exemptive orders. Guidance provided by this release should be considered generally applicable to a money market fund operating pursuant to an exemptive order or pursuant to Rule 2a-7.

In response to its requests for comments, the Commission received 21 letters. The commentators universally agreed that proposed Rule 2a-7 should be adopted, with certain amendments. A number of commentators, however, expressed strong objections to some of the positions taken by the Commission in Release 12206. Those objections and the Commission’s response are discussed in detail below. As a result of its consideration of the comments, the Commission has determined to adopt Rule 2a-7, subject to several modifications of the proposal, and to issue this release, which will serve, rather than Release 12206, as the operative interpretive vehicle.

## Discussion

Under Rule 2a-7, investment companies that have investment portfolios consisting entirely of U.S. dollar-denominated short-term debt obligations (“money market funds”)<sup>2</sup> may use either the penny-rounding pricing method or the amortized cost valuation method for purposes of computing their price per share on their net asset value per share, respectively, provided that they comply with the conditions enumerated in the rule. Those conditions are designed to ensure that any money market fund that adopts one of the above procedures in an effort to maintain a stable price per share will be able to maintain that stable price.

The conditions contained in the rule, as well as those conditions found in individual exemptive orders, provide for a special system of safeguards to protect the fund. The responsibility for designing and effectuating that system is placed on the board of directors. As a part of that system of safeguards, the directors have undertaken the specific responsibility of

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<sup>1</sup> See footnote 44, *infra*.

<sup>2</sup> The Commission received a comment that the rule should be amended to include this definition of a money market fund. The description has not been added as a definition under the rule because it is not an exclusive definition of a money market fund. The rule permits only an investment company that has the requisite portfolio (e.g., entirely U.S. dollar-denominated short-term debt obligations) to rely upon it, provided that all the conditions of the rule are satisfied. The Division of Investment Management has recently taken the position that it would not object if a money market fund utilizing an amortized cost exemptive order invests, within certain limitations, in shares or units of other investment companies which invest primarily in high quality, short-term municipal instruments and which determine their net asset value based on the amortized cost or penny-rounding methods in reliance on Commission exemptive orders or proposed Rule 2a-7 under the Act when it is adopted. See letter from Gerald Osheroff, Associate Director, Division of Investment Management to John J. Scott, Esquire, on behalf of The Benchmark Tax-Exempt Fund, dated June 28, 1983.

monitoring the market value of the portfolio, in the case of funds using amortized cost valuation, and have represented that the fund will limit investments to those instruments which the board deems to meet certain criteria. Some commentators opined that such responsibilities should be placed on the investment adviser rather than the board of directors. While the Commission realizes that, as a practical matter, board of directors may lack technical expertise and must rely on the investment adviser to provide factual information and advice, it believes that the final responsibility for the fund's operations should remain with the board of directors. The Commission bases its determination on the fact that the board is traditionally the fund's ultimate authority, as well as the possibility of inherent conflicts between the interests of the investment adviser and those of the funds. Accordingly, the rule as adopted continues to place ultimate responsibility for fulfilling the conditions of the exemptive relief on the board of directors.

In stating that certain functions are the responsibility of the board of directors, the rule does not require that the board personally become involved in the day-to-day operations of the fund, nor does the rule require the board to be an insurer of the fund or the fund's investment adviser. The Commission sought in Release 12206 to clarify, through examples, that the board could delegate certain day-to-day functions to the investment adviser and still be in compliance with the rule. However, comments received in response to the rule proposal indicated apparent confusion by some parties who were concerned that the rule would require the board personally to carry out the day-to-day operations of the fund. The Commission recognizes that such a requirement would be inefficient and unrealistic. Therefore, in an effort to clarify its position, the Commission has modified somewhat the language of the rule, as discussed hereinafter.

The rule, like the prior exemptive orders, specifically states that the board shall be responsible for certain functions, such as monitoring the value of the portfolio and determining the quality of its instruments. While the board retains the final responsibility for the operations of the fund and the specific procedures required by the rule, the rule does not preclude the board from delegating duties and functions (to be carried out under its supervision) to the investment adviser. This release set forth in detail some methods by which the board may delegate certain responsibilities and still be deemed to be in compliance with the rule. These examples are not intended to be the exclusive method of compliance. However, they are meant to set forth the Commission's view that a delegation will not be deemed satisfactory where the board's only participation is an approval after the fact. The Commission believes that, at a minimum, the board should have knowledge in advance of how the functions will be performed by the investment adviser; the board should assure itself that such methods are reasonable and provide any guidance necessary; and finally, the board should review periodically the investment adviser's performance.

The rule also provides, under both methods, for the computation of a share price that will represent fairly the current net asset value per share of the investment company, thus reducing any possibility of dilution of shareholders' interests or other unfair results.<sup>3</sup>

Rule 2a-7 provides that money market funds satisfying the necessary conditions may use either the penny-rounding or amortized cost method. In Release 12206 the Commission stated that while a fund which had elected one of the methods was not foreclosed from switching to another method,<sup>4</sup> the rule would not permit a fund to use both methods at the same time, i.e., the amortized cost valuation method to calculate its net asset value per share and rounding of that net asset value to the nearest one cent of a dollar when computing its price per share.<sup>5</sup>

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<sup>3</sup> If shares are sold based on a net asset value which turns out to be either understated or overstated in comparison to the amount at which portfolio investments could have been sold, then either the interests of existing shareholders or new investors will have been diluted.

<sup>4</sup> Prior to any such switch, the board of directors should approve such action and any necessary disclosure should be made to shareholders.

<sup>5</sup> See footnote 5 of Release 12206.

The Commission received a substantial number of comments expressing the view that money market funds using the amortized cost valuation method should be permitted to penny-round when computing their price per share. These commentators argued that without the ability to penny-round, funds using the amortized cost valuation method would be disadvantaged, and that the ½ of 1 percent limitation on the deviation of the price away from the market-based net asset value per share would limit the amount of rounding to the equivalent of that used by funds under the penny-rounding method. After considering these comments, the Commission has determined that it is appropriate to permit funds using the amortized cost valuation method to round to the extent permitted to funds opting to use the penny-rounding method, i.e., the deviation between the price per share and the market based net asset value per share may not exceed ½ of 1 percent.

While the Commission is proposing to permit a fund using the amortized cost valuation method to round its net asset value per share beyond the extent considered material as set forth in Investment Company Act Release No. 9786 (May 31, 1977) (“Release 9786”), 42 FR 28999 (June 7, 1977)<sup>6</sup> in computing its price per share, it emphasizes the responsibilities of the board when such a method is used. A basic premise justifying the use of the amortized cost valuation method is the fact that securities held until maturity will eventually yield a value equivalent to the amortized cost value, regardless of the current disparity between amortized cost value and market value. Thus, the Commission is willing to permit funds to use amortized cost valuation so long as the disparity between the amortized cost value and current market value remains minimal. Funds using the amortized cost valuation method may need to use penny-rounding in computing their price per share when a gain or a loss in the value of their portfolio, which was not offset against earnings, is recognized. Where the gain or loss has been recognized, there is no longer merely a potential for a deviation between the value assigned by the fund for the securities sold and that actually realized by the fund. The Commission does not wish to define the permissible amount of deviation. However, to the extent a fund has realized gains or losses that cause the fund’s price per share to deviate from the amortized cost net asset value per share, the board must be particularly careful to ensure that the fund can maintain a stable price per share. The fact that a fund may penny-round while utilizing amortized-cost valuation does not, of course, diminish the board’s responsibility to monitor the market-based net asset value, nor does it increase the permissible deviation between share price and market-based asset value.

### Permissible Portfolio Investments

The rule, like the previously granted exemptive orders, is designed to limit the permissible portfolio investments of a money market fund seeking to use either penny-rounding or the amortized cost valuation method to maintain a stable price per share to those instruments that have a low level of volatility<sup>7</sup> and thus will provide a greater assurance that the money market fund will continue to be able to maintain a stable price per share that fairly reflects the current net asset value per share of the fund. Accordingly, money market funds relying on the rule may purchase only those portfolio instruments which meet the quality and maturity requirements of the rule.<sup>8</sup> The rule, however, would not prohibit a money market fund from holding cash reserves. It should be noted that the rule does not speak to the acquisition or valuation of puts or stand-by commitments by a money market fund wishing to use the subject valuation or pricing

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<sup>6</sup> Release 9786 sets the amount of less than 1/10 of one cent on a share value of one dollar as the frenchmark for materiality

<sup>7</sup> There are basically two types of risk which cause fluctuations in the value of money market fund portfolio instruments: the market risk, which primarily results from fluctuations in the prevailing interest rate, and the credit risk. In general, instruments with shorter periods remaining until maturity and which are of higher quality have reduced market and credit risks and thus tend to fluctuate less in value over time than instruments with longer remaining maturities or of lesser quality.

<sup>8</sup> The applications for exemptive relief have routinely set forth the specific types and quality of instruments in which money market funds could invest. The instruments consisted exclusively of debt obligations, including such instruments as treasury bills and notes and other government issued or guaranteed debt securities, certificates of deposit and time deposits from domestic banks and thrift institutions and from foreign banks, bankers’ acceptances of domestic and foreign banks, commercial paper, corporate bonds and notes and repurchase agreements on other debt obligations. While the rule does not set out the various types of debt instruments in which a money market fund relying on the rule may invest, the rule does require that all portfolio instruments mature in one year or less and be of high quality. The types of instruments a particular fund may invest in are, of course, further limited by its choice of investment policy. See also, footnote 2, *supra*.

methods.<sup>9</sup> The Commission has granted exemptive orders to permit the acquisition of puts, but thus far, only under limited circumstances and subject to certain conditions.<sup>10</sup> Accordingly, a fund requiring exemptive relief in order to acquire puts or standby commitments must still seek an individual exemptive order. If in the future the issues concerning the acquisition of puts are resolved, the rule may be amended.

### Maturity of Portfolio Instruments

A money market fund may rely on the rule only if its entire investment portfolio consists of instruments with a remaining maturity of one year or less. As prescribed in the rule, which is generally a codification of positions taken by the Commission regarding the conditions contained in the exemptive order, the maturity of an instrument generally is deemed to be its stated maturity, with a special exception provided for certain variable and floating rate paper. Accordingly, an instrument is deemed to satisfy the one year or less maturity requirement for purposes of the rule if, on the date of purchase<sup>11</sup> by the money market fund: (i) The instrument, regardless of the length of maturity when originally issued, currently has no more than 365 days remaining until the principal amount owed is due to be paid, or, in the case of an instrument called for redemption, until the date on which the redemption payments must be paid,<sup>12</sup> or when originally issued, the principal amount due was to be paid in not more than 375 days<sup>13</sup>, (ii) where the instrument has a variable rate of interest<sup>14</sup> and is issued or guaranteed by the United States government or any agency thereof, it has no more than 365 days remaining until the next readjustment or renegotiation of the interest rate to be paid, regardless of the stated maturity of the instrument, and the board of directors has determined that it is reasonable to expect<sup>15</sup> that

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<sup>9</sup> The Commission considers the terms puts and standby commitments to encompass any agreement by a third party to purchase, at some future date and at a prescribed price, a security issued by another party. Hence, instruments which include a demand feature where the demand obligation runs to a third party will be considered to be subject to a put. Compare the investments made by Daily Tax Free Income Fund, Inc. (File No. 2-78513), in participation interests issued by banks in industrial development bonds, which were regarded as instruments having a demand feature running to the issuer and not instruments subject to puts, and a letter to the Honorable Lee Sherman Dreyfus, Governor of Wisconsin, dated October 22, 1982 (publicly available March 3, 1983), discussing the applicability of proposed Rule 2a-7 to proposed bonds.

<sup>10</sup> See, e.g., Investment Company Act Release No. 11867 (July 21, 1981). The Commission intends to propose a rule in the near future which will include, among other measures, a codification of orders granted under Section 12(d)(3) [15 U.S.C. 80a-12(d)(3)] to permit the acquisition of puts from brokers or dealers for limited purposes.

<sup>11</sup> The date of purchase is regarded as the date on which the fund's interest in the instrument is subject to market action. Thus, for securities purchased under normal settlement procedures, the length of maturity would be calculated starting on the trade date. For instruments such as "when issued" securities (securities purchased for delivery beyond the normal settlement date), if the commitment to purchase the instrument includes either a set price or yield, then the maturity will be calculated based upon the commitment date. See also Investment Company Act Release No. 10666 (April 18, 1979) 44 FR 25128 (April 27, 1979) for a discussion of other issues raised by the purchase of instruments that subject the fund to risk prior to the actual inclusion of the instrument in the fund's portfolio.

<sup>12</sup> This portion of the definition of "one year" was expended from that contained in the proposed rule in response to comments received by the Commission. Under the rule an instrument would be deemed to have a maturity of one year or less if either that particular instrument or the entire issue was to be redeemed within the year period. When determining whether an instrument called for redemption presents minimal credit risks to the fund (conditions (a)(2)(iv) and (a)(3)(iii)) the board should consider the risk that the obligation will not be honored on the redemption date.

<sup>13</sup> This part of the definition has been extended beyond the usual definition of one year (365 days) to encompass securities, particularly government securities such as project notes, which are denominated as and intended to be "one year" notes but which occasionally are issued with maturities slightly longer than 365 days. (See Investment Company Act Release No. 11679 (March 11, 1981).) This part of the definition is not meant to encompass securities which were originally issued and intended to be longer than "one year" instruments. Those instruments could be purchased by a money market fund relying on this rule only if they have 365 or fewer days remaining until maturity.

<sup>14</sup> Variable rate instruments are those instruments whose terms provide for automatic establishment of a new interest rate on set dates.

<sup>15</sup> The language of this requirement was modified from that originally . . . proposed to clarify that the rule requires only that the board make a reasonable evaluation of the instrument, not be insurers of the instrument.

when the rate is readjusted it will cause the instrument to have a current market value which approximates its par value;<sup>16</sup> (iii) the instrument (a) has a demand feature which allows the fund unconditionally to obtain the amount due from the issuer<sup>17</sup> upon notice of seven days or less,<sup>18</sup> (b) has either a floating rate of interest<sup>19</sup> or a variable rate of interest that is readjusted no less frequently than once per year,<sup>20</sup> where, in the case of a variable rate instrument, the board of directors has determined that it is reasonable to expect that whenever a new rate is established it will cause the instrument to have a current market value which approximates its par value and in the case of a floating rate instrument the board has determined that it can reasonably conclude that such floating rate feature will operate in such a way that the market value of such instrument will always approximate its par value,<sup>21</sup> and (c) will be reevaluated by the board at least quarterly to ensure that the instrument is of high quality;<sup>22</sup> or (iv) where the instrument is a repurchase agreement or an agreement upon which portfolio instruments are lent (“portfolio instrument lending agreement”)<sup>23</sup> regardless of the maturity of the securities serving as collateral for the agreement, the repurchase is scheduled to occur or the loaned securities are scheduled to be returned within 365 days or less.<sup>24</sup>

The rule places the ultimate responsibility for the quarterly quality determinations and the determinations about the readjustment of the interest rate on the board of directors. However, the day to day functions involved in making such

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<sup>16</sup> This definition, which goes beyond a codification of orders issued, was expanded based upon the Commission’s understanding that the volatility of such instruments would not be greater than the volatility of fixed interest rate instruments having a maturity equal to the readjustment period of the U.S. government guaranteed variable rate notes. However, the Commission’s position is based entirely upon experience with Small Business Administration guaranteed debentures (“SBA notes”) which are the only instruments currently falling within this category so far as the Commission is aware. Accordingly, the board of directors of a money market fund considering investment in any such instrument other than a SBA note should, as a part of its overall duty to supervise the operations of the fund to ensure stability, determine that it can expect the volatility of such notes not to differ materially from the volatility of fixed rate notes of the same quality. Moreover, the Commission will consider amendment of this or any other provision of the rule if market experience indicates that it is inappropriate to the rule’s overall purposes.

<sup>17</sup> In theory, the existence of a demand feature alone, i.e., with no variable or floating rate feature, should be sufficient to enable a fund to maintain a stable net asset value per share because the holder could receive the principal amount of the instrument in a short period of time regardless of market and creditworthiness changes. However, the Commission has insufficient evidence the (1) funds will exercise such a demand feature whenever interest rates increase or the creditworthiness of the issuer is reduced and (2) there is a market for such instruments and even if there is, whether it always evaluates the instrument at a price approximating its par value. The demand feature, however, must run to the issuer. *See* footnote 9, *supra*.

<sup>18</sup> A demand note subject to a notice period of five business days would be deemed to satisfy this provision of the rule even if intervening weekends and holidays could cause the notice period, under same circumstances, to run more than seven calendar days.

<sup>19</sup> Floating rate instruments are those instruments whose terms provide for automatic adjustments of their interest rates whenever some other specified interest rate changes, where such specified interest rate is changed as market conditions change, rather than upon some periodic basis.

<sup>20</sup> *See* application of Municipal Fund for Temporary Investment. (File No. 812-4970) filed September 15, 1981, ordered March 5, 1982, (Investment Company Act Release No. 12278); and letter from Gerald Osheroff, Associate Director, Division of Investment Management to Joel T. Matcovsky, Merrill Lynch Asset Management, Inc., dated December 10, 1981.

<sup>21</sup> By this requirement, the Commission does not expect the board to be an insurer of the instrument. However, the provision requires that the instrument be evaluated as to whether an expectation of reaching the result set forth in the rule is reasonable.

<sup>22</sup> If the instrument were ever deemed to be of less than high quality, the fund either would have to sell the instrument or exercise the demand feature, whichever were more beneficial to the fund.

<sup>23</sup> Repurchase agreements may be regarded as securities issued by the entity promising to repurchase the underlying security at a later date (*see* Securities Act Release No. 6351 (September 25, 1981), *46 FR 48637* (October 2, 1981) and Investment Company Act Release No. 10666 (April 18, 1979), *44 FR 25126* (April 27, 1979).) Therefore, a money market fund is generally prohibited by the provisions of Section 12(d)(3) of the Act [*15 U.S.C. 80a-12(d)(3)*] from acquiring a repurchase agreement issued by a broker or dealer unless it structures the repurchase arrangement in accordance with the manner described in the Investment Company Act release, which is designed to ensure that the investment company’s investment, including accrued interest earned, is fully collateralized. *See however*, footnote 31, *infra*. The same analysis may apply to portfolio instrument lending agreements.

<sup>24</sup> Repurchase agreements and portfolio instrument lending agreements which have no specified date, but rather are subject to demand, have generally been regarded as having a maturity equal to the notice period required. The rule as adopted reflects this treatment.

determinations may be delegated by the board to the investment adviser, so long as the delegation is done in a reasonable fashion, meeting the standards for reasonable board oversight articulated elsewhere in this release.<sup>25</sup>

### **Maturity of the Portfolio**

In addition to requirements regarding the maturity of individual portfolio investments, the rule imposes restrictions on the dollar-weighted average maturity of the entire portfolio. Paragraphs (a)(2)(iii) and (a)(3)(ii) of the rule provide that a money market fund must maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable price per share. This provision imposes an obligation on the directors of the fund to ascertain that the fund is maintaining an average portfolio maturity that, given the then current market conditions, will permit it to maintain a stable price or net asset value per share. During periods of higher volatility in the market, the board of directors should be aware of the greater difficulty in maintaining a stable price or net asset value per share and should take steps to ensure that they are providing adequate oversight to the money market fund. In addition, the rule provides that in no event shall the fund maintain a dollar-weighted average portfolio maturity that exceeds 120 days. Should the disposition of a portfolio instrument or some market action cause the dollar-weighted average portfolio maturity to exceed 120 days, the board of directors is obligated to cause the fund to invest its available cash in a way that will reduce its dollar-weighted averaged portfolio maturity to 120 days or less as soon as reasonably practicable.

For purposes of computing the average portfolio maturity, instruments generally will be deemed to have a maturity equal to the period remaining until the date of maturity of the instrument noted on its face. Instruments which have been called for redemption are deemed to have a maturity equal to the period remaining until the redemption payment is to be made. Certain variable or floating interest rate instruments, which meet the conditions enumerated in the prior section of this release and are deemed to have a remaining maturity of one year or less for purposes of the rule,<sup>26</sup> may be treated as having a maturity other than that noted on the face of the instrument. Any such variable rate instruments with demand features may be deemed to have a maturity equal to the longer of the period remaining until the next rate readjustment or the period remaining until the principal amount can be recovered through demand.<sup>27</sup> Any such floating interest rate instruments with a demand feature may be treated as having a maturity equal to the period remaining until the principal amount due on the instrument can be recovered through demand.<sup>28</sup> Any such variable rate instruments (issued or guaranteed by the U.S. government or an agency thereof) that do not have a demand feature may be treated as having a maturity equal to the period remaining until the next calculation of the interest rate rather than the period remaining until the principal amount is due. Repurchase agreements and portfolio instrument lending agreements shall be treated as having a maturity equal to the period remaining until the repurchase is scheduled to occur or the loaned-instruments are scheduled to be returned. When no date is specified but the agreements are subject to demand,

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<sup>25</sup> Money market funds investing in, or seeking to invest in, an instrument with a maturity not falling within one of the above-described categories (i) through (iv) would not be able to rely upon the rule to permit the use of either penny-rounding or the amortized cost valuation method. Thus, funds wishing to invest in other types of instruments will have to file individual applications for exemptive relief.

<sup>26</sup> See the discussion on Maturity of Portfolio Instruments, which sets forth the conditions that must be fulfilled in order for the maturity to be deemed a period other than that remaining until the maturity date noted on the face of the instrument.

<sup>27</sup> Because certain of such variable rate demand instruments may not be readily marketable, the demand notice period may be the shortest period during which the holder may practically expect to bear the market risk associated with the instrument. However, because the Commission believes that the demand features of such instruments are seldom used except for liquidity purposes, holders will usually be exposed to market risk during the period remaining to the date of the next interest rate adjustment.

<sup>28</sup> If the board determined that a demand instrument, either floating or variable rate, were no longer of high quality, the fund could not base its maturity on the period remaining until recalculation of the interest rate or on the demand period, but, as noted at footnote 22 *supra*, would have to exercise the demand feature or sell the instrument, whichever were more beneficial to the fund.

the maturity shall be based upon the notice period required.<sup>29</sup> Finally, although variable rate instruments with neither a United States government or government agency guarantee nor a demand feature may be purchased only if the period until the maturity date set on the face of the instrument is one year or less, the rule will permit, for purposes of determining the dollar-weighted average maturity of the entire portfolio under the rule, such instruments to be treated as having a maturity equal to the period remaining until the next readjustment of the interest rate, provided that the board determines that it is reasonable to expect that the new rate will cause the instrument to have a current market rate which approximates its par value.<sup>30</sup>

### Quality of Portfolio Instruments

In addition to the above limitations on the maturity of the portfolio of a money market fund seeking to rely on the rule, paragraphs (a)(2)(iv) and (a)(3)(iii) of the rule contain conditions relating to the quality of all portfolio instruments. The rule provides that each portfolio instrument must be denominated in United States dollars and must also be an instrument which: (1) The board had determined presents minimal credit risks to the fund; and (2) is rated “high quality” by a major rating service or, if the security is unrated, is determined by the board to be of comparable quality.<sup>31</sup>

The Commission received conflicting comments regarding the quality standards that should be imposed under the rule. Some commentators believed that the rule should rely totally upon fund management to judge the quality of instruments and recommended deleting the requirement that the instruments, if rated by a third party, receive a high quality rating. Other commentators suggested that the requirement that the board find that the instrument presents minimal credit risks is superfluous and that the rule should require only a finding of high quality. Regardless of what standard was imposed, a substantial number of commentators believed that the board should not be involved in the quality determination at all, and that the determination should be made by the investment adviser.

The Commission believes that both tests are significant and, therefore, has retained both in the rule. The requirement that a security have a high quality rating provides protection by ensuring input into the quality determination by an outside source. However, the mere fact that an instrument has or would receive a high quality rating may not be sufficient

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<sup>29</sup> Although repurchase agreements (“repos”) will be treated as having a maturity based upon the length of the agreement and not the maturity of the instruments which serve as collateral, the board of directors should be aware of the risks involved with the purchase of repos that are collateralized by instruments with remaining maturities of greater than one year. If the issuer of the repo should default, the instrument serving as collateral would become a part of the money market fund’s portfolio. Instruments with longer maturities generally have greater volatility and thus would expose the fund to a greater risk of an unstable price per share. Moreover, the instrument would not satisfy the provisions defining permissible portfolio instruments. Therefore, the Commission would take the position that such a security should not become a part of the portfolio and must be disposed of as soon as possible. Of course, if the default is due to bankruptcy, the fund may be unable to perfect its possession of the collateral. (See footnote 31, *infra*.) The same analysis would apply to transactions where the money market fund loans portfolio instruments and instruments having maturities of greater than one year are received as collateral for the loan. If the borrower defaults, the fund would be left with instruments which would not meet the provisions of the rule. Under the same analysis, these instruments should not become a part of the portfolio and must be disposed of as soon as possible.

<sup>30</sup> This provision reflects a slight expansion of the relief given through exemptive order, which required periods of renegotiation to be 30 days or less and the remaining maturity of the instrument to be 180 days or less. (Investment Company Act Release No. 11679 (March 11, 1981).)

<sup>31</sup> With regard to investments in repurchase agreements (“repos”), the Commission believes that in determining whether the investment meets the quality provisions of the rule, the board must look both to the quality of the issuer of the promise to repurchase as well as the quality of the underlying collateral. More specifically, in determining whether the repo presents minimal credit risks, the fund must assess the credit risk involved in getting payment in a timely fashion. That assessment must include an evaluation of the issuer’s creditworthiness as well as the creditworthiness of the collateral, since the financial position of the issuer may affect the fund’s ability to obtain the collateral. Given the uncertain status of repos under the Bankruptcy Code, mutual funds face certain risks if they invest in repos issued by a party that subsequently initiates bankruptcy proceedings. See, e.g., *In re Lambard-Wall, Inc., Reorganization Case No. 82 Bkcy 11586 (EJR) (Bankr. S.D.N.Y., filed Aug. 12, 1982)*. Investment Company Act Release No. 13005 (February 2, 1983), *48 FR 5894* (February 9, 1983) sets forth specific suggestions concerning factors that may assist funds in evaluating the creditworthiness of repo issuers. Although the board must look to both the issuer of the repo and the underlying collateral when determining minimal credit risk, the Commission believes that in making a “high quality determination” it is appropriate for the board to look solely to the quality of the underlying collateral.

The Commission regards only that portion of the agreement which is fully collateralized to be the “repurchase agreement” subject to the treatment discussed above. Any agreement or portion of an agreement which is not fully collateralized would be regarded as an unsecured loan. As such, the loan itself would be required to meet the quality requirements set forth in the rule, both in terms of presenting minimal credit risks and high quality rating.

to ensure stability. The Commission believes that the instrument must be evaluated for the credit risk that it presents to the particular fund at that time in light of the risks attendant to the use of amortized cost valuation or penny-rounding. Moreover, the board may look at some aspects when evaluating the risk of an investment that would not be considered by the rating services.

As stated earlier, the Commission believes that the ultimate responsibility for the quality of portfolio instruments should be placed on the board of directors, who have undertaken special responsibilities designed to ensure stability of the fund. However, as discussed earlier, although the rule provides that the fund will invest only in those instruments which the board has determined to be of sufficient quality, the Commission will not object to the delegation of the day-to-day function of determining quality, provided that the board retains sufficient oversight. An example of acceptable delegation would be for the board to set forth a list of “approved instruments” in which the fund could invest, such list including only those instruments which the board had evaluated and determined presented minimal credit risks.<sup>32</sup> The board could also approve guidelines for the investment adviser regarding what factors would be necessary in order to deem a particular instrument as presenting minimal credit risk. The investment adviser would then evaluate the particular instruments proposed for investment and make only conforming investments. In either case, on a periodic basis the board should secure from the investment adviser and review both a listing of all instruments acquired and a representation that the fund had invested in only acceptable instruments. The board, of course, could revise the list of approved instruments or the investment factors to be used by the investment adviser.

Again, these examples are not meant to set the exclusive methods by which the board could fulfill its responsibilities. However, they are meant to provide guidance as to what the Commission would consider adequate oversight. Generally, adequate oversight would involve the board satisfying itself in advance that the methods to be used by the adviser in fulfilling the functions are correct, and then reviewing the adviser’s actions. However, the Commission is of the view that the board would not be complying with the requirement to review the quality of the fund’s portfolio instruments if it merely approved the transactions in which the fund engaged, after the fact.

In order to fulfill the rule’s requirements that the instruments be rated “high quality,” the instruments, if rated, must have been given a rating by a major financial rating service such as Standard & Poor’s Corporation, Moody’s Investors Services or Fitch Investors Service<sup>33</sup> that would be considered high quality.<sup>34</sup> Even if the board of directors believes that the rating service incorrectly rated the instrument too low or that because of changed circumstances the instrument is now of higher quality, this provision of the rule precludes a money market fund which is relying on the rule from investing in any rated instrument which does not have a “high quality” rating.<sup>35</sup>

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<sup>32</sup> The Commission envisions that the investment adviser would provide the board with the data to evaluate the instruments and make its assessment.

<sup>33</sup> Standard & Poor’s Corporation (“Standard & Poor’s”), Moody’s Investors Services (“Moody’s”) and Fitch Investors Service (“Fitch”) are set forth as examples of rating services that are considered by the Commission to meet the definition of a major financial rating service. The Commission does not intend to prescribe that the ratings must come only from one of these three services.

<sup>34</sup> Using bonds as an example, Moody’s defines “high quality” for bonds to be those instruments which receive an Aaa or Aa rating. Similarly, the Commission would consider bonds rated AAA or AA by Standard & Poor’s or by Fitch to be high quality. Therefore, a money market fund seeking to rely on this rule could invest only in bonds which were rated AA (Aa) or better. Commercial paper receiving one of the two top ratings (Prime-1 or 2, A-1 or 2, or Fitch-1 or 2) also would be considered high quality. The rule requires only that an instrument receive a “high quality” rating from one major financial rating service. In a case where an instrument received different ratings from different services, the instrument would be an acceptable investment so long as at least one rating was a high quality rating and provided that the board found that the instrument presented minimal credit risks.

<sup>35</sup> However, a rated instrument that is subject to some external agreement (such as a letter of credit from a bank), where such external agreement was not considered when the instrument was given its rating, for purposes of this rule, will be considered an unrated security. The Commission believes that agreements such as letters of credit can significantly affect the credit risk associated with an instrument. Therefore, since the security may have significant characteristics which are not included in the rating, it is appropriate to consider a security subject to an external agreement, as an unrated security, and thus permit the board to determine whether the instrument, taking into account the external agreement, is of comparable quality.

If the board were to consider an external agreement as a basis for judging the quality of an underlying security, that external agreement would have to be unconditional and have terms coextensive with those of the underlying security. Moreover, the instrument could not be judged to be of better quality than that of comparable debt securities of the issuer of the external agreement. It should be noted however, that if the rating service included the external agreement in its calculation of the rating, the instrument will be regarded as a rated instrument, regardless of the board’s lack of concurrence with the rating.



If an instrument has received no rating from a major rating service, then, assuming that the board has found that it presents minimal credit risks to the fund, it would be a permissible investment under the rule, provided that the board also finds that the instrument is of “comparable quality” to that of instruments that are rated “high quality”.<sup>36</sup>

In meeting the rule’s requirement that the fund invest only in those securities which the board determines to meet certain quality standards, the board may delegate to the investment adviser the responsibility for investigating and judging the creditworthiness of particular instruments. However, like the procedures discussed above, the board must exercise sufficient oversight if it wishes to delegate this function to the investment adviser. Again, sufficient oversight would involve the board setting guidelines, its approval of the adviser’s methods in advance and routine surveillance of the adviser’s performance.

### Liquidity of the Portfolio

While the rule does not limit a money market fund’s portfolio investments solely to negotiable and marketable instruments, money market funds, like all open-end management investment companies, are subject to limitations on restricted or illiquid securities. In Investment Company Act Release No. 5847 (October 21, 1960), *35 FR 19989* (December 31, 1970) (“Release 5847”), the Commission set forth its view that, because an open-end company has an obligation to value its portfolio correctly and to satisfy all redemption requests within the statutorily prescribed period, it must limit its acquisition of restricted securities and other securities not having readily available market quotations to the extent necessary to ensure that it can fulfill its obligations. In addition, the Commission took the position that, in light of those obligations, in no event should the percentage of such securities exceed ten percent of the company’s net assets. Money market funds relying on the rule, like any other open-end management company, must limit their portfolio investments in illiquid instruments<sup>37</sup> to not more than ten percent of their net assets.<sup>38</sup> However, because of the nature of money market funds, the difficulties that could arise in conjunction with the purchase of illiquid instruments by such funds might be even greater than for other types of open-end management investment companies. Therefore, the board of directors of a money market fund relying on the rule may have a fiduciary obligation to limit further the acquisition of illiquid portfolio investments.

While the Act requires only that an investment company make payment of the proceeds of redemption within seven days,<sup>39</sup> most money market funds promise investors that they will receive proceeds much sooner, often on the same day that the request for redemption is received by the fund. In addition, most money market funds, because they are primarily vehicles for short-term investments, experience a greater and perhaps less predictable volume of redemption transactions than do other investment companies. Thus, a money market fund must have sufficient liquidity to meet redemption requests on a more immediate basis. By purchasing or otherwise acquiring illiquid instruments, a money market fund exposes itself to a risk that it will be unable to satisfy redemption requests promptly.

In addition, as set forth in Release 5847, management of the investment company’s portfolio could also be affected by the purchase of illiquid instruments. If the investment company found that it was forced to sell portfolio instruments in order to satisfy redemptions, it might sell marketable securities which it would otherwise wish to retain in order to avoid attempting to dispose of non-negotiable instruments or other illiquid instruments, since the sale of non-negotiable or illiquid securities would necessitate the money market fund’s accepting a reduced price. The judgment concerning which securities would be retained would no longer be based upon comparative investment merit. Therefore, the board

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<sup>36</sup> As noted above, provided that certain conditions are met, third party agreements may be analyzed in evaluating whether an instrument is of sufficient quality.

<sup>37</sup> Illiquid instruments, in this context, would generally encompass any instrument which cannot be disposed of promptly and in the usual course of business without taking a reduced price. This would include, but is not limited to, repurchase agreements for greater than seven days, non-negotiable instruments, and instruments for which no market exists. But *cf.* the discussion in the text preceding footnote 45, *infra*, of the treatment of a non-negotiable instrument, which may be redeemed with the issuer subject to a penalty. Where the fund is using amortized cost valuation, such an instrument need not be regarded as an illiquid security if, when the fund monitors the deviation, it uses a market value for such security, which includes the effect of the penalty charge.

<sup>38</sup> In the event that changes in the portfolio or other external events cause the investments in illiquid instruments to exceed ten percent of the fund’s net assets, the fund must take steps to bring the aggregate amount of illiquid instruments back within the prescribed limitations as soon as reasonably practicable. However, this requirement generally would not force the fund to liquidate any portfolio instrument where the fund would suffer a loss on the sale of that instrument.

<sup>39</sup> Section 22(e) of the Act [*15 U.S.C. 80a-22(e)*].

of directors has a particular responsibility to ensure that when a money market fund purchases or acquires illiquid instruments, such instruments will not impair the proper management of the fund.

Finally, the purchase of illiquid instruments can seriously complicate the valuation of a money market fund's shares and can result in the dilution of shareholders' interests. If illiquid instruments which were valued at amortized cost were disposed of at a reduced price, then, in retrospect, the net asset value of the money market fund would have been overstated. Similarly, if illiquid instruments were valued at a discounted value (to compensate for the possibility that they may have to be disposed of prior to maturity), but were held to maturity and thus yielded their full value, the net asset value of the money market fund would have been understated. Regardless of the types of instruments purchased, the board of directors of a money market fund is under the same obligation to ensure that the price per share correctly reflects the current net asset value per share of the fund. Therefore, when a fund purchases illiquid instruments, the board of directors has a fiduciary duty to ascertain that the fund is operated in such a manner that the purchase of such instruments does not materially affect the valuation of the fund's shares.

### **Obligation of the Board to Maintain Stable Price**

A money market fund that describes itself in its prospectus as having or seeking to maintain a stable price per share through portfolio management and use of a special pricing or asset valuation method has an obligation to its shareholders to continue the chosen method so long as it is consistent with the provisions of the Act, until shareholders are notified of a change in policy. The Commission believes that where a money market fund adopts either the amortized cost valuation or penny-rounding pricing method under the rule to enhance its ability to maintain a stable price it has a heightened responsibility to shareholders to maintain that stable price. Accordingly, under paragraphs (a)(2)(i) and (a)(3)(i) of the rule, the board of directors of a money market fund wishing to use either penny-rounding or the amortized cost valuation method has a particular obligation to assure that the fund is managed in such a way that a stable price will be maintained.

The rule as originally proposed contemplated that funds using either the amortized cost method or penny-rounding method would stabilize their net asset value per share or their price per share, respectively, at \$1.00. In so doing the Commission did not wish to foreclose funds from using a single stabilized value other than \$1.00, but was merely codifying what seemed to be an industry practice. The Commission received a few comment letters which expressed the desire to have some flexibility in the value at which a fund would be stabilized. Therefore, paragraphs (a)(2)(i) and (a)(3)(i) of the rule were revised to permit funds using amortized cost or penny-rounding to stabilize the net asset value per share or price per share, respectively, at a single value, rather than specifically at \$1.00.

For a fund seeking to use the amortized cost valuation method, the board of directors has a responsibility to establish procedures reasonably designed to stabilize the fund's net asset value per share. For a fund seeking to use the penny-rounding method, the board of directors has a responsibility, through its supervision of the fund's operations and delegation of special responsibilities to the investment adviser, to assure, to the extent reasonably practicable, that the money market fund's price per share remains stabilized at the single value selected.<sup>40</sup>

Testimony by witnesses from the investment company industry presented at the hearings on the original applications for amortized cost valuation alleged that with the limitations on quality and length of maturity provided, short of extraordinarily adverse conditions in the market, a money market fund that is properly managed should be able to maintain a stable price per share.<sup>41</sup> The orders granting exemptive relief and this rule, which codifies those orders, are premised on that representation. Therefore, the Commission believes that if a money market fund relying on this rule is unable to maintain a stable net asset value per share, and this inability is not due to highly unusual conditions affecting

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<sup>40</sup> The rule mandates that the board net in some specific ways to fulfill its responsibility to ensure a stable net asset value or price: having the fund maintain an appropriate dollar-weighted average maturity and permitting the fund to invest only in instruments which present a minimal credit risk and are of high quality. Thus, for example, it appears that the board of directors should, absent extenuating circumstances which would cause such action not to be in the best interest of the fund, cause the money market fund to dispose of any security as soon as practicable, if the quality of that instrument falls below "high quality." See also footnote 22, *supra*.

<sup>41</sup> *In the Matter of InterCapital Liquid Asset Fund, Inc., et al.*, Admin. Proc. 3-5431, December 20, 1978, at 1414.

the money markets in general, there is a strong presumption that the board of directors has not fulfilled its obligation to ensure that the fund is properly managed.<sup>42</sup>

### Monitoring the Fairness of the Valuation or Pricing Method

In addition to the restrictions on the types of portfolio investments that may be made, the provisions of the rule impose obligations on the board of directors to assess the fairness of the valuation or pricing method and take appropriate steps to ensure that shareholders always receive their proportionate interest in the money market fund. Paragraph (a)(1) of the rule provides that the board of directors of each money market fund relying on the rule must determine that the valuation or pricing method selected is in the best interests of the shareholders of the fund. That finding must be made prior to the implementation of the selected method, and the board must continue thereafter to believe that the method fairly reflects the market-based net asset value per share.<sup>43</sup> Moreover, the minutes should reflect the finding and include the factors that were considered by the board and the board's analysis of those factors in reaching its conclusion. The rule imposes an obligation on the board to discontinue the use of the selected valuation or pricing method if it ceases to reflect fairly the market-based net asset value per share. In that case, the fund's current price and net asset value per share would ordinarily have to be determined in conformance with the provisions of Section 2(a)(41) of the Act [*15 U.S.C. 80a-2(a)(41)*] and Rules 2a-4 and 22c-1 thereunder [*17 CFR 270.2a-4 and 270.22c-1*].

In addition to the general obligation to assess the fairness of the valuation or pricing system, paragraph (a)(2)(ii) of the rule requires the board of a money market fund relying on this rule and using the amortized cost method of valuation to adopt procedures whereby the board periodically will review the monitoring of the deviation between the per share net asset value based on the market value of the portfolio ("market-based value") and the price per share computed from a net asset value per share calculated using the amortized cost valuation of the portfolio, which must be performed at intervals that are deemed appropriate by the board and are reasonable in light of current market conditions. In addition, the rule requires the maintenance of a record of both functions. The rule does not prescribe specific intervals for such monitoring; however, the board must select intervals that are reasonable "in light of current market conditions." This means that the reviews should be frequent enough so that the board may become aware of changes in the market-based per share net asset value before they become material. During periods of high market volatility, this requirement may necessitate that the deviation between such market-based value and price be monitored on a daily basis. During periods of lower volatility, it may be reasonable to monitor such deviation less frequently.

As with other functions required by the rule, the board is not compelled to perform the actual day-to-day monitoring itself. That function may be performed by the investment adviser or some other entity. However, the board is ultimately responsible for the monitoring function. The board does not fulfill its responsibility to review such monitoring by merely requiring the investment adviser to notify it at some designated benchmark, unless the board has a reasonable basis for believing that the portfolio is being correctly and appropriately monitored. In order to have such a reasonable basis, the Commission believes that the board should assure itself that the intervals between monitoring will be changed as appropriate to be responsive to changing market conditions and that the monitoring process will include an appropriate method to determine the market value of each type of instrument contained in the fund's portfolio. In addition, the Commission believes that periodically the board should review the actual monitoring calculations.

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<sup>42</sup> The Commission received several negative comments in response to this view. These commentators stated that no presumption of failure by the board to fulfill its responsibilities should flow from the fund's failure to maintain a stable net asset value per share and that the Commission should focus upon whether the procedures adopted were reasonable. As stated elsewhere in this release, the Commission does not expect the board of directors to be insurers of the activities of the investment adviser or of the fund. The Commission has evaluated in the past, and would similarly evaluate in the future, the actions of the board of directors based upon a reasonable business standard. However, in permitting funds to use the amortized cost valuation method, the Commission was assured that under all but extreme circumstances, the responsibilities imposed by the rule, if fulfilled, would produce stability. The rule and the specific exemptive orders provide the board with substantial discretion in adopting procedures to achieve this end. The mere adoption of those specific procedure required in the rule and exemptive orders will not, per se, fulfill the board's responsibilities. On the other hand, if a board adopts procedures which are reasonably designed to assure stability and the board acts in a reasonable fashion to assure that those procedures are followed, the Commission would not hold the board responsible for any failure to maintain a stable net asset value per share.

<sup>43</sup> This requirement was not explicitly listed as a condition of the prior exemptive orders; however, the obligation existed as a result of; (1) the general obligation of a board to value portfolio instruments at fair value, which would cause the net asset value per share to reflect fairly each shareholder's interest, and (2) the specific condition of the orders that required the board to take action to eliminate any potential for dilution or unfair results, which might include ceasing to use the amortized cost method.

In determining the market-based value of the portfolio for purposes of computing the amount of deviation, all portfolio instruments, regardless of the time to maturity, should be valued based upon market factors and not their amortized cost value.<sup>44</sup> That value should reflect the amount that would be received upon the current sale of the asset. Accordingly, a non-negotiable instrument which is not treated as an illiquid security because it may be redeemed with the issuer, subject to a penalty for early redemption, must be assigned a value for monitoring purposes which takes into account the reduced amount that would be received if it were currently liquidated.<sup>45</sup>

The rule was modified slightly to indicate explicitly that the monitoring may be performed with suitable substitutes for market quotations. The Commission will not object if a fund, with the approval of its board, determines the market-based value of each instrument using estimates of market value which reflect current market conditions or using values derived from yield data relating to classes of money market instruments obtained from reputable sources, provided the certain minimum conditions are met. Where estimates of market value rather than actual quotations are used, the board should review and approve the method by which such estimates will be obtained. Any pricing system based on yield data for selected instruments used by a fund must be based upon market quotations for sufficient numbers and types of instruments to be a representative sample of each class of instrument held in the portfolio, both in terms of the types of instruments as well as the differing quality of the instruments. Moreover, periodically, the board should check the accuracy of the pricing system or the estimates. If the fund uses an outside service to provide this type of pricing for its portfolio instruments, it may not delegate to the provider of the service the ultimate responsibility to check the accuracy of the system.

The rule does not include a specific requirement that a money market fund using the penny-rounding method monitor the market-based value of its shares because such market-based valuation generally is itself the basis for the calculation of the per share net asset value upon which the price per share is computed. However, where a penny-rounding money market fund uses the amortized cost method to value portfolio instruments with remaining maturities of 60 days or less,<sup>46</sup> monitoring the deviation between the net asset value per share calculated using the market based value of all its portfolio instruments and its price per share may be necessary in order for the board to fulfill its responsibility to oversee the use of the penny-rounding method. If the price per share obtained through penny-rounding does not fairly represent each shareholder's interest in the fund, the board is obligated to use another pricing system which does fairly reflect each shareholder's interest. Particularly in a volatile market, if a penny-rounding fund were to use amortized cost valuation for a material portion of its portfolio, monitoring of actual market values might be necessary in order for the board to make a determination regarding the current fairness of prices obtained under the penny-rounding method. Moreover, the board's obligation to assure that the money market fund is maintaining an appropriate dollar-weighted average maturity to ensure stability may require that the per share net asset value based upon the market value of all the fund's portfolio instruments be monitored in order for the board to make a reasonable determination whether the maturity must be changed in order to ensure stability. The money market fund should retain a written record of any monitoring and the frequency of such monitoring should be appropriate in light of current market conditions.

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<sup>44</sup> Release 9786 set forth the Commission's position that it would not object to a board of directors determining, in good faith, that it was appropriate for a money market fund to value securities with less than 60 days remaining until maturity at amortized cost, unless the particular circumstances dictate otherwise. The impact of that release was to obviate the necessity of exemptive relief for such valuation. Thus, while it may be appropriate for the board to value certain portfolio securities at amortized cost without adherence to the conditions contained in the rule. Release 9786 does not affect, the monitoring procedures under this rule. Where the fund is using amortized cost valuation to such an extent that exemptive relief is necessary, i.e., its portfolio contains any security with a maturity in excess of 60 days, the monitoring procedures contained in the rule are designed to place a limitation on the total deviation between the fund's amortized cost value and its market-based value. In order to calculate precisely that total deviation, all instruments must be valued at market value. In addition, prudence would seem to suggest that funds which are relying solely on Release 9786 in order to allow them to use the amortized cost method of valuing their portfolio securities should institute procedures to monitor whether any "particular circumstances" have developed which make the used of amortized cost no longer appropriate.

<sup>45</sup> A non-negotiable instrument, which may be put back to the issuer subject to a penalty may be treated as a liquid security, provided that for monitoring purposes the market value assigned to the instrument includes the effect of the penalty, or it may be treated as an illiquid security, with no reduction in value to reflect the penalty charge; provided that the security is then counted towards the ten percent limitation on illiquid securities. A money market fund, especially a fund with expedited redemption features, should carefully consider, however, whether securities subject to a penalty may impair the fund's liquidity.

<sup>46</sup> See footnote 44, *supra*.

### Obligation of the Board to Take Action to Stabilize Net Asset Value Per Share

Pursuant to paragraph (a)(2)(i) of the rule, the board of directors of a money market fund using the amortized cost method must establish procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to stabilize the funds' per share net asset value at a single price. While the rule does not mandate the specific content of the procedures other than as set forth in paragraph (a)(2)(ii), described below, the procedures must be in writing (paragraph (a)(2)(v)) and should provide for action on the part of the investment adviser or the board of directors to ensure that the per share net asset value remains stable. Since the rule prescribes only the minimum provisions that must be included in the procedures adopted by the board, the Commission emphasizes that the board should consider carefully what types of procedures it may wish to establish in order to satisfy the responsibilities to ensure stability and fair valuation undertaken in connection with selecting the valuation method. Examples of types of other procedures that boards may wish to consider adopting are: (1) "early warning systems" whereby the board establishes a procedure requiring the investment adviser to inform the board, and the board to meet and consider what action is appropriate to take, whenever the market based per share net asset value of the fund falls below or rises above some predesignated level; and (2) procedures which require the investment adviser to modify its portfolio purchases in specified ways as market conditions change.

The specific provisions prescribed in paragraph (a)(2)(ii) of the rule include an obligation that, in the event that the deviation between market-based net asset value per share and amortized cost price exceeds  $\frac{1}{2}$  of 1 percent<sup>47</sup> the board of directors will promptly consider what action, if any, should be initiated by the board.<sup>48</sup> In fulfilling that obligation, the Commission takes the position that it is inappropriate, and will not satisfy the condition, for the board of directors to determine that it need not take any action to stabilize the per share net asset value on the basis that the amount of deviation will be reduced over time by anticipated interest rate changes in the market. The Commission bases its position on the fact that the board has, by undertaking to establish procedures to stabilize the net asset value per share, obligated itself to take affirmative action to ensure stability. Because no one can forecast with certainty market trends, or at what point the fund might experience a large increase in redemptions, the Commission believes that a decision not to take any action to reduce the deviation, based upon a belief that market action will reduce the deviation, is not an action reasonably designed to ensure stability.<sup>49</sup>

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<sup>47</sup> In determining whether the deviation exceeds  $\frac{1}{2}$  of 1 percent, the market-based per share net asset value must be calculated to the nearest one-hundredth of a cent on a share value of one dollar with no rounding. Therefore, where a fund has an amortized cost price of \$1.00, a market-based net asset value per share of .99500 would not be considered as exceeding the  $\frac{1}{2}$  of 1 percent mark, but a value of .99499 could not be rounded up and thus the deviation would be considered to exceed this benchmark.

<sup>48</sup> The Commission received a comment that the rule should be revised to permit corrective action to be taken either by the board or by the investment adviser pursuant to guidelines established by the board once the fund reached the point where the deviation exceeded  $\frac{1}{2}$  of 1 percent. While the Commission has no objection to the board directing the investment adviser to take the actual steps necessary to correct the deviation, it does not believe that the determination of what action should be delegated to the investment adviser, even if it is pursuant to board guidelines. The purpose of this provision is to have the board personally review the operations of the fund at a point which the Commission views as critical. Therefore, this portion of the rule remains unaltered. We note, however, that as discussed elsewhere in this release, the board may adopt procedures for the investment adviser to take corrective action within certain guidelines established by the board at stages prior to reaching  $\frac{1}{2}$  of 1 percent deviation.

<sup>49</sup> The Commission received a number of comments disagreeing with its view that the board is required to take affirmative action to stabilize the per share net asset value of the fund. Commentators expressed the view that the board should be given total discretion to exercise reasonable business judgment concerning what actions, if any, are needed to ensure stability. While the Commission agrees that the board should be given considerable discretion in determining how the fund should be operated to achieve the goal of stability, the rule and the exemptive orders require the board to operate within certain limitations that are designed to function as safety checks. Therefore, the Commission continues to take the position that the board should not have unfettered discretion. However, the Commission has modified its prior position to the extent that it will not necessarily regard a board's decision not to take action based upon the anticipated maturation of portfolio instruments as per se unreasonable. Any such decision, however, would be closely scrutinized to determine whether in light of the particular circumstances, such a decision was an action reasonably designed to ensure stability.

The board is required additionally to take such action as it deems appropriate whenever it believes that the amount of deviation may result in material dilution or other unfair results to investors or existing shareholders.<sup>50</sup> The rule neither specifies what actions the board must take, nor lists, as orders of exemption have, possible courses of action. However, there is a variety of methods to reduce the deviation, including: Adjusting dividends; selling portfolio instruments prior to maturity to realize capital gains or losses or to shorten the average portfolio maturity of the money market fund; or redeeming shares in kind.<sup>51</sup>

In any event, as provided in paragraph (a)(1) of the rule, if the board were ever to determine that the deviation was such that it could no longer conclude that the amortized cost price fairly reflected the market-based net asset value per share, because of the possibility of dilution or other unfair results, it would have to discontinue use of the amortized cost method of valuation and calculate its price per share in accordance with the provisions of the Act and rules thereunder.<sup>52</sup> It should be noted, however, that the board of directors must undertake, as a duty to shareholders, the responsibility of establishing procedures reasonably designed to preclude the necessity for such a switch in valuation methods.

Although the rule does not prescribe the specific actions that the board of directors of a fund using the penny-rounding method must take at a given time to assure that the price per share does not fluctuate, the rule explicitly imposes an obligation on the board to operate the fund in such a manner and, therefore, take action, to preclude a change in the price per share. As the net asset value per share begins to move away from one dollar, the board should consider, among other things altering the average portfolio maturity or the quality of instruments purchased to stabilize the current price per share at one dollar.

With the penny-rounding method, if the net asset value<sup>53</sup> ever fell below .99500 or rose above 1.00500 without rounding on a share value of \$1.00, the fund would have to change its price per share to \$.99 or \$1.01, respectively, or would have to cease to use the penny-rounding method and calculate its price with the accuracy of at least a tenth of a cent. However, under the conditions of the rule, a fund may similarly have to adjust its price under another circumstance. As noted in Release 9788, a fund using penny-rounding may, if the board deems it appropriate, value portfolio securities with less than 60 days until maturity at amortized cost. If all securities held by such a fund were to be valued at market and the net asset value per share based upon those market values, rounded to the nearest one cent, did not fairly reflect the single price per share, then pursuant to paragraph (a)(1) of the rule the fund would have to cease to price its shares at the single price established by the board.

#### **Record of Actions Taken to Stabilize Price**

Under paragraph (a)(2)(v) of the rule a money market fund using the amortized cost method must maintain a written record that documents the board's compliance with its obligations under the rule, including its responsibility to consider and take action where mandated. The rule provides that the documentation, which should include a discussion of all instances where the board considered whether action should be taken and what actions were initiated, must be included in the minutes of the board of directors' meetings and must be preserved for six years. Such documentation must also be made available for inspection by the staff of the Commission. In addition, pursuant to paragraph (a)(2)(vi), if any action is taken pursuant to paragraph (a)(2)(ii)(C) of the rule, the board of directors shall cause the fund to file quarterly, as

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<sup>50</sup> It should be noted that this requirement of the rule does not depend upon a determination that the deviation will result in material dilution, only that it may. Because the Commission deems a deviation of  $\frac{1}{2}$  of 1 percent to be a material amount, under all but highly unusual circumstances, the Commission would find that a deviation exceeding  $\frac{1}{2}$  of 1 percent may result in material dilution or other unfair results to shareholders. Thus, it is unlikely that a board of directors could, in conformance with the provisions of the rule, make a finding that no action was necessary when the deviation reached that level. Moreover, a board may find that the possibility of material dilution exists when the deviation is less than  $\frac{1}{2}$  of 1 percent. In such an event, the board would also be obligated to take corrective action.

<sup>51</sup> The Commission is not proposing to codify such examples in order to avoid any implication that other actions would be inappropriate.

<sup>52</sup> Even without this provision of the rule, the board of directors has an obligation to discontinue a pricing method that does not fairly reflect the value of the fund's securities. As set forth in Release 9786, Section 2(a)(41) requires the board of directors to value the fund's assets at fair value as determined in good faith. The language of this obligation was modified slightly in response to comments that indicated that the original language requiring the price to fairly reflect the value of each shareholder's interest was vague; that the shareholder's interest was the fair market value of a share and that the rule should be modified to reflect that.

<sup>53</sup> The net asset value must be calculated using market-based values for all instruments other than those with less than 60 days until maturity, which generally may be valued at amortized cost, unless particular circumstances dictate otherwise. See footnote 44, *supra*.

an attachment to Form N-1Q [17 *CFR* 274.106], a statement describing with specificity the circumstances surrounding the action and the nature of the action taken. This provision of the rule is a slight departure from the existing orders in that it requires funds to make a filing only if some action was taken.<sup>54</sup> The Commission believes that the modified filing requirement, in conjunction with the board's monitoring, will provide adequate controls over the use of the amortized cost valuation method and is in accord with the purposes of new provisions regarding the filing of Form N-1Qs and the reduced paperwork burdens thereof.<sup>55</sup>

List of Subjects in 17 *CFR* Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

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<sup>54</sup> The existing orders require a quarterly filing stating whether or not any action was taken. In order to eliminate differential treatment, the Division will not recommend that the Commission take any action against a fund if it continues to rely on its individual exemptive order but follows the Form N-1Q reporting requirement contained in the rule.

<sup>55</sup> See Securities Act Release No. 6368 (December 16, 1981) 46 *FR* 62246 (December 23, 1981).

Text of Rule

## Part 270—Rules and Regulations, Investment Company Act of 1940

Part 270 of Chapter II of Title 17 of the Code of Federal Regulations is amended by adding new § 270.2a-7, as follows:

§ 270.2a-7. Use of the amortized cost valuation and penny-rounding pricing methods by certain money market funds.

(a) The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by a registered investment company (hereinafter referred to as a money market fund), notwithstanding the requirements of Section 2(a)(41) of the Investment Company Act of 1940 [15 U.S.C. 80a-2(a)(41)] and of Rule 3a-4[17 CFR 270.2a-4] and Rule 22c-1 [17 CFR 270.22c-1] thereunder, may be computed either by use of the amortized cost method of valuation or by use of the penny-rounding method of pricing: Provided, That:

(1) The board of directors of the money market fund (trustees in the case of a trust) determines, in good faith based upon a full consideration of all material factors, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or a stable price per share, by virtue of either the amortized cost method of valuation or by use of the penny-rounding method of pricing, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share; and either

(2) In the case of a money market fund using the amortized cost method of valuation:

(i) In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors (trustees) undertakes—as a particular responsibility within the overall duty of care owed to its shareholders—to establish procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value;

(ii) Included within the procedures to be adopted by the board of directors (trustees) shall be the following:

(A) Procedures adopted whereby the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute which reflects current market conditions) from the money market fund's amortized cost price per share, will be determined at such intervals as the board of directors (trustees) deems appropriate and are reasonable in light of current market conditions; periodic review by the board of directors (trustees) of the amount of the deviation as well as the methods used to calculate the deviation; and maintenance of records of the determination of deviation and the board's review thereof,

(B) In the event such deviation from the money market fund's amortized cost price per share exceeds ½ of 1 percent, a requirement that the board of directors (trustees) will promptly consider what action, if any, should be initiated by the board of directors (trustees), and

(C) Where the board of directors (trustees) believe the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results;

(iii) The money market fund will maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share; Provided, however, That the money market fund will not: (A) Purchase any instrument with a remaining maturity of greater than one year, or (B) maintain a dollar-weighted average portfolio maturity which exceeds 120 days;

(iv) The money market fund will limit its portfolio investments, including repurchase agreements, to those United States dollars-denominated instruments which the board of directors (trustees) determines present minimal credit risks and which are of “high quality” as determined by any major rating service, or in the case of any instrument that is not rated, of comparable quality as determined by the board of directors (trustees);



(v) The money market fund will record, maintain, and preserve permanently in an easily accessible place a written copy of the procedures (and any modification thereto) described in paragraph (a)(2)(i) of this section and the money market fund will record, maintain, and preserve for a period of not less than six years (the first two years in an easily accessible place) a written record of the board of directors' (trustees) considerations and actions taken in connection with the discharge of its responsibilities, as set forth above, to be included in the minutes of the board of directors' (trustees') meetings. The documents preserved pursuant to this condition shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act [*15 U.S.C. 80a-30(b)*] as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act [*15 U.S.C. 80a-30*]; and

(vi) If any action was taken pursuant to paragraph (a)(2)(ii)(C) of this section, the money market fund will file a statement as an attachment to Form N-1Q (filed pursuant to Rule 30b1-1(b)) describing with specificity the nature and circumstances of such action within 30 days after the close of each calendar quarter during which such action was taken; or

(3) In the case of a money market fund using the penny-rounding method of pricing:

(i) In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors (trustees) undertakes—as a particular responsibility within the overall duty of care owed to its shareholders—to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one per cent, will not deviate from the single price established by the board of directors (trustees).

(ii) The money market fund will maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable price per share; provided, however, That the money market fund will not (A) purchase any instrument with a remaining maturity of more than one year, or (B) maintain a dollar-weighted average portfolio maturity which exceeds 120 days; and

(iii) The money market fund will limit its portfolio investments, including repurchase agreements, to those United States dollar-denominated instruments which the board of directors (trustees) determines present minimal credit risks, and which are of "high quality" as determined by any major rating service or, in the case of any instrument that is not rated, of comparable quality as determined by the board of directors (trustees).

(b) Definitions. (1) The "amortized cost method of valuation" is the method of calculating an investment company's current net asset value whereby portfolio securities are valued by reference to the fund's acquisition cost as adjusted for amortization of premium or accumulation of discount rather than by reference to their value based on current market factors.

(2) The "penny-rounding method of pricing" is the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(3) A variable rate instrument is one whose terms provide for automatic establishment of a new interest rate on set dates.

(4) A floating rate instrument is one whose terms provide for automatic adjustment of its interest rate whenever some specified interest rate changes.

(5) The maturity of an instrument shall be deemed to be the period remaining until the date noted on the face of the instrument as the date on which the principal amount owed must be paid, or in the case of an instrument called for redemption, the date on which the redemption payment must be made, except that:

(i) If the board of directors (trustees) has determined that it is reasonable to expect that whenever a new interest rate on a variable rate instrument is established it will then cause the instrument to have a current market value which approximates its par value, (A) an instrument that is issued or guaranteed by the United States government or any agency thereof which has a variable rate of interest readjusted no less frequently than annually may be deemed to have a

maturity equal to the period remaining until the next readjustment of the interest rate; (B) an instrument which has a demand feature that entitles the holder to receive the principal amount of such instrument from the issuer upon no more than seven days' notice and which has a variable rate of interest may be deemed to have a maturity equal to the longer of the period remaining until the interest rate will be readjusted or the period remaining until the principal amount owed can be recovered through demand, Provided, That the board of directors (trustees) determines no less frequently than quarterly that the instrument is of high quality; and (C) an instrument which has a variable rate of interest may be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate, Provided, That the period remaining until the date noted on the face of the instrument as the date on which the principal amount owed must be paid is one year or less;

(ii) An instrument which has a demand feature that entitles the holder to receive the principal amount of such instrument from the issuer upon no more than seven days' notice and which has a floating rate of interest may be deemed to have a maturity equal to the period of time remaining until the principal amount owed can be recovered from the issuer through demand, Provided, That the floating interest rate is adjusted concurrently with any change in an identified market interest rate to which it is pegged and the board of directors (trustees) determines (A) that it is reasonable to expect that such floating rate feature will ensure that the market value of such instrument will always approximate its par value, and (B) no less frequently than quarterly that the instrument is of high quality;

(iii) A repurchase agreement may be treated as having a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or where no specific date is specified, but the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities; and

(iv) A portfolio lending agreement may be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where no specific date is specified, but the agreement is subject to demand, the notice period applicable to a demand for return of the loaned securities.

(6) "One year" shall mean 365 days except, in the case of an instrument that was originally issued as a one year instrument, but had up to 375 days until maturity, one year shall mean 375 days.

Statutory Basis: Rule 2a-7 is promulgated pursuant to the provisions of Sections 6(c) (*15 U.S.C. 80a-6(c)*), 22(c) (*15 U.S.C. 80a-22(c)*) and 38(a) (*15 U.S.C. 80a-37(a)*) of the Act.

By the Commission.  
George A. Fitzsimmons  
Secretary  
July 11, 1983

## ADOPTION OF REQUIREMENTS REGARDING ACQUISITION AND VALUATION OF CERTAIN PORTFOLIO INSTRUMENTS BY REGISTERED INVESTMENT COMPANIES

Release No. IC-14983

March 21, 1986

**ACTION:** Adoption of final rule and rule amendments.

**SUMMARY:** The Commission is adopting amendments to an existing rule that permits money market funds to use the amortized cost method of valuing their portfolio securities or the penny-rounding method of computing their price per share. The amendments will allow funds relying on the rule to acquire put options and to treat variable rate or floating rate debt securities with periodic demand features, a type of put option, as short-term debt securities under certain conditions. The amendments also clarify the responsibilities that the existing rule assigns to money market fund directors and allow money market funds to rely on a high quality rating assigned by a nationally recognized statistical rating organization that it does not control and is not controlled by or under common control with the issuer of or any insurer, guarantor or provider of credit support for the rated securities.

The Commission is also adopting an amendment to an existing rule that exempts certain investment company acquisitions of securities issued by persons engaged in securities related activities in order to clarify the circumstances under which investment companies may acquire demand features and another type of put option known as standby commitments. Finally, the Commission is adopting a new rule that allows registered investment companies to assign a fair value of zero to standby commitments.

**EFFECTIVE DATE:** April 21, 1986.

**FOR FURTHER INFORMATION CONTACT:** Jack W. Murphy, Attorney, (202) 272-2048 or Elizabeth K. Norsworthy, Chief, (202) 272-2048, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

After the effective date, questions should be directed to the Office of the Chief Counsel, (202) 272-2030, Division of Investment Management, 450 Fifth Street, NW., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission today is adopting amendments to Rules 2a-7 [17 CFR 270.2a-7] and 12d3-1 [17 CFR 270.12d3-1] and adopting Rule 2a41-1 [17 CFR 270.2a41-1] under the Investment Company Act of 1940 [15 U.S.C. 80a-1, *et seq.*] (“Act”).

Last July, the Commission proposed amendments to Rules 2a-7 and 12d3-1 and adoption of new Rule 2a41-1<sup>1</sup> to give money market funds more flexibility to acquire certain types of put options known as demand features and standby commitments. The fifteen commentators on the proposal generally supported the initiative taken by the Commission, but believed that certain aspects of the proposal should be modified or eliminated. Those comments are reflected in the final version of the rule and rule amendments as discussed below.

Subject to specified conditions, Rule 2a-7 allows certain open-end investment companies known as money market funds to use either the amortized cost method of valuing their portfolio securities<sup>2</sup> or the penny-rounding method of pricing

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<sup>1</sup> See Investment Company Act Release No. 14607 (July 1, 1985) [50 FR 27982] (“proposing release”).

<sup>2</sup> A money market fund using the amortized cost method of valuation values the debt securities in its portfolio and other assets at acquisition cost. The interest earned on each portfolio debt security (plus any discount received or less any premium paid upon purchase) is then accrued ratably over the remaining maturity of the security. By declaring these accruals to its shareholders as a daily dividend, the money market fund is able to set a fixed price per share, which is usually \$1.00. The final version of the rule retains the description of the amortized cost method that appears in the existing rule. Although the proposal would have clarified that language, the Commission has decided to retain the original language because the commentators expressed so much concern that the proposed change might have some hidden meaning.

their securities.<sup>3</sup> The rule requires money market funds using the above methods to limit their investments to instruments that are of high quality and that have a remaining maturity of one year or less. Funds relying on the rule must also maintain an average dollar-weighted portfolio maturity of no more than 120 days.<sup>4</sup>

The amendments to Rule 2a-7 permit money market funds relying on the rule to acquire put options, including demand features and standby commitments, under certain conditions. The final version of the rule uses the term “put” to describe the type of options that may be acquired, instead of the term “liquidity put” that was used in the proposal. As proposed, the final rule imposes a five percent limitation on the puts that a fund may acquire from the same institution. However, unlike the proposal, the final rule tracks Section 5(b)(1) of the Act [*15 U.S.C. 80a-5(b)(1)*] and Rule 5b-2 thereunder [*17 CFR 270.5b-2*] by imposing that limitation with respect to only 75 percent of a fund’s portfolio and allowing a fund to invest up to ten percent of its assets in unconditional puts or other securities issued by the same institution.<sup>5</sup>

The final rule also clarifies the circumstances under which a demand feature or standby commitment may be considered to be of high quality. Both the long-term and the short-term aspects of demand instruments must be of high quality before they can be acquired by a fund relying on the rule unless the demand feature is unconditional. In that event, the fund may focus only on the short-term quality of the instrument. This provision modifies the proposal which would have required that a fund examine both the short-term and long-term aspects of any demand instrument before treating the instrument as a short-term debt security. The final version of the rule also makes it clear that a fund may not acquire a standby commitment unless a determination has been made that the issuer of the commitment presents a minimal risk of default.

As in the proposal, the amendments permit funds relying on Rule 2a-7 to use certain demand features to shorten the maturity of variable and floating rate instruments.<sup>6</sup> In the final version of the rule, such demand features must entitle the fund to receive the principal amount of the underlying security or securities and must be exercisable either (i) at any time on no more than thirty days’ notice; or (ii) at specified intervals not exceeding one year and upon no more than thirty days’ notice. Since the proposal would have prescribed a seven day minimum notice period, a note has been added to the final rule to remind money market fund directors of their responsibility to ensure that the fund has sufficient liquidity.

As in the proposal, amended Rule 2a-7 simply states the conditions that must be satisfied before a demand feature can be used to shorten the maturity of the security or securities underlying the feature. While the directors, of course, remain ultimately responsible for that decision, the amended rule no longer requires them to make an explicit finding with respect to each instrument.<sup>7</sup>

Finally, Rule 2a-7 is amended to allow money market funds to rely on a high quality rating if the rating is assigned by a nationally recognized statistical rating organization (“NRSRO”) that does not control and is not controlled by or under common control with the issuer of, or any insurer, guarantor or provider of credit support for the securities. The final

<sup>3</sup> A money market fund using the penny-rounding pricing method values portfolio securities for which market quotations are readily available at current market value, and other securities and assets at fair value as determined in good faith by the board of directors. The current net asset value per share is then rounded to the nearest one percent, allowing the fund to maintain a fixed price per share (usually \$1.00). Penny-rounding funds may also use the amortized cost valuation method to value portfolio securities having a remaining maturity of sixty days or less. *See* Investment Company Act Release No. 13380 (July 11, 1983) [*48 FR 32555*] adopting the existing rule (“adopting release”) at footnote 44, citing Investment Company Act Release No. 9786 (May 31, 1977), *42 FR 28999*. The final version of the rule retains the description of penny-rounding that appears in the existing rule. As in the case of the description of the amortized cost method that appears in the existing rule, the Commission had proposed to describe the penny-rounding method more precisely. The original rule language is retained to assuage commentator concern as to any hidden meaning behind the proposed language change.

<sup>4</sup> Generally, the maturity of an instrument is considered to be the period remaining until the date noted on the face of the instrument as the date on which the principal amount must be paid.

<sup>5</sup> An unconditional put is defined in the rule as a put that is readily exercisable in the event of a default in the payment of principal or interest on the underlying security or securities. Conversely, a conditional put would not be readily exercisable in the event of default.

<sup>6</sup> As proposed, the definitions of variable and floating rate instruments have been clarified.

<sup>7</sup> *See* the proposing release, *supra* note 1, at notes 40-43 and accompanying text. *See also* adopting release, *supra* note 3, at notes 19-25 and accompanying text.

Also, as proposed, parenthetical references to “trustees” that appear in the existing rule are deleted because the definition of “director” in Section 2(a)(12) of the Act [*15 U.S.C. 80a-2(a)(12)*] specifically includes a member of a board of trustees.

rule refers only to that aspect of the Act's definition of "affiliated person" that includes any person directly or indirectly controlling, controlled by or under common control with another person and not, as proposed, to all aspects of that definition.<sup>8</sup>

Rule 12d3-1 provides exemptive relief from Section 12(d)(3) of the Act [15 U.S.C. 80a-12(d)(3)] to allow investment companies to purchase or otherwise acquire securities issued by persons engaged in securities related activities. The amendment to Rule 12d3-1 permits any type of investment company—not just money market funds relying on Rule 2a-7—to acquire puts issued by persons engaged in securities related activities so long as the company complies with the same diversification requirements that are found in amended Rule 2a-7. Finally, the Commission is adopting Rule 2a41-1 under Section 2(a)(41) of the Act [15 U.S.C. 80a-2(a)(41)] essentially as proposed to allow investment companies to assign a fair value of zero to standby commitments under certain conditions.

Since the proposing release described in detail the market changes and exemptive applications that prompted the proposed rule and rule amendments, this release focuses on the changes that have been made in the proposal to reflect the comments received.

## Discussion

### A. Amendments to Rule 2a-7

**1. Puts that may be acquired by funds relying on the rule and puts that may be used to shorten maturity.** The final amendments to Rule 2a-7 use the general term "put" to describe the options that money market funds relying on the rule may acquire. A put is defined as a right to sell a specified underlying security or securities within a specified period of time and at a specified exercise price, that may be sold, transferred or assigned only with the underlying security or securities.<sup>9</sup>

The proposed amendments used the term "liquidity puts" to refer to the put options that funds relying on the rule could acquire. Several commentators, however, felt that the use of this term, together with certain statements contained in the proposing release, might unnecessarily restrict money market funds to purchasing put options solely for liquidity purposes. In this regard, they pointed out that while funds relying on the rule may acquire puts for such purposes, they may also acquire the puts to shorten the maturity of the underlying securities or to permit reinvestment of fund assets at a more favorable rate of return. Since the Commission did not intend to prevent funds from acquiring puts for these other purposes, the term "put" is used in the final version of the rule.

The final version of the rule separately defines demand features and standby commitments instead of describing those options within the definition of put. The definition of standby commitment is adopted as proposed. The definition of demand feature, however, has been modified so that the final rule makes clear that the exercise price need not include accrued interest. This change has been made because the proposal could have been read to require that accrued interest must always be paid at the time of exercise, a result that was not intended.

As in the proposal, a fund relying on the rule may use demand features to shorten the maturity of only variable or floating rate instruments.<sup>10</sup> One commentator suggested that the final rule permit funds to use demand features to shorten the maturity of fixed rate instruments. However, the Commission still believes that an instrument should have an adjustable interest rate, as well as a demand feature, to be treated as a short-term debt security. For example, if a fund

<sup>8</sup> See Section 2(a)(3) [15 U.S.C. 80a-2(a)(3)]. Control is defined in Section 2(a)(9) of the Act [15 U.S.C. 80a-2(a)(9)] to include direct or indirect ownership of more than 25 percent of the voting securities of a company.

<sup>9</sup> Several commentators believed that although a fund relying on the rule may not "sever" a put from the underlying security or securities, the put itself may be "severable." The Commission continues to believe, however, that the cost of a separately traded put could differ significantly from its market value and therefore could cause the fixed price of a fund's shares to deviate significantly from the market-based value of its portfolio.

<sup>10</sup> The maturity of a variable rate instrument must be the longer of the period remaining until the principal amount can be recovered through demand or the period remaining until the interest rate is to be readjusted. Although a few commentators suggested that the maturity should be the shorter of the specified periods, the Commission continues to believe that the more prudent measurement is the longer of the periods.

using amortized cost decides that exercise of a demand feature is not in the best interests of the fund or if the demand feature cannot be exercised, then the Commission believes that a mechanism must exist that can be reasonably expected to return the value of the instrument to par, i.e., a variable interest rate, or that can reasonably be expected to keep the value of the instrument at par, i.e., a floating interest rate. Otherwise, the market-based value of the instrument could deviate significantly from its amortized cost value after the exercise date.

A few commentators urged the Commission to permit funds to use standby commitments as well as demand features to shorten maturity. However, applicants for exemptive relief have routinely represented that they are unlikely to exercise their standby commitments; they only exercise this type of put as a last resort to facilitate portfolio liquidity.<sup>11</sup> In view of these representations, the Commission does not believe that it would be appropriate to allow funds to use the commitments to shorten maturity.

**2. Limitation on puts from a single institution.** The diversification requirements contained in the final amendments to Rule 2a-7 track those in Section 5(b)(1) of the Act and provide that immediately after the acquisition of any put, a money market fund which uses the amortized cost valuation method may not, with respect to 75 percent of the total amortized cost value of its assets, have more than five percent of its assets invested in securities subject to puts from the same institution. Similarly, in the case of a money market fund which uses the penny-rounding pricing method, the fund may not, with respect to 75 percent of the total market-based value of its assets, have more than five percent of its assets invested in securities subject to puts from the same institution. In each case, however, the amended rule also tracks Rule 5b-2 under the Act and provides that a fund may invest up to ten percent of its assets in unconditional puts and other securities issued by the same institution. An unconditional put is considered to be a put that is exercisable even in the event of a default in the payment of principal or interest on the underlying securities. A put is considered to be from the institution to whom the fund will look for payment of the exercise price.<sup>12</sup>

Since, as noted above, these requirements track the diversification requirements of Section 5(b)(1) of the Act [15 U.S.C. 80a-5(b)(1)] and Rule 5b-2 thereunder [17 CFR 270.5b-2],<sup>13</sup> a diversified fund complying with Rule 2a-7 will not have to take any further steps to ensure compliance with Section 5 with respect to the puts in its portfolio. However, the fund will still have to comply with Section 5 with respect to the securities underlying those puts.

The proposed amendments would have limited funds relying on the rule to investing no more than five percent of their total assets in securities subject to any type of put from the same institution. A number of commentators felt that these proposed limitations were unnecessarily restrictive. Several questioned the need for any separate limitation in Rule 2a-7, given the existing diversification requirements imposed by Section 5<sup>14</sup> and by subchapter M of the Internal Revenue Code of 1954 (“IRC”).<sup>15</sup> Another commentator maintained that the acquisition of puts should not be subject to any diversification requirements, given the relatively small number of financial institutions engaged in issuing puts.

On the other hand, several commentators did not oppose the inclusion of a separate limitation in Rule 2a-7. One commentator expressly supported the proposed five percent limitation on the grounds that it would prevent money market funds from being subjected to “unnecessary and unintended market risks.” Other commentators argued that the proposed five percent limitation should be modified so that it would track the Act’s diversification requirements, i.e., the limitation should apply only to 75 percent of the fund’s portfolio and the fund should be able to invest up to ten percent of its portfolio in unconditional puts from the same institution. Still other commentators expressed the opinion that funds should be able to invest up to ten percent of their assets in any kind of puts issued by the same institution.

<sup>11</sup> See the proposing release, *supra* note 1, at notes 18-24 and accompanying text.

<sup>12</sup> In the case of a standby commitment, the put would be from the broker, dealer or bank that has agreed to repurchase the underlying securities. In the case of a demand feature, the put would be from the party that has provided a letter of credit or other credit facility to ensure payment of the exercise price.

<sup>13</sup> The diversification requirements of Rule 2a-7 and Section 5 are not identical because the puts that a money market fund may acquire are typically not assigned a separate value. Accordingly, the amended rule’s percentage limitations are applied to the securities subject to puts from the same institution, not to the puts themselves.

<sup>14</sup> See Section 5(b)(1) and Rule 5b-2 thereunder.

<sup>15</sup> See 26 U.S.C. 851 *et seq.*

Two commentators noted that if the final version of the rule contained a diversification requirement, the provision should more clearly identify the party that would be considered the issuer of the put. One of these commentators stated that the limitation should not be applicable to the remarketing agent for a demand instrument, but should apply to the provider of credit support, such as a letter of credit, since the holder of the instrument relies primarily upon that party in assessing the quality of the put. On the other hand, another commentator felt that it could be inappropriate to apply a limitation to the issuer of a letter of credit supporting a demand feature in light of the tax implications of *Philadelphia Gear Corp. v. FDIC*.<sup>16</sup> Several commentators also noted that if the final version of the rule contained a diversification requirement, the Commission should clarify the interrelationship between that requirement and diversification requirements under Section 5.

The Commission has decided to include a separate diversification requirement in the final version of the rule in order to ensure that a fund's liquidity will not be impaired by relying too heavily upon the same institution or upon only a handful of institutions to support whatever puts are in the fund's portfolio. However, as described above, the proposed five percent limitation has been clarified and modified to track the Act's diversification requirements.

**3. Quality of portfolio securities.** The final version of the amendments specifically provides that funds relying on the rule may only acquire securities that are of high quality, as determined by at least one NRSRO that is not an affiliated person, as defined in Section 2(a)(3)(C) of the Act, of the issuer of or any insurer, guarantor or provider of credit support for, the rated securities or that are found to be of comparable quality by the board of directors. This allows a fund to rely on a NRSRO rating only if the NRSRO does not control, and is not controlled by or under common control with the issuer or any insurer, guarantor or provider of credit support.<sup>17</sup>

As proposed, a fund could not rely on a NRSRO rating if the NRSRO were an affiliated person of the issuer, insurer, guarantor or provider of credit support, i.e., meeting all parts of the definition of affiliated person found in Section 2(a)(3). One commentator urged the Commission to eliminate the unaffiliated requirement altogether, arguing that the requirement would place an undue burden of compliance on funds relying on the rule. However, as discussed in the proposing release, although the concept of independence is implicit in the term NRSRO, the Commission believes that for the purposes of Rule 2a-7, independence should be defined within the context of the Act. The proposal has been modified, however, to focus only on the control aspect of the definition of affiliated person because the Commission believes that funds should have little or no difficulty in ascertaining whether a control relationship exists between a NRSRO and the issuer, insurer, guarantor or provider of credit support of the rated securities.

The final amendments provide that both the short-term and long-term aspects of a demand instrument must be rated high quality or found by the board to be of high quality<sup>18</sup> unless the demand feature is unconditional. In that event, the fund may focus only on the short-term quality of the instrument. A demand feature is considered to be unconditional if exercisable even in the event of a default in the payment of principal or interest on the underlying securities.

The proposed amendments would have provided that a fund may use a demand feature to shorten the maturity of a demand instrument only if the demand instrument has a short-term and a long-term high quality rating or is found to be of comparable quality. Several commentators urged the Commission to focus only on the quality of the demand feature, not on the quality of the securities underlying the demand feature. Two commentators believed, however, that this should be the case only if the demand feature is unconditional. In addition, several commentators noted that the quality of the

<sup>16</sup> *751 F.2d 1131 (10th Cir. 1984), cert. granted 106 S.Ct 245 (1985)* (No. 84-1972). That case held that a standby letter of credit is a "deposit" for purposes of Federal Deposit Insurance Corporation ("FDIC") insurance. Since federal tax law denies tax-exempt status to municipal debt securities that are guaranteed in whole or in part by the United States Government, the holding in *Philadelphia Gear* could mean the loss of the tax-exempt status of any municipal bond that is supported by a letter of credit issued by an FDIC-insured bank. Such a holding could significantly limit the number of institutions that could continue to provide credit support for tax-exempt issues.

<sup>17</sup> See *supra* note 8.

<sup>18</sup> See proposing release, *supra* note 1, at note 36 for a discussion of the credit factors that the board should examine in making a comparable quality determination. A demand instrument may be considered an unrated security in the event that a rating agency has not taken into account the existence of an external agreement to provide credit support, such as insurance or a letter of credit. Also, where only the long-term or short-term quality has been rated, the board may make a comparable quality determination with regard to the unrated credit aspect.

securities underlying a demand feature should still be taken into account when a fund makes its investment decision.<sup>19</sup> Finally, some commentators maintained that a separate quality requirement for demand instruments is unnecessary, given the high quality requirements presently contained in Rule 2a-7.

In view of the nature of demand instruments, the Commission continues to believe that Rule 2a-7 should separately address the quality requirements that should be applicable to those instruments. Since a demand instrument must be of high quality for a fund relying on the rule to acquire it, as well as to shorten its maturity, this separate requirement has been added to the rule's existing quality requirements, not to the rule's maturity requirements as originally proposed. While the final version of the rule still generally requires a fund to focus on both the long-term and short-term aspects of a demand instrument, an exception is made in the case of demand instruments with unconditional demand features. Where credit support will be provided even in the event of default on the underlying securities, the Commission agrees that a fund should be able to focus only on the quality of the short-term aspect of the demand instrument—the demand feature. If the quality of any demand instrument falls below the high quality level required by the rule, a fund must dispose of the instrument within a reasonable period of time by exercising the demand feature or by selling the demand instrument on the secondary market, whichever is in the best interests of the fund and its shareholders.

Finally, the quality requirements of the amended rule provide that a standby commitment will be considered to be of high quality if the directors have determined that the issuer of the commitment presents a minimal risk of default. This representation has been routinely made by applicants who have received exemptive relief to acquire standby commitments<sup>20</sup> and is added to the rule at the request of one commentator who pointed out that without clarification, it would be difficult for the directors to know how to ascertain whether a standby commitment is of high quality.

**4. Notice limitations on demand instruments.** As noted above, the final rule expands from seven to 30 days the notice requirement for the demand features that funds relying on the rule may use to shorten the maturity of variable and floating rate debt instruments. Because the notice period has been lengthened, a note has been added to the rule reminding directors of their responsibility to ensure that their fund has sufficient liquidity.

Open-end investment companies are required to limit their acquisition of illiquid securities to ensure that all redemption requests will be satisfied within the seven day period prescribed by Section 22(e) of the Act [15 U.S.C. 80a-22(e)]. In 1969, the Commission took the position that in no event should the percentage of illiquid securities held by an open-end investment company exceed 10% of the market-based value of the company's net assets.<sup>21</sup> The term "illiquid security" generally includes any security which cannot be disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within seven days.

In the release adopting Rule 2a-7, the Commission elaborated upon the responsibilities of money market fund board of directors with regard to the acquisition and valuation of illiquid securities, noting that because of the nature of money market funds, the difficulties that could arise in conjunction with the purchase of illiquid securities might be even greater than for other types of open-end management investment companies. In particular, the Commission pointed out that money market funds often have a greater and perhaps less predictable volume of redemptions than other open-end investment companies. Further, the portfolio management of a money market fund might be impaired if a fund were forced to meet redemption requests by selling marketable securities that it would otherwise wish to retain in order to avoid attempting to dispose of illiquid portfolio instruments. Finally, the valuation of illiquid securities may potentially overstate or understate the fund's net asset value to the detriment of shareholders. In light of these potential problems, the

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<sup>19</sup> One commentator maintained that a fund should focus only on the quality of the underlying security or securities. That commentator believed that a demand instrument is analogous to a short-term repurchase agreement ("repo") collateralized by long-term securities and that a fund's board of directors should be allowed to make a high quality determination if the securities underlying the demand feature are of high quality, just as the Commission has permitted when the securities underlying a repo are of high quality. *See* adopting release, *supra* note 3, at note 31.

<sup>20</sup> *See* Notices of applications and orders cited in the proposing release, *supra* note 1, at note 19.

<sup>21</sup> *See* Investment Company Act Release No. 5847 (October 21, 1969) [35 FR 19989].



board of directors of a money market fund relying on the rule must take steps to limit the acquisition of illiquid portfolio instruments to a level lower than the ten percent limit set for other types of open-end investment companies.<sup>22</sup>

A number of the commentators felt that a seven day notice period was unreasonably short for periodic demand instruments that entitle the holder to receive the principal amount of the underlying securities at specified intervals not exceeding one year. Several commentators asked the Commission to lengthen the prescribed notice period to 30 days because present market conditions have resulted in a standard notice period of 15 to 30 days for such instruments. In addition, one commentator indicated that limiting the notice period to seven days could impair the ability of a remarketing agent to successfully remarket the instrument. Other commentators believed that the rule should not contain any notice requirement for periodic demand instruments. These commentators observed that, after notice has been given, a periodic demand instrument trades in the market as a security having a maturity equal to the period remaining until the date on which the exercise price is to be paid.

In addition to addressing the proposed notice requirement for periodic demand instruments, several commentators questioned whether the amended rule should continue to have a seven day notice requirement for demand features that are exercisable at any time.<sup>23</sup> Those commentators felt that this requirement should be removed or expanded in light of the market conditions discussed above. Moreover, one commentator noted that while the widespread use of seven day demand instruments demonstrates that a successful remarketing effort is possible within seven days, all involved parties would prefer a longer notice period so that a longer and possibly more effective remarketing effort could take place.

In the final version of the rule, the Commission has decided to expand to 30 days the notice requirements for all types of demand features, whether exercisable at specified intervals or at any time. The Commission still believes that some limit must be placed on the extent to which funds relying on the rule will have to anticipate their cash and investment needs more than seven days in advance. However, the Commission believes that funds should be able to invest in the demand instruments that are being marketed with notice periods of up to 30 days, as long as the directors are cognizant of their responsibility to maintain an adequate level of liquidity. To emphasize that responsibility, a note has been added to the rule summarizing and referring to the Commission's position outlined above. In the context of determining the liquidity of demand instruments, the Commission expects that the directors would establish procedures to evaluate the existence and depth of the secondary market for such instruments, as well as the period remaining until the principal amount can be recovered.

#### **B. Amendment to Rule 12d3-1**

As amended, Rule 12d3-1 provides exemptive relief to allow registered investment companies to acquire puts, as defined in amended Rule 2a-7, from persons engaged in securities related activities. This is in contrast to the proposal that provided exemptive relief only to money market funds that have complied with all of the provisions of Rule 2a-7. At the request of two commentators, the proposal has been redrafted so that the final amendment applies to all types of investment companies and conditions exemptive relief upon a company's compliance with the same diversification requirements that are found in amended Rule 2a-7. Since these diversification requirements track those of Section 5(b)(1) of the Act and Rule 5b-2 thereunder, a diversified fund would not have to take any additional steps to diversify the puts that it has acquired from persons engaged in securities related activities. However, the fund would still have to comply with Section 5 with respect to the securities underlying those puts.

#### **C. Rule 2a41-1**

The Commission is also adopting new Rule 2a41-1 essentially as proposed to allow a registered investment company to assign a fair value of zero to a standby commitment, provided that the standby commitment is not used to affect the fund's valuation of the underlying security or securities and any consideration paid for the commitment is accounted for as unrealized depreciation until the commitment is exercised or expires.

List of Subjects in 17 CFR Part 270

<sup>22</sup> See adopting release, *supra* note 3, at notes 37-39 and accompanying text. In view of these liquidity concerns, the proposed amendments to Rule 2a-7 would have permitted funds relying on the rule to shorten the maturity of long-term debt securities subject to demand features only if the demand features could be exercised upon no more than seven days' notice.

<sup>23</sup> The seven day notice period for demand features exercisable at any time was carried over from the text of the existing rule.

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Rule and Rule Amendments

Part 270 of Chapter II of Title 17 of the Code of Federal Regulations is amended as shown.

### **Part 270—Rules and Regulations, Investment Company Act of 1940**

1. The authority citation for Part 270 is amended by adding the following citations:

Authority: Secs. 38, 40, *54 Stat. 841, 842, 15 U.S.C. 80a-37, 80c-89* \* \* \* §§ 270.2a-7, 270.2a41-1 and 270.12d3-1 also issued under Secs. 6(c) [*15 U.S.C. 80a-6(e)*], 22(c) [*15 U.S.C. 80a-22(e)*] and 38(a) [*15 U.S.C. 80a-37(a)*].

2. Section 270.2a-7 is amended by removing the parenthetical phrase “trustees in the case of a trust” in paragraph (a)(1); removing the parenthetical term “trustees” throughout paragraphs (a)(2)(i), (a)(2)(ii), (a)(2)(v) and (a)(3)(i); redesignating (a)(2)(v) as (a)(2)(vi), and (a)(2)(vi) as (vii); revising paragraphs (a)(2)(iv), (a)(3)(iii), and (b); and adding a note to the end of the section and new paragraphs (a)(2)(v), (a)(3)(iv), and (c) to read as follows. The authority citation at the end of the section is removed.

§ 270.2a-7 Use of the amortized cost valuation and penny-rounding pricing methods by certain money market funds.

(a) \* \* \*

(2) \* \* \*

(iv) The money market fund will limit its portfolio investments, including puts and repurchase agreements, to those United States dollar-denominated instruments which the board of directors determines present minimal credit risks and which are (A) of “high quality” as determined by any nationally recognized statistical rating organization that is not an affiliated person, as defined in Section 2(a)(3)(C) of the Act [*15 U.S.C. 80a-2(a)(3)(C)*], of the issuer of, or any insurer, guarantor or provider of credit support for the instrument which the money market fund is considering acquiring, or (B) in the case of any instrument that is not rated, of comparable quality as determined by the board of directors. In this regard, a demand instrument must have received both a short-term and a long-term high quality rating or have been determined to be of comparable quality by the board of directors, except that a demand instrument that has an unconditional demand feature may be acquired solely in reliance upon a short-term high quality rating or upon a finding of comparable short-term quality by the board of directors. The directors may base a determination that a standby commitment is of comparable quality upon a finding that the issuer of the commitment presents a minimal risk of default.

(v) Immediately after the acquisition of any put, the money market fund will not, with respect to 75 percent of the total amortized cost value of its assets, have invested more than 5% of the total amortized cost value of its assets in securities underlying puts from the same institution. An unconditional put shall not be considered to be a put from that institution, provided, that, the amortized cost value of all securities held by the money market fund and issued or guaranteed by the same institution does not exceed 10 percent of the total amortized cost value of the fund’s assets. For the purposes of this paragraph, a put will be considered to be from the party to whom the fund will look for payment of the exercise price and an unconditional put will be considered to be a guarantee of the underlying security or securities.

\* \* \* \* \*

(3) \* \* \*

(iii) The money market fund will limit its portfolio investments, including puts and repurchase agreements, to those United States dollar-denominated instruments which the board of directors determines present minimal credit risks and which are (A) of “high quality” as determined by any nationally recognized statistical rating organization that is not an affiliated person, as defined in Section 2(a)(3)(C) of the Act [*15 U.S.C. 80a-2(a)(3)(C)*], of the issuer of or any insurer, guarantor or provider of credit support for the instrument which the money market fund is considering acquiring, or (B) in the case of an instrument that is not rated, of comparable quality as determined by the board of directors. In

this regard, a demand instrument must have received both a short-term and a long-term high quality rating or have been determined to be of comparable quality by the board of directors, except that a demand instrument that has an unconditional demand feature may be acquired solely in reliance upon a short-term high quality rating or upon a finding of comparable short-term quality by the board of directors. The directors may base a determination that a standby commitment is of comparable quality upon a finding that the issuer of the commitment presents a minimal risk of default.

(iv) Immediately after the acquisition of any put, the money market fund will not, with respect to 75 percent of the total market-based value of its assets, have invested more than 5% of the total market-based value of its assets in securities underlying puts from the same institution. An unconditional put shall not be considered to be a put from that institution, *provided, that*, the market based value of all securities issued or guaranteed by the same institution and held by the money market fund does not exceed ten percent of the total market-based value of the fund's assets. For the purposes of this paragraph, a put will be considered to be from the party to whom the fund will look for payment of the exercise price and an unconditional put will be considered to be a guarantee of the underlying security or securities.

(b) For the purposes of this rule, the maturity of a portfolio instrument shall be deemed to be the period remaining until the date noted on the face of the instrument as the date on which the principal amount must be paid, or in the case of an instrument called for redemption, the date on which the redemption payment must be made, except that:

(1) An instrument that is issued or guaranteed by the United States government or any agency thereof which has a variable rate of interest readjusted no less frequently than annually may be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.

(2) A variable rate instrument, the principal amount of which is scheduled on the face of the instrument to be paid in one year or less, may be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.

(3) A variable rate instrument that is subject to a demand feature may be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) A floating rate instrument that is subject to a demand feature may be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(5) A repurchase agreement may be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or where no date is specified, but the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.

(6) A portfolio lending agreement may be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where no date is specified, but the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(c) Definitions. (1) The "amortized cost method of valuation" is the method of calculating an investment company's net asset value whereby portfolio securities are valued by reference to the fund's acquisition cost as adjusted for amortization of premium or accumulation of discount rather than by reference to their value based on current market factors.

(2) The "penny-rounding method of pricing" is the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(3) A "put" is a right to sell a specified underlying security or securities within a specified period of time and at a specified exercise price, that may be sold, transferred or assigned only with the underlying security or securities.

(4) A "standby commitment" is a put that entitles the holder to achieve same day settlement and to receive an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise.

(5) A “demand feature” is a put that entitles the holder to receive the principal amount of the underlying security or securities and which may be exercised either (A) at any time on no more than 30 days’ notice; or (B) at specified intervals not exceeding one year and upon no more than 30 days’ notice.

(6) An “unconditional put” or an “unconditional demand feature” is a put or a demand feature that by its terms, would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

(7) A “variable rate instrument” is one whose terms provide for the adjustment of its interest rate on set dates and which, upon such adjustment, can reasonably be expected to have a market value that approximates its par value.

(8) A “floating rate instrument” is one whose terms provide for the adjustment of its interest rate whenever a specified interest rate changes and which, at any time, can reasonably be expected to have a market value that approximates its par value.

(9) The term “nationally recognized statistical rating organization” shall mean any nationally recognized statistical rating organization, as that term is used in Rule 15c3-1(c)(2)(vi)(F) under the Securities Exchange Act of 1934 [*17 CFR 240.15c3-1(c)(2)(vi)(F)*].

(10) “One year” shall mean 365 days except, in the case of an instrument that was originally issued as a one year instrument, but had up to 375 days until maturity, one year shall mean 375 days.

Note: The board of directors of a money market fund relying on this rule is reminded that the Commission has said that “because of the nature of money market funds, the difficulties that could arise in conjunction with the purchase of illiquid instruments by such funds might be even greater than for other types of openend management investment companies. . . . By purchasing or otherwise acquiring illiquid instruments, a money market fund exposes itself to a risk that it will be unable to satisfy redemption requests promptly. . . . In addition, . . . management of the investment company’s portfolio could also be affected by the purchase of illiquid instruments. . . . Finally, the purchase of illiquid instruments can seriously complicate the valuation of a money market fund’s shares and can result in the dilution of shareholders’ interests.” See Investment Company Act Release No. 13380 (July 11, 1983) [*48 FR 32555* at 32561-32562 July 18, 1983]. See also Investment Company Act Release No. 5847 (October 21, 1969) [*35 FR 19989*].

3. By adding § 270.2a41-1 to read as follows:

§ 270.2a41-1 Valuation of standby commitments by registered investment companies.

(a) A standby commitment as defined in Rule 2a-7(c)(4) under the Act [*17 CFR 270.2a-7(c)(4)*] may be assigned a fair value of zero, Provided, That:

(1) The standby commitment is not used to affect the company’s valuation of the security or securities underlying the standby commitment; and

(2) Any consideration paid by the company for the standby commitment, whether paid in cash or by paying a premium for the underlying security or securities, is accounted for by the company as unrealized depreciation until the standby commitment is exercised or expires.

4. By revising paragraphs (d)(8)(iii) and (d)(8)(iv) and adding new paragraph (d)(8)(v) of § 270.12d3-1 to read as follows. The authority citation at the end of the section is removed.

§ 270.12d3-1 Exemption of acquisitions of securities issued by persons engaged in securities related businesses.

\* \* \* \* \*

(d) \* \* \*

(8) \* \* \*

(iii) Exercise of options, warrants, or rights acquired in compliance with this rule;

(iv) Conversion of convertible securities acquired in compliance with this rule; and

(v) Acquisition of puts, as defined in Rule 2a-7(c)(3) under the Act [*17 CFR 270.2a-7(c)(3)*], provided that, immediately after the acquisition of any put, the company will not, with respect to 75 percent of the total value of its assets, have invested more than five percent of the total value of its assets in securities underlying puts from the same institution. An unconditional put shall not be considered a put from that institution, provided, that, the value of all securities issued or guaranteed by the same institution and held by the investment company does not exceed ten percent of the total value of the company's assets. For the purposes of this section, a put will be considered to be from the party to whom the company will look for payment of the exercise price and an unconditional put, as defined in Rule 2a-7(c)(6) under the Act [*17 CFR 270.2a-7(c)(6)*], will be considered to be a guarantee of the underlying security or securities.

\* \* \* \* \*

By the Commission.

Shirley E. Hollis  
Assistant Secretary  
March 12, 1986

## PROPOSED REVISIONS TO RULES REGULATING MONEY MARKET FUNDS

Release Nos. 33-6870; IC-17589

July 17, 1990

AGENCY: Securities and Exchange Commission.

ACTION: Proposed amendments to rules and forms.

SUMMARY: The Commission is proposing for public comment amendments to rules and forms under the Securities Act of 1933 and the Investment Company Act of 1940 affecting money market funds. The proposed amendments would tighten the risk-limiting conditions of Rule 2a-7, the rule that permits money market funds to use the amortized cost method of valuing portfolio securities and the penny-rounding method of computing price per share, and would require all funds that hold themselves out to the public as money market funds to meet those conditions. The amendments are intended to reduce the likelihood that a money market fund would not be able to maintain a stable net asset value.

DATES: Comments must be received on or before [60 days after publication in the Federal Register.]

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549. All comment letters should refer to File No. S7-13-90. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Richard Pfordte, Special Counsel, or Kenneth J. Berman, Special Counsel, Office of Disclosure and Adviser Regulation (202) 272-2107, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 5-2, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") today is proposing for comment several amendments to rules and forms affecting money market funds, including Rule 2a-7 [17 CFR 270.2a-7] under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] ("1940 Act"). Rule 2a-7 is used by most money market funds to maintain a stable net asset value of \$1.00 per share.

The Commission is proposing for comment amendments to Rule 2a-7 to: (1) require any registered investment company using the rule ("money market fund" or "fund") to (A) limit its investment in the securities of any one issuer to no more than five percent of fund assets, measured at the time of purchase and (B) limit its investment in the securities of all issuers having the second highest rating assigned by any nationally recognized statistical rating organization ("NRSRO")<sup>1</sup> to no more than five percent of fund assets, with investment in any one such issuer being limited to no more than one percent of fund assets, in each case measured at the time of purchase; (2) (A) substitute the term "eligible quality" for the term "high quality"<sup>2</sup> and define eligible quality (i) in respect of a rated security, to mean a security which has been rated (or the issuer of which has been rated) by all NRSROs which have issued a rating with respect to the security (or issuer) in one of the two highest rating categories and (ii) in respect of an unrated security, to mean a security which has not been rated and whose issuer's other securities have not been rated less than eligible quality; (B) require a fund, in the event that the rating of a portfolio security is downgraded by a NRSRO or the issuer defaults on its obligations, to reassess promptly whether the security presents minimal credit risks, determine whether continuing to hold the security is in the best interest of the fund, and record such actions in fund records; and (C) require a fund to notify the Commission if it holds defaulted securities which amount to one half of one percent or more of fund assets; (3) require a fund to maintain a dollar-weighted average portfolio maturity of not more than ninety days, and to purchase no security with a remaining maturity of more than two years; and (4) make it unlawful for any registered investment company to use "money market" in its name or hold itself out as a "money market fund" unless it meets the conditions of Rule 2a-7

<sup>1</sup> The term "nationally recognized statistical rating organization" is used in the Commission's uniform net capital rule [17 CFR 240.15c3-1(c)(2)(vi)(F)]. The Commission's Division of Market Regulation responds to requests for NRSRO designation through no-action letters.

<sup>2</sup> Money market funds may only invest in "high quality" securities. See paragraphs (a)(2)(iv) and (a)(3)(iii) of Rule 2a-7 [17 CFR 270.2a-7(a)(2)(iv), 270.2a-7(a)(3)(iii)]. Unless otherwise indicated, the term "high quality" is used in reference to the current requirements of the rule and the term "eligible quality" is used in reference to the proposed amendments.

relating to portfolio diversification (proposed paragraph (c)(4), which would require that a fund invest no more than five percent of its assets in the securities of any one issuer and no more than five percent of its assets in the securities of all issuers that have less than the highest credit rating from any NRSRO, with investment in any one such issuer being limited to one percent of fund assets), quality (proposed paragraph (c)(3), which would require that fund investments be limited to securities presenting minimal credit risks and which are “eligible quality”), and maturity (proposed paragraph (c)(2), which would require that the average weighted maturity of the fund’s portfolio not exceed ninety days and that fund investments be limited to securities with a remaining maturity of two years or less) (collectively, the “risk-limiting conditions”). The proposed amendments would also clarify certain other aspects of Rule 2a-7.

Except for the proposed diversification conditions and the limitation on investment in securities that have not received the highest rating from any NRSRO, the proposed risk-limiting conditions would be applicable to all money market funds, including those that hold themselves out as distributing income that is exempt from federal income tax (“tax exempt funds”). The Commission is not at this time proposing to make the diversification requirements and the limit on investment in securities not having the highest NRSRO rating applicable to tax exempt funds.

The Commission is also proposing for comment amendments to Rule 482 [17 *CFR* 230.482] under the Securities Act of 1933 [15 *U.S.C.* 77a *et seq.*] (“1933 Act”) and Rule 34b-1 under the 1940 Act [17 *CFR* 270.34b-1], and Forms N-1A, N-3, and N-4 [17 *CFR* 274.11A, 274.11b, and 274.11c] under the 1933 and 1940 Acts to: (i) require the cover page of money market fund prospectuses to disclose prominently that fund shares are neither insured nor guaranteed by the U.S. government and that there is no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share; and (ii) revise the definition of a “money market fund” for purposes of those funds eligible to quote a seven-day yield in advertisements and sales literature to include only those money market funds that meet the risk-limiting conditions.

The amendments proposed today are intended to reduce the likelihood that a money market fund would “break a dollar,” that is, reduce its share price to less than \$1.00 because of significant fluctuations in the value of its portfolio securities under certain circumstances. The amendments and the Commission’s reasons for proposing them are discussed below.

## I. Background

Money market funds, which were first introduced in the mid-1970s, are open-end management investment companies investing in short-term debt instruments. Through these funds, individual investors can participate in the money markets. Money market funds have also attracted investments from corporations, bank trust departments, and other institutional investors.<sup>3</sup>

Money market funds have become the most popular type of investment company in the United States, in terms of both the number of shareholder accounts and asset size. At the end of 1975, there were 36 money market funds with approximately \$3.7 billion in assets in approximately 209,000 shareholder accounts.<sup>4</sup> There are currently 649 money market funds with over \$450 billion in assets in approximately 21.3 million shareholder accounts.<sup>5</sup> Mutual funds as a group (2,918 funds, including money market funds) had approximately 58.2 million shareholder accounts and \$982 billion of assets; over thirty-seven percent of these assets were in money market funds.<sup>6</sup>

One unique feature of money market funds is that they seek to maintain a stable net asset value per share, typically at \$1.00 per share. Investors have apparently found it convenient to purchase and sell shares of money market funds at a fixed price; under such arrangements, an increase or decrease in the value of a shareholder’s account is reflected in an increase or decrease in the number of shares owned. Many money market funds allow investors to use checks to redeem

<sup>3</sup> A significant number of funds are aimed exclusively at institutional investors. Currently 114 money market funds sell shares only to institutions. IBC/Donoghue’s Money Fund Report (June 1, 1990) (hereinafter, “Money Fund Report”). Data derived from the Money Fund Report is as of May 29, 1990.

<sup>4</sup> Investment Company Institute Mutual Fund Fact Book 78, 79 (30th ed. 1990) (hereinafter, “Mutual Fund Fact Book”).

<sup>5</sup> Money Fund Report, *supra* note 3. The information with respect to shareholder accounts is derived from the Mutual Fund Fact Book, *supra* note 4 at 79.

<sup>6</sup> Mutual Fund Fact Book, *supra* note 4.

shares and, because the value of an account does not change due to fluctuations of share values, many investors use money market funds as alternatives to checking accounts since they can readily ascertain their account balance.

To maintain a stable price per share, most money market funds use the amortized cost method of valuation or the penny-rounding method of pricing, as permitted by Rule 2a-7. But for Rule 2a-7, Section 2(a)(41) of the 1940 Act [15 U.S.C. 80a-2(a)(41)], together with Rules 2a-4 and 22c-1 under the 1940 Act [17 CFR 270.2a-4, 270.22c-1], would require a money market fund to calculate its current net asset value per share by valuing portfolio securities for which market quotations are readily available at market value, and other securities and assets at fair value as determined in good faith by the board of directors (“marking-to-market”). These valuation requirements are designed to prevent the interests of investors from being diluted or otherwise adversely affected if fund shares are not priced fairly.<sup>7</sup>

The Commission adopted Rule 2a-7 in 1983 to codify standards that had been developed in a series of orders exempting money market funds from the pricing and valuation provisions of the 1940 Act.<sup>8</sup> Because money market funds generally invest only in debt securities with a maturity of one year or less (“short-term”), valuing these securities under traditional requirements can be difficult or costly. To reduce costs to funds, and to enable them to more readily maintain a stable price per share, the rule permits money market funds to use the amortized cost method of valuation and penny-rounding method of pricing. To determine net asset value under the amortized cost method of valuation, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accumulation of discount. Share price is determined under the penny-rounding method of pricing by valuing securities at fair market value or amortized cost,<sup>9</sup> and then rounding the net asset value per share to the nearest one cent on a share value of one dollar.

The rule limits money market funds to investing in “high quality,”<sup>10</sup> short term, dollar denominated debt securities, because these securities do not greatly fluctuate in value with interest rate changes, and as a result are subject to less market risk, in comparison to lower quality and longer term securities. A basic premise underlying the amortized cost method is that securities held until maturity will yield a value equivalent to the amortized cost value, regardless of any current disparity between the amortized cost value and market value.<sup>11</sup> The rule’s conditions are designed to reduce the potential for the net asset value of the money market fund using the amortized cost method of valuation to deviate materially from a valuation that would be determined if the fund were using the mark-to-market method required by Rules 2a-4 and 22c-1 under the 1940 Act. In the case of the penny-rounding method, these conditions limit risk so that funds are permitted to round to the nearest cent on a share value of a dollar (as opposed to the nearest one tenth of one cent).<sup>12</sup>

Most money market funds find compliance with Rule 2a-7 to be the preferable way to maintain a stable net asset value. A few funds, however, do not rely on the rule. These funds value portfolio securities by marking-to-market daily, except for those securities maturing in sixty days or less, which may be valued at amortized cost.<sup>13</sup> They seek to maintain a constant price per share despite the fluctuation of net asset value which occurs with mark-to-market valuation of securities by including changes in the market value of their assets as part of the dividends they declare daily. This method of maintaining a constant price per share is sometimes referred to as the “full payout” method.

<sup>7</sup> If shares are sold or redeemed based on a net asset value which turns out to have been either understated or overstated in comparison to the amount at which portfolio instruments could have been sold, then the interests of either existing shareholders or new investors will have been diluted. See Investment Trusts and Investment Companies: Hearings on S.3580 Before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3rd Sess. 136-138, 288 (1940).

<sup>8</sup> See Investment Company Act Rel. No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] (hereinafter, “Release 13380”).

<sup>9</sup> The Commission has adopted an interpretive position permitting all investment companies to use the cost amortization method of valuation with respect to debt securities that mature in sixty days or less. See Investment Company Act. Rel. No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)] (hereinafter, “Release 9786”).

<sup>10</sup> Under the current rule, “high quality” securities are generally considered to be those that have received one of the top two ratings by a NRSRO or, in the case of unrated securities, are of comparable quality. See Release 13380, *supra* note 8, at n. 34. The proposed amendments would modify this definition in certain respects, and substitute the term “eligible quality” for “high quality.” See Part II.2 of this Release and *supra* note 2.

<sup>11</sup> Release 13380, *supra* note 8, 48 FR at 32557.

<sup>12</sup> See *id.* at n. 8 and accompanying text, and Investment Company Act Rel. No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] at n. 5.

<sup>13</sup> See Release 9786, *supra* note 9.



Rule 2a-7 requires money market funds using the amortized cost method also to monitor the market value of portfolio securities. If the value of securities changes because, for example, interest rates rise significantly, then the market value of securities may be less than their value under the amortized cost method. When the amount of deviation exceeds one half of one percent, Rule 2a-7(a)(2)(ii) requires the board of directors of a money market fund to take such action as it deems appropriate to eliminate or reduce to the extent practicable the deviation, including reducing the net asset value per share to less than \$1.00. Similarly, the share price of a fund using the penny-rounding method will change if the per share price determined by marking-to-market deviates by more than one-half of one cent (for a share price of \$1.00) from the established price as determined under the penny-rounding method.<sup>14</sup>

The money markets have changed significantly since the adoption of Rule 2a-7 in 1983, particularly in respect of commercial paper. The commercial paper market has expanded considerably: at the end of 1989, commercial paper outstanding amounted to over \$500 billion, as compared to approximately \$180 billion at the end of 1983. The percentage of money market fund assets invested in commercial paper has increased from twenty-nine percent in 1983 to fifty percent at the end of 1989.<sup>15</sup>

A recent study by Moody's Investor Service ("Moody's") found that over an eighteen year period, five issuers with Moody's short-term ratings defaulted on commercial paper. Four of these defaults occurred in the first ten months of 1989.<sup>16</sup> In addition, two issuers not included in this study, Integrated Resources, Inc. and Mortgage and Realty Trust, have defaulted on their commercial paper since June 1989. In the latter two cases, the commercial paper had a "high quality"<sup>17</sup> rating from a NRSRO until shortly before the default and was held by several money market funds at the time of the default. The shareholders of these money market funds were not adversely affected, however, because each fund's investment adviser purchased the defaulted commercial paper from the funds at its amortized cost or principal amount.<sup>18</sup>

The credit ratings of some large money center banks also have declined recently.<sup>19</sup> These banks issue instruments such as large certificates of deposit which money market funds purchase, and provide credit support for securities of other issuers which otherwise would not be "eligible quality" and thus would not be permitted investments for money market funds relying on Rule 2a-7.<sup>20</sup>

The Commission believes that, in light of these developments, it is appropriate to reexamine the conditions of the rule. The Commission is proposing certain changes designed to assure that the valuation methods authorized by the rule continue to be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act.<sup>21</sup> The Commission also believes that it is appropriate to propose certain amendments that are designed to protect investors by assuring that any investment company that holds itself out as a money market fund meets the proposed risk-limiting conditions of Rule 2a-7.

Money market funds are not insured or guaranteed by the U.S. government, and investment in a money market fund is subject to the risks normally associated with investing in securities.

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<sup>14</sup> This is commonly referred to as "breaking a dollar."

<sup>15</sup> See Laing, *Never Say Never*, *Barron's*, Mar. 26, 1990, at 6, col. 1.

<sup>16</sup> See Moody's Special Report, *Defaults and Orderly Exits of U.S. and European Commercial Paper Issuers*, 5-6 (Nov. 1989) (hereinafter, "Commercial Paper Defaults"). See also *Junk is Ripping into Commercial Paper*, *Bus. Wk.* 84-86 (Mar. 26, 1990).

<sup>17</sup> The proposed amendments would substitute the term "eligible quality" for the term "high quality." See Section II.2. of this Release for a discussion of the meaning of "eligible quality" for purposes of Rule 2a-7. Unless otherwise indicated, the term "high quality" is used in reference to the current requirements of the rule and the term "eligible quality" is used in reference to the proposed amendments.

<sup>18</sup> If the advisers had not purchased the securities and the market value of the commercial paper had declined by a substantial amount because of the default and, as a result, the amortized cost value of a fund's portfolio deviated by more than one half of one percent from its market value, the affected funds could have been required to break a dollar. See *supra* note 14 and accompanying text.

<sup>19</sup> See Moody's *Industry Outlook: U.S. Money Center Banks* (Aug. 1989) (the credit ratings of most money center banks were downgraded during 1986-88).

<sup>20</sup> See *infra* note 52 and accompanying text.

<sup>21</sup> See Section 6(c) of the 1940 Act [*15 U.S.C. 80a-6(c)*] under which Rule 2a-7 was adopted. Since its adoption, Rule 2a-7 has been amended only once, in 1986, to permit money market funds to acquire put options and standby commitments. See *Investment Company Act Rel. No. 14983* (Mar. 12, 1986) [*51 FR 9773* (Mar. 21, 1986)] (hereinafter, "Release 14983").

## II. Proposed Revisions to Rules

The proposed amendments to Rule 2a-7<sup>22</sup> would impose additional conditions with respect to diversification, quality and portfolio maturity; would make the risk-limiting conditions of Rule 2a-7 applicable to all investment companies that hold themselves out as money market funds, not just to those using the valuation procedures permitted by the rule; would require certain disclosure by money market funds; and would clarify the meaning of certain terms and requirements in the rule; and would limit funds eligible to quote seven day yields in advertisements to those funds that comply with the proposed risk-limiting conditions.

### 1. Diversification

In order to limit investment risk for shareholders, mutual funds generally diversify their investments to some extent, i.e., they invest in many securities rather than in only a few issues. Diversification limits investment risk to a fund by spreading the risk of loss among a number of securities.<sup>23</sup> The Commission is proposing to require money market funds (other than tax exempt money market funds) to comply with certain specific diversification requirements, and to limit their overall investment in securities not receiving the highest NRSRO rating. As explained below in Section II.6. of this Release, the Commission is not at this time proposing to make these conditions applicable to tax exempt money market funds.

#### a. Five Percent Test for All Securities

Most money market funds are diversified investment companies as that term is defined in the 1940 Act. Diversified investment companies under Section 5(b)(1) of the 1940 Act [15 U.S.C. 80a-5(b)(1)] are required, with respect to seventy-five percent of their assets, to invest in cash, cash items, government securities, other investment companies, and “other portfolio securities.” With respect to other portfolio securities, a diversified fund may not invest more than five percent of its assets in the securities of any one issuer.<sup>24</sup> Under Section 5(b)(1) the remaining twenty-five percent of fund assets may be invested in any manner. Money market funds also comply with the diversification requirements of subchapter M of the Internal Revenue Code of 1986.<sup>25</sup>

Rule 2a-7 currently contains a diversification condition only with respect to securities underlying puts, and is applicable only with respect to seventy-five percent of the fund’s assets.<sup>26</sup> This condition is designed to ensure that a fund’s liquidity would not be impaired by the fund relying too heavily upon the same institution or upon only a handful of institutions to maintain liquidity.<sup>27</sup> This rationale has applicability to fund investments generally, since the ability of a fund to maintain a stable net asset value under Rule 2a-7 may be impaired to the extent it invests heavily in one or more institutions that subsequently experience credit problems or default on their securities.

Most money market funds have policies imposing stricter diversification standards than those required by Section 5(b)(1) of the 1940 Act or subchapter M of the Internal Revenue Code. For example, many money market funds limit their investment in any one issuer to not more than five percent of fund assets.<sup>28</sup> The proposed amendments would impose this

<sup>22</sup> The proposed revisions to Rule 2a-7 would substantially revise the paragraph numbering of the rule. A conversion table, attached as an appendix to this release, indicates where provisions of the current rule are found in the proposed amended rule.

<sup>23</sup> See J. Francis, *Management of Investments* 732 (2nd ed. 1988).

<sup>24</sup> However, Rule 5b-2 under the 1940 Act [17 CFR 270.5b-2] provides that a guarantee is not deemed to be a security of the guarantor provided that the value of all securities held by the fund guaranteed or issued by the guarantor does not exceed ten percent of its total assets. The substance of Rule 5b-2 would be incorporated into proposed paragraph (c)(4)(iii)(C) of Rule 2a-7.

<sup>25</sup> 26 U.S.C. 851 *et seq.* To be a “regulated investment company” under subchapter M of the Internal Revenue Code, a fund must, among other things, have at the close of each quarter of the taxable year invested at least fifty percent of its total assets in (i) cash and cash items, (ii) government securities, (iii) securities of other regulated investment companies, or (iv) securities (other than those in clauses (ii) and (iii)) of any one or more issuers. In addition, the regulated investment company cannot, with respect to fifty percent of its assets, invest more than five percent of its total assets in the securities of one issuer, and the total amount of the securities acquired cannot represent more than ten percent of the outstanding voting securities of such issuer. See Section 851(b)(4).

<sup>26</sup> See paragraphs (a)(2)(v) and (a)(3)(iv) of the current rule.

<sup>27</sup> See Release 14983, *supra* note 21.

<sup>28</sup> See, e.g., prospectuses of Axe-Houghton Money Market Fund, Inc., dated Oct. 31, 1988, Weiss Peck & Greer Funds Trust, dated May 1, 1990, Stein Roe Mutual Funds, dated Nov. 1, 1989, and Lord Abbett Cash Reserve Fund, dated Nov. 1, 1988.

stricter test on all money market funds, except for tax exempt funds. That is, the proposed amendments would limit a money market fund to investing no more than five percent of the value of its total assets, at the time of acquisition, in the securities of any one issuer (other than U.S. government securities specified in Section 2(a)(16) of the 1940 Act [*15 U.S.C. 80a-2(a)(16)*]) (the “five percent diversification test”).<sup>29</sup> Paragraph (c)(4)(i) of the amended rule would differ from the diversification test under Section 5(b)(1) of the 1940 Act only to the extent that the five percent diversification test would apply to all of the assets of the money market fund and not only with respect to seventy-five percent of the fund’s assets.<sup>30</sup> Tax exempt funds would continue to be subject only to the diversification requirements of the current rule with respect to puts.<sup>31</sup>

#### b. Test for Securities Not Having the Highest NRSRO Rating

Rule 2a-7 limits fund investment to securities receiving either the highest or second highest NRSRO ratings,<sup>32</sup> or unrated securities the board (or its delegate) finds to be of comparable quality. Investment in issuers receiving the second highest, rather than the highest, NRSRO rating may create a greater risk for funds seeking to maintain a stable price per share.<sup>33</sup> The Commission proposes to impose an additional requirement with respect to securities of issuers that have received the second highest rating of any NRSRO (or, if unrated, are of comparable quality, as determined by the board of directors).<sup>34</sup> The proposed amended Rule 2a-7(c)(4) would limit a money market fund to investing no more than five percent of its total assets in securities not having the highest NRSRO rating (the “five percent quality test”), with investment in any one such issuer being limited to no more than one percent of total assets (the “one percent diversification test”), in each case determined at the time of acquisition.<sup>35</sup>

Compliance with the five percent diversification test, the five percent quality test and the one percent diversification test would be measured at the time the fund purchases a security, and thus a fund would not be required subsequently to dispose of a security because of a change in the percentage of fund assets the security represents or in the fund’s overall investment in securities not having the highest NRSRO rating. In the event a security that had the highest quality rating (e.g., Prime-1) at the time it was acquired is subsequently downgraded but is still eligible quality (e.g., Prime-2), the money market fund would not be required to dispose of the security if more than one percent of fund assets consisted of securities issued or guaranteed by the issuer of the down-graded security or more than five percent of fund assets were invested in securities not having the highest NRSRO rating. However, the board (or its delegate) would be required to reassess promptly whether the security presents minimal credit risks as required by proposed paragraph (c)(5)(i). The money market fund could not subsequently acquire any additional securities of that issuer if, after purchase, it would exceed the one percent diversification test unless such securities had been subsequently upgraded.<sup>36</sup> Similarly, it could not

<sup>29</sup> The proposed amendments would not change the current rule’s requirements for computing the asset value of a fund for this purpose. In the case of a fund using the amortized cost method of valuation, a fund’s “total assets” would be computed by reference to the total amortized cost value of its assets; in the case of other funds, it would be based on market value. *See* proposed paragraph (a)(12).

<sup>30</sup> Thus, the proposed amended rule, if adopted, should be interpreted identically to Section 5(b)(1) of the 1940 Act except to the extent that the proposed rule applies to 100 percent of the fund’s assets. In addition, the interpretative position taken by the Commission’s Division of Investment Management in *MoneyMart Assets Inc.* (pub. avail. Sept. 3, 1980) (permitting a diversified fund to invest more than five percent of its assets in repurchase agreements fully collateralized by government securities where the fund has the unqualified right to sell the collateral in the event of a default by the other party to the agreement) would be codified in proposed paragraph (c)(4)(i) and would be applicable to the diversification computations under the proposed rule.

<sup>31</sup> A fund may invest up to five percent of its assets in puts from one institution, and may invest up to ten percent of its assets in unconditional puts from any one institution. *See* paragraphs (a)(2)(v) and (a)(3)(iv) of the current rule and proposed paragraph (c)(4)(ii).

<sup>32</sup> Currently, there are five NRSROs: Duff and Phelps, Inc. (“D&P”), Fitch Investors Services, Inc. (“Fitch”), McCarthy, Crisanti & Maffei, Inc. (“MCM”), Moody’s Investors Service (“Moody’s”) and Standard & Poor’s Corp. (“S&P”). *See supra* note 1.

<sup>33</sup> *See infra* note 43 and accompanying text.

<sup>34</sup> In the case of issuers rated by Moody’s, this provision would be applicable to issuers that received a rating of Prime-2; in the case of securities rated by D&P, Fitch, MCM and S&P, it would be applicable to securities rated Duff 2, F-2, MCM-2 and A-2, respectively.

<sup>35</sup> The one percent limit is expected to permit funds to purchase securities not having the highest NRSRO rating in standard lots or denominations while at the same time limiting the risk of investing in the securities of an issuer that is considered to be less than the highest quality.

<sup>36</sup> For purposes of Rule 2a-7, a fund acquires a security when an issuer reissues or “rolls over” a debt instrument. Therefore, at the time of the rollover, the fund must be in compliance with the diversification requirements of the rule.

acquire any additional securities that did not have the highest NRSRO rating if, after purchase, the fund's investment in all such securities would exceed five percent of its total assets.

The Commission requests comment on the proposed five percent diversification test, the five percent quality test and the one percent diversification test. Specific comment is requested on whether the percentage levels of the diversification tests are too high or too low, and whether alternative levels (such as three, four, six or ten percent, in lieu of the proposed five percent diversification test; or one-half of one, two, three or four percent in lieu of the proposed one percent diversification test) should be adopted. Comment is also requested on the five percent quality test, specifically on whether an overall limit on fund investment in securities not having the highest NRSRO rating is appropriate, and whether alternative levels (such as ten, fifteen, or twenty five percent) should be adopted. Comment is also requested on the impact of the proposed requirements on smaller money market funds. For example, would a smaller fund be unable to purchase certain types of securities because the fund could not purchase a security in the denomination in which it is ordinarily traded?<sup>37</sup> Commenters are also requested to suggest alternative tests that would address the Commission's concerns relating to diversification and quality. Commenters are also requested to discuss the effect on the commercial paper market of either the five percent diversification test or the proposed limitations on investment in securities that do not have the highest NRSRO rating. Comment is specifically invited from issuers of, or dealers in, commercial paper on the effects that this proposal would have on the capital markets. With respect to the actions required to be taken if the rating of a security is downgraded, comment is requested on whether any NRSRO downgrade should be determinative, or whether more than one NRSRO downgrade should be required.

Some representatives of the investment company industry have suggested that money market funds be permitted to invest only in securities that have the highest rating of at least one NRSRO (e.g., A-1 or Prime-1) because of the greater risk of default represented by a lower rating. They have suggested that a more stringent diversification requirement for securities that have not received the highest NRSRO rating would not significantly limit this risk. The Commission solicits comment on whether, as an alternative, it should adopt a definition of "eligible quality" that includes only securities that have the highest rating of all (or less than all) NRSROs rating the security or its issuer (or, if unrated, are of comparable quality as determined by the fund's board of directors). As discussed below in Section II.6. of this release, the Commission is not proposing that these alternatives, if adopted, be applicable to tax exempt funds.

## 2. Quality of Portfolio Investments

Rule 2a-7 requires money market funds to invest in securities which the board determines present minimal credit risks and which are "high quality," as determined by any NRSRO, or if unrated, are of comparable quality as determined by the fund's board of directors. The Commission is proposing to amend these provisions of the rule to clarify the meaning of certain terms and to change the term "high quality" to "eligible quality."

### a. Rated Securities

Rule 2a-7 limits money market funds to purchasing securities which are "high quality," as determined by any NRSRO, or, in the case of unrated securities, are of comparable quality as determined by the board of directors. "High quality" is not currently defined in the text of the rule; however, Release 13380 describes a security as being of "high quality" if it has received one of the top two ratings by any NRSRO, or, in the case of unrated securities, if it is of comparable quality as determined by the fund board of directors.<sup>38</sup> Certain NRSROs assign ratings to specific securities;<sup>39</sup> others rate the capacity of issuers to repay senior debt without reference to a specific security.<sup>40</sup> Proposed paragraph (a)(5) would define an "eligible quality" security as one which has been rated (or the issuer of which has been rated) by all NRSROs that have assigned a rating with respect to such security (or issuer) in one of the two highest rating categories.<sup>41</sup>

<sup>37</sup> For example, the proposed amendment would preclude a fund with less than \$10,000,000 in assets from purchasing the commercial paper of a P-2 issuer if it could only be purchased in denominations of \$100,000.

<sup>38</sup> See Release 13380, *supra* note 8, at n. 34.

<sup>39</sup> See Standard & Poor's Corp., Standard & Poor's Credit Overview: Corporate and International Ratings 87 (1986).

<sup>40</sup> See Moody's Investor Service, Moody's Global Short-Term, Market Record 6 (Apr. 1990).

<sup>41</sup> With respect to an unrated security, "eligible quality" would include a security of comparable quality as determined by the fund's board of directors or its delegate. See Part II.2.b. of this Release.

Currently, Rule 2a-7 permits a fund relying on the rule to invest in a security as long as at least one NRSRO has rated the security in the requisite category. Some securities have “split” ratings, i.e., different quality ratings from different NRSROs.<sup>42</sup> A split rating may be the result of the failure of one NRSRO to perceive quality problems (or improvements) that another NRSRO has perceived and has reflected in its ratings; it may also reflect differences among NRSROs as to the emphasis placed on different conditions.<sup>43</sup> The Commission believes that a more cautious approach, which requires the security to receive the requisite rating from each NRSRO rating the security, to be warranted. Accordingly, paragraph (a)(5) of the proposed amended rule would require that a security receive one of the top two ratings from all NRSROs that have assigned a rating with respect to such security. As discussed above, the Commission is also requesting comment on whether the definition of “eligible quality” should only include a security (or issuer) that has received the highest NRSRO rating from all NRSROs (or, if unrated, that is of comparable quality, as determined by the fund’s board of directors).<sup>44</sup>

Comment is requested on whether this proposal would place unnecessary restrictions on money market funds in terms of their ability to invest in securities that present minimal credit risks. The Commission requests data on the number of securities or issuers that have received split ratings and the extent to which split ratings have resulted from one NRSRO changing its rating in anticipation of credit deterioration as opposed to credit improvement. Comment is also requested on alternatives to the Commission proposal. For example, in the event of a split rating, should the rule permit a money market fund to rely on the most recent rating, or, where the security is rated by more than two NRSROs, on the rating assigned by the majority (or two) of the NRSROs? The Commission would find it helpful if any alternatives were accompanied by suggested rule text. Comment is also requested on whether money market funds would face any significant burdens in keeping track of all the NRSRO ratings of a particular security or issuer. Comment is also requested on the impact that these proposals would have on issuers of commercial paper and other short-term debt securities in terms of their ability to raise capital.

When Rule 2a-7 was initially proposed, there was substantial comment on the significance of NRSRO ratings. The Commission concluded that the requirement that a security, if rated, have a “high quality” rating “provides protection by ensuring input into the quality determination by an outside source.”<sup>45</sup> Comment is requested on whether NRSRO ratings are appropriate guides to creditworthiness, whether the role of NRSRO ratings in Rule 2a-7 is appropriate or necessary, whether credit quality judgments should be left exclusively to fund directors and investment advisers, and whether reliance on such ratings may discourage others from performing independent credit assessments.

Some NRSROs provide ratings of money market funds. These ratings purport to evaluate the safety of principal invested in a money market fund. The Commission has previously proposed to amend Rules 134 and 436 [*17 CFR 230.134, 230.436*] under the 1933 Act to allow a money market fund receiving a rating from a NRSRO to include the rating in the fund’s prospectus and advertisement without the filing of the NRSRO’s consent (in effect, exempting the NRSRO from liability under Section 11 at the 1933 Act) (the “money market fund ratings proposal”).<sup>46</sup> Comment is requested on whether the Commission should adopt the money market fund ratings proposal as an alternative to amending Rule 2a-7,

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<sup>42</sup> See Bush, Rating Agencies’ Performance Put on Watch, *The Financial Times Limited*, May 2, 1990 at 37, col. 1.

<sup>43</sup> NRSROs have been criticized for responding slowly to changes in an issuer’s credit position. It has been noted that the market often anticipates credit rating changes before they occur. See Fabozzi & Pollack (eds.), *The Handbook of Fixed Income Securities* 370 (1983).

<sup>44</sup> See Part II.1.b of this Release.

<sup>45</sup> Release 13380, *supra* note 8, at 48 *FR* 32560.

<sup>46</sup> See Investment Company Act Rel. No. 14984 (Mar. 4, 1986) [*51 FR* 9839 (Mar. 21, 1986)]. Section 7 of the 1933 Act [*15 U.S.C. 77g*] requires the consent of any expert named as having prepared or certified a report or valuation for use in connection with a registration statement to be filed with the registration statement. Section 11(a)(4) of the 1933 Act [*15 U.S.C. 77k(a)(4)*] subjects to Section 11 liability persons who consent to being named as having prepared or certified such a report or valuation. Ordinarily, NRSROs do not provide their consent to having their ratings referred to in the prospectus based on their concerns over the effect of Sections 7 and 11. Therefore, money market funds have been unable to include their ratings in fund prospectuses; however, such ratings can be included in fund sales literature.

or whether the money market fund ratings proposal should be adopted to supplement the proposed amendments to Rule 2a-7, or whether the money market fund ratings proposal should be adopted at all.<sup>47</sup>

The Commission is not proposing to change Rule 2a-7's condition that a money market fund limit its investment to securities that are determined to present "minimal credit risks."<sup>48</sup> This condition may require funds to consider credit risks not considered by a NRSRO.<sup>49</sup> As the Commission stated in Release 13380, an instrument must be evaluated for the credit risks that it presents to the particular fund at that time in light of the risks attendant to the use of amortized cost valuation or penny-rounding. The staff of the Division of Investment Management (the "Division") has suggested elements that should be considered in an analysis of whether a security presents minimal credit risk.<sup>50</sup> The factors identified by the Division are not an exclusive list, and the board or its delegate should take into account any additional factors it believes to be material in assessing the credit risks posed by a particular investment.

#### b. Unrated Securities

Rule 2a-7 provides that, if a security is not rated by a NRSRO, the board of directors must determine that the security is comparable in quality to a security rated "high quality" in order for a fund to invest in the security.<sup>51</sup> The Division has taken the position that for a board of directors or its delegate to conclude that an unrated security is of "high quality," no similar security of the same issuer can be rated less than "eligible quality." Further, simply because an outstanding security with similar characteristics is rated "eligible quality," the board or its delegate could not, without further analysis, conclude that the unrated security is "eligible quality" (or presents minimal credit risks).<sup>52</sup>

The Commission proposes to codify the Division's position in the proposed amended rule. Proposed paragraph (a) (15) would define the term "unrated security" to mean a security that (i) does not have a current rating assigned by any NRSRO and is issued by an issuer that does not have a current rating assigned by any NRSRO with respect to its unsecured short-term debt (i.e., debt maturing in one year or less); or (ii) is the subject of an external credit support agreement that was not in effect when the security was assigned its rating. In analyzing securities that fall under the second category, the board would consider whether the security, taking into account the external agreement, is of comparable quality to an "eligible quality" security. The security could not be judged to be of better quality than that of comparable debt securities of the issuer of the external agreement.<sup>53</sup> Proposed paragraph (a)(5) would provide that an unrated security could not be determined to be of eligible quality if another short-term debt security issued by the same issuer had received a rating of less than "eligible quality" from a NRSRO unless, as provided in proposed paragraph (a) (15), it is the subject of an external credit support agreement. As is the case under the current rule, under the proposed amendments, if an issuer's long-term debt has been rated, but its short-term debt has not, the fund's board of directors (or its delegate) could not rely on the long-term rating as the sole basis for concluding that a security is "eligible quality," although the board may take this factor into account in its evaluation. Comment is requested on the proposed definition of "unrated security" and whether the proposed definition of "eligible quality" would impose any additional burdens on funds in connection with the analysis of the credit quality of an unrated security.

#### c. Changes in Credit Risk and Quality

<sup>47</sup> For example, a money market fund rating might assist an investor who desires to avoid funds that hold instruments rated less than the highest rating offered by a particular NRSRO. Both of the NRSROs that assign ratings to money market funds limit their highest money market fund rating to funds that invest only in U.S. government securities and securities that have been given the highest rating by the NRSRO rating the fund.

<sup>48</sup> See paragraphs (a)(2)(iv) and (a)(3)(iii) of the current rule and proposed paragraph (c)(3). The responsibility for this determination is placed on the fund's board of directors which may delegate the day-to-day function of determining credit quality to the fund's investment adviser (its "delegate"), provided that the board retains sufficient oversight. That is, the board must, at a minimum, establish and approve procedures that the adviser will follow, and thus have knowledge in advance how the adviser will perform its functions. In addition, the board should assure itself that the adviser's methods are reasonable and must review periodically the adviser's performance. See Release 13380, *supra* note 8, 48 FR at 32557.

<sup>49</sup> Release 13380, *supra* note 8, 48 FR at 32560.

<sup>50</sup> See Letter to Registrants (pub. avail. May 8, 1990) and Investment Company Institute (pub. avail. Dec. 6, 1989).

<sup>51</sup> See paragraphs (a)(2)(iv) and (a)(3)(iii) of the current rule.

<sup>52</sup> See Letter to Registrants (pub. avail. May 8, 1990).

<sup>53</sup> The second category codifies the position taken by the Commission in Release 13380, *supra* note 8, at n. 35.

Rule 2a-7 does not explicitly prescribe the action the board (or its delegate) should take in the event the quality of a security is lowered after the security has been acquired by the fund. Release 13380 states that, where a portfolio security is no longer “high quality,” the board must cause the money market fund to dispose of the security as soon as practicable, but that an exception may exist where the directors determine that it would not be in the best interest of the fund to sell such security.<sup>54</sup> The Commission believes that it may be useful if the duties of the board, as summarized in Release 13380, are incorporated into the rule.

In the event securities are downgraded by a NRSRO and yet are still “eligible quality” securities, i.e., rated at least in the second highest category by all NRSROs which have assigned ratings to such issuer or security, proposed paragraph (c)(5)(i) provides that a prompt reassessment must be made as to whether the security presents minimal credit risks and such action must be taken as the board determines be in the best interest of to be in the best interests of the fund and its shareholders. The board may, of course, determine that it is in the best interest of the fund to continue to hold the security.

A security may expose a money market fund to a greater potential for loss if (i) it is in default, (ii) it is downgraded by any NRSRO below the top two ratings, or (iii) the board (or its delegate) determines it no longer presents minimal credit risks. Where a money market fund holds such a security, its board of directors should take prompt action to protect the best interests of fund shareholders. Proposed paragraph (c)(5)(ii) of the rule provides that the money market fund must dispose of such a security “as soon as practicable” absent a specific finding by the board that this would not be in the best interests of the fund.

A money market fund holding defaulted portfolio securities that, immediately before the default, accounted for one half of one percent or more of fund assets would, under proposed paragraph (c)(5)(iii), be required promptly to notify the Commission of this fact and of what action the fund intends to take.<sup>55</sup>

Rule 2a-7(a)(2)(vi) currently requires quality determinations to be recorded in the books and records of the fund, and to be made available for inspection by the Commission. The amended rule also would require that records be kept with respect to the actions taken in the event a portfolio security is in default or is downgraded.<sup>56</sup>

Comment is requested on these proposed changes. Specifically, in light of proposed paragraph (c)(5)(iii) requiring notice to the Commission in certain circumstances, are the other proposed changes necessary?

### 3. Maturity of Portfolio Securities

Rule 2a-7 provides that a money market fund must maintain a dollar-weighted average portfolio maturity (“average maturity”) appropriate for its objective of maintaining a stable price per share, and that in no event can a fund maintain an average maturity that exceeds 120 days or purchase a security with a remaining maturity of more than one year.<sup>57</sup> This provision codified the terms of exemptive orders issued prior to the rule’s adoption. During the mid-1970s, average maturities for all money market funds as a group ranged between seventy and 110 days. However, since 1978, the average industry maturity has never ranged higher than forty-three days.<sup>58</sup> This dramatic decrease in average maturity apparently reflects both changes in fund portfolio management practices and the adoption in 1986 of amendments to Rule 2a-7 that permit funds to more extensively use demand features to shorten the maturity of variable and floating rate instruments, and may also reflect changes in the money markets as well.<sup>59</sup> A shorter average maturity reduces the money market fund’s exposure to interest rate risk.<sup>60</sup>

<sup>54</sup> *Id.* at nn. 22 and 40.

<sup>55</sup> The proposal would require the notification to be first made by telephone or facsimile transmission, thereafter followed by a first class letter, directed to the attention of the Director of the Division of Investment Management of the Commission.

<sup>56</sup> See proposed paragraph (c)(8). The fund would also be required to report on these actions in its semi-annual report on Form N-SAR [17 CFR 274.101].

<sup>57</sup> See paragraphs (a)(2)(iii) and (a)(3)(ii) of the current rule.

<sup>58</sup> See Mutual Fund Fact Book, *supra* note 4, at 103.

<sup>59</sup> Release 14983, *supra* note 21. Since 1986, the average portfolio maturity for all funds has ranged between thirty and thirty-eight days. Between 1983 and 1986, it ranged between thirty-seven and forty-three days. See Mutual Fund Fact Book, *supra* note 4.

<sup>60</sup> See Standard & Poor’s Corp., Credit Reviews - Mutual Funds 11 (Oct. 16, 1989).

The Commission is proposing to amend Rule 2a-7 to provide that the board of directors must establish an average maturity appropriate for the fund, but that in no event shall the fund maintain an average maturity exceeding ninety days. As in the case of the current 120 day limitation, the ninety day limitation would be a maximum.<sup>61</sup> Comment is requested on the proposal, including whether the proposed amended rule should have a shorter average maturity, for example, sixty or seventy-five days. Additionally, comment is requested generally on the proposed risk-limiting conditions of Rule 2a-7. Are these proposed revisions the correct approach to limiting money market fund risks? Are they likely to have adverse effects on competition among money market funds or on the money markets?

The Commission is also proposing to amend the provision of the rule which prohibits a fund from purchasing a security with a remaining maturity of greater than one year.<sup>62</sup> The Commission proposes that the maximum remaining maturity be increased to two years.<sup>63</sup> The one year maturity provision is a codification of a condition appearing in exemptive orders issued by the Commission prior to the adoption of Rule 2a-7. Experience with money market funds suggests that a one year limitation is not necessary because the weighted average maturity requirement effectively limits the extent to which a fund can invest in securities with longer remaining maturities that would be subject to greater volatility from interest rate fluctuations. However, the Commission is concerned that deleting the one year maturity provision entirely could increase a fund's exposure to credit risks. The Commission requests comment on whether the one year maturity provision should be retained in its present form, whether it should be deleted altogether, or whether some other maximum (e.g., three years) would be appropriate.

The Commission also proposes to delete the Note appended to Rule 2a-7 which reminds the boards of directors of money market funds about the difficulties that could arise if funds purchase illiquid securities. This change is intended to simplify the rule and does not indicate a change in the position of the Commission on the necessity for money market funds to maintain a liquid portfolio.

Tax exempt money market funds historically have average maturities which exceed those of taxable money market funds.<sup>64</sup> Comment is requested whether the rule should permit tax exempt money market funds to have longer average maturities than taxable funds and, if so, the average maturity appropriate for such funds, and whether any additional conditions should be imposed on tax exempt funds to address the Commission's concerns if these funds were permitted to have longer average maturities.

As noted above, many money market funds are sold only to institutional investors which may not need the protections that would be afforded by the proposed amendments. Comment is requested on whether funds which limit their investors to institutions should be permitted to continue to operate under the current rule if the proposed amendments are adopted, or whether they should be subject to some or all of the proposed risk-limiting conditions. Commenters are requested to discuss possible definitions for identifying institutional money market funds and which, if any, provisions of Rule 2a-7 should apply to such funds.

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<sup>61</sup> It should be noted that this provision of Rule 2a-7 imposes an obligation on the directors of the fund to ascertain that the fund is maintaining an average maturity that, given market conditions, will permit it to maintain a stable price or net asset value per share. Thus, during periods of very high market volatility, a ninety day average maturity may be too long, and the board would be required to take such actions as are necessary to assure that the average maturity is adjusted accordingly.

<sup>62</sup> Paragraph (c)(10) of the current rule defines "one year" to mean a period of 365 days or, in the case of securities that are denominated as and intended to be "one year" notes but actually mature in a somewhat longer period, 375 days. The latter provision was designed to permit funds to invest in certain types of government securities that had this characteristic. *See* Release 13380, *supra* note 8, at n. 13. The proposed amendments would eliminate the definition of "one year" and define "two years" to be a period of either 730 or 731 days. Comment is requested on whether this definition should be modified to take into account the characteristics of any specific type of security.

<sup>63</sup> Paragraph (b) of the current rule includes special provisions for determining the maturity of securities, including variable rate securities and securities subject to demand features. Paragraph (d) of the proposed amended rule would incorporate these provisions of the current rule, modified to reflect the change from one to two years. Comment is requested on whether any other provisions of paragraph (b) of the current rule should be changed.

<sup>64</sup> During the years 1987-89, the average maturities ranged between thirty-one and fifty days for taxable money market funds and thirty-six to sixty-seven days for tax-free money market funds. Source: IBC/Donoghue's Money Fund Report (1987-8).



#### 4. Investment Companies Holding Themselves Out as Money Market Funds

There are several mutual funds with substantial assets under management that do not use the amortized cost method of valuation or the penny-rounding method of pricing and are not subject to the risk-limiting conditions of Rule 2a-7.<sup>65</sup> Mutual funds not using Rule 2a-7 are similar to the funds that rely on the rule in that these mutual funds also seek to maintain a stable price per share by declaring as a daily dividend all income and capital changes. However, because they do not rely on Rule 2a-7, these mutual funds can have investment policies that differ substantially from money market funds subject to Rule 2a-7. For example, these mutual funds could invest in securities that are less than “eligible quality” or denominated in foreign currency, and have an average portfolio maturity well in excess of that permitted by Rule 2a-7, although these practices might make it more difficult for these mutual funds to maintain a stable net asset value.

Fund marketing and disclosure documents encourage investor expectations that money market funds are relatively secure investments and that fund investment policies are designed to maintain a stable net asset value.<sup>66</sup> These expectations are reflected in the risk-limiting conditions of Rule 2a-7. It may not be appropriate for an investment company to hold itself out as or create the implication that it is a money market fund when it engages in investment strategies that are not consistent with a policy of maintaining a stable net asset value. Therefore, the Commission proposes to revise Rule 2a-7 to make it unlawful for a registered investment company to (1) adopt “money market” or similar terms as part of its name or title, or name or title of any security of which it is the issuer, or (2) hold itself out to investors as a money market fund, or the equivalent of a money market fund, unless the company meets the risk-limiting conditions of paragraphs (c) (2), (c)(3) and (c)(4) of proposed amended Rule 2a-7. The Commission believes that these conditions are key to investors’ perceptions concerning the safety of money market funds. These conditions are designed to reduce the likelihood of deviations between a fund’s share price and its market based per share net asset value by requiring funds to invest in eligible quality instruments that are not significantly affected by changes in interest rates.

An investment company holding itself out as a money market fund would not be required to use the amortized cost method of valuation or the penny-rounding method of pricing. Nor would the rule require a fund that does not meet the risk-limiting conditions of the rule to change its investment policies. The rule would only require such a fund to meet the risk-limiting conditions of the rule if it continued to hold itself out as a money market fund, and any money market fund could continue to maintain a stable price per share through means other than amortized cost or penny-rounding.

#### 5. Money Market Fund Prospectus Disclosure

Articles about money market funds often contain the statement that “no investor has ever lost money in a money market fund.”<sup>67</sup> While money market funds have been one of the safest available investment options, the Commission believes it is important for investors to understand that money market funds are not risk-free.<sup>68</sup> In addition, it is important for

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<sup>65</sup> The Division has taken the position that, if an investment company has a name indicating that it is a money market fund, it should have investment policies requiring investment of at least eighty percent of its assets in debt securities maturing in thirteen months or less. See Guide 1 to Form N-1A. The Guide is based on Section 35(d) of the 1940 Act [*15 U.S.C. 80a-34(d)*] which provides, in effect, that a registered investment company may not use a name or title which may be deceptive or misleading. Names which suggest that an investment company is a money market fund include any name which includes the word “money market” or a name which suggests that an investment in the fund is the functional equivalent of cash (such as “money fund,” “cash fund,” “cash accumulation fund,” “cash management fund,” “cash reserves,” “cash trust,” “liquid reserves,” “ready assets” or “liquid assets”), or a name that suggests that dividends are declared on a daily basis in order to maintain a stable per share net asset value (such as “daily dividends” or “daily income”), or derivations of the foregoing.

<sup>66</sup> See, e.g., *Money Market Funds: A Part of Every Financial Plan* (publication of Investment Company Institute).

<sup>67</sup> See Laing, *Never Say Never*, *supra* note 15, and Zigas, *How Risky is Your Money Market Fund?*, *Bus. Wk.*, Mar. 26, 1990, at 86.

<sup>68</sup> As noted above, there have been instances when money market funds have held securities in their portfolios which have defaulted. The investment advisers or sponsors of the funds voluntarily purchased the defaulted securities so that the funds experienced no losses and were able to avoid having their price per share fall below \$1.00. There is no assurance that, in the future, when a money market fund holds defaulted securities, its adviser or sponsor voluntarily will absorb any losses so that the fund will not have to break net asset value.

investors in money market funds, including those that invest in government securities, to understand that the U.S. government does not guarantee the value of their investment in the fund.<sup>69</sup>

As a result, the Commission is proposing to revise the registration statement forms used by money market funds to require the cover page of the prospectus to disclose prominently that the shares of a money market fund are neither insured nor guaranteed by the U.S. government and that there is no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share.<sup>70</sup> The Commission requests comment on the proposed disclosure, whether additional or alternative disclosure would be appropriate, and the location of the disclosure in the prospectus.

## 6. Tax Exempt Money Market Funds

There are currently 222 money market funds that hold themselves out as distributing income that is exempt from federal income tax, including eighty-three that also distribute income exempt from state and local income tax.<sup>71</sup> Tax exempt funds have a total of \$75.6 billion dollars in assets and represent approximately seventeen percent of the assets of all money market funds.<sup>72</sup> Many of these funds could not meet the proposed diversification requirements and the limitations that would be placed on investment in securities that have not received the highest NRSRO rating without substantially restructuring their portfolios and, perhaps, losing some of their tax advantages.<sup>73</sup> Therefore, as noted above, the Commission is not at this time proposing to make the diversification requirements (other than the existing diversification requirement relating to puts) or the five percent quality test applicable to tax exempt funds. Comment is requested on what conditions, if any, should be imposed on tax exempt funds as a substitution for the diversification requirements and the five percent quality test (such as additional risk disclosure), or whether it is possible to apply the same conditions.

## 7. Funds Eligible to Quote Seven Day Yields

Rule 482 under the 1933 Act permits registered investment companies, including money market funds, to publish “omitting prospectus” advertisements subject to certain conditions set out in the rule.<sup>74</sup> Since 1980, the rule has standardized performance advertising by money market funds. Under the rule, money market funds, as defined in the rule, have been limited to quoting seven day yield quotations calculated in accordance with a prescribed formula. The Commission took this action because the lack of comparability of money market fund yield quotations could confuse and mislead investors, and because of the significant role which yield quotations were playing in promoting money market funds.<sup>75</sup>

The Commission amended Rule 482 in 1988 to standardize performance information in advertisements of other types of management investment companies (“mutual funds”).<sup>76</sup> The 1988 amendments require other types of mutual funds

<sup>69</sup> One hundred fourteen money market funds invest exclusively in U.S. government and agency securities or repurchase agreements collateralized by such securities; of these, forty-eight money market funds invest exclusively in U.S. treasury securities. Money Fund Report, *supra* note 3, at 2. However, the U.S. government does not guarantee the market value of these securities, and these funds are not risk free, since the value of portfolio securities will fluctuate with changes in interest rates. In addition, repurchase agreements may present credit risks. *See supra* note 30.

<sup>70</sup> The proposal would amend Form N-1A, the registration statement for all open-end investment companies, including money market funds, and Form N-3, the registration statement for separate accounts organized as management investment companies.

<sup>71</sup> Money Fund Report, *supra* note 3, at 2.

<sup>72</sup> *Id.*

<sup>73</sup> Tax exempt funds often concentrate investment in the obligations issued by a single state (or municipalities located in the state). *See* Mutual Fund Fact Book, *supra* note 4, at 74; Money Fund Report, *supra* note 3, at 9-12. Therefore, they may only be able to invest in a limited number of issuers, making diversification more difficult to achieve.

<sup>74</sup> The advertisements must (i) contain only information the substance of which is included in a Section 10(a) prospectus, (ii) state conspicuously where a prospectus may be obtained, and (iii) not contain, nor be accompanied by, any application by which a prospective investor may purchase shares of the fund. *See* Rule 482(a)(2), (a)(3) and (a)(5) [17 CFR 230.482(a)(2), (a)(3) and (a)(5)].

<sup>75</sup> Investment Company Act Rel. No. 11379 (Sept. 30, 1980) [45 FR 67079 (Oct. 9, 1980)]. The rule in effect in 1980 limited money market funds to advertising yields calculated in accordance with Form N-1, the predecessor to Form N-1A.

<sup>76</sup> Investment Company Act Rel. No. 16245 (Feb. 2, 1988) [53 FR 3868 (Feb. 10, 1988)] (hereinafter “Release 16245”). The amendments to Rule 482 permit fund advertisements to quote a uniformly calculated yield, tax equivalent yield, and total return, and to quote performance by non-standardized total return quotations provided that any non-standardized total return quotation is accompanied by uniformly calculated one, five and ten year average total return quotations.

to include uniformly computed total return quotations for specified periods in any performance advertising.<sup>77</sup> This requirement was imposed out of concern that, for these funds, a yield quotation alone suggests “a promised return such as a yield of a bank certificate of deposit, or . . . stability of principal such as that of a money market fund . . . .”<sup>78</sup> The Commission did not require money market fund yield quotations to be accompanied by total return quotations because the yields of money market funds will generally be the same as their total return. This is because the principal value of money market fund shares generally does not change and portfolio securities are generally held to maturity, thus avoiding the realization of gains and losses upon sale.<sup>79</sup>

Currently Rule 482 defines “money market fund” as an investment company which holds itself out as being a “money market fund” or which has an investment policy calling for investment of at least eighty percent of its assets in debt securities maturing in thirteen months or less. This broad definition encompasses funds that can have investment policies that could be inconsistent with the notion of stability of principal.<sup>80</sup> As a result, it may not be correct to assume that a yield quotation for such a fund, by itself, is appropriate. Accordingly, the Commission is proposing to amend paragraph (d) of Rule 482 to limit the definition of “money market funds” to those funds that meet the risk-limiting conditions set forth in proposed amended Rule 2a-7.<sup>81</sup>

The proposed amendment would not require funds to use the amortized cost method of valuation or the penny rounding method of pricing in order to quote seven day yields. These funds could continue to use the full pay-out method to maintain their stable per share net asset value. However, the amendments to Rule 482 should provide further assurance that the special treatment afforded to money market funds under that rule will be limited to those funds for which the risk that yield will diverge from total return is minimal. It should also further enhance the comparability of money market fund advertisements by limiting use of the seven day yield format to those funds which share certain basic investment policies.

### III. Transition Period

If the proposed rule and form amendments are adopted, the Commission would expect to provide that the amendments would not become effective for ninety days after publication in the Federal Register in order to give registrants, issuers of commercial paper and other securities, and other participants in the money markets an appropriate period of time to make any changes required by the rule including, in the case of investment companies that could no longer hold themselves out as money market funds, amendments to disclosure documents. Comment is requested on whether ninety days would be sufficient or whether a longer period would be appropriate.

### IV. General Request for Comments

Any interested persons wishing to submit written comments on the proposed rule and form changes that are the subject of this Release, to suggest additional changes (including changes to provisions of Rule 2a-7 that the Commission is not proposing to amend), or to submit comments on other matters that might have an impact on the proposals contained herein, are requested to do so. Commenters suggesting alternative approaches are encouraged to submit proposed rule text.

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<sup>77</sup> The yield quotation prescribed for mutual funds also differs from the money market yield formula.

<sup>78</sup> Release 16245, *supra* note 76, at text accompanying n. 12. The Commission stated that use of a yield quotation alone in an advertisement may omit material information necessary to make the advertisement not misleading.

<sup>79</sup> *Id.*

<sup>80</sup> See Part II.4. of this Release. These funds do not meet the conditions, and do not take advantage, of the exemption provided by Rule 2a-7.

<sup>81</sup> The Commission is also proposing conforming amendments to Item 22(a) of Form N-1A, Item 25(a) of Form N-3, and Item 21(a) of Form N-4, which set forth the yield formulae used by money market funds and money market funded separate accounts issuing variable annuity contracts. In addition, the Commission is proposing to revise Rule 34b-1 under the 1940 Act to limit use of the seven day yield in sales literature. Note that Rule 34b-1 has also been proposed to be amended in Investment Company Act Rel. No. 17294 (Jan. 8, 1990) [55 FR 1460 (Jan. 16, 1990)].

## V. Cost/Benefit of the Proposal

The Commission believes that the proposal will not substantially change costs for money market funds. Most money market funds rely upon Rule 2a-7 and must comply with the provisions of the rule. The imposition of further portfolio quality and diversification requirements will not require most funds to alter their portfolios because they will already be in compliance; other funds will be able to come into compliance at minimal cost simply by investing in higher-rated securities as current holdings mature; and some funds will have to sell securities and reinvest the proceeds in higher-rated securities. Compliance with the shorter average maturity requirements should not impose a material amount of increased costs because the average maturity of most funds currently is less than the requirement of the proposed amendment to Rule 2a-7. Investment companies that hold themselves out as money market funds but do not currently rely on Rule 2a-7 also should not have substantially increased or decreased costs if these investment companies are required to comply with the risk-limiting conditions of the proposed rule. Many of these investment companies have investment policies that substantially mirror the risk-limiting conditions of the proposed rule, or have portfolios that would comply with those conditions in most material respects. Since some funds may, however, be required to change their names or methods of operation, the Commission requests comment on the extent to which these investment companies will incur increased costs under the proposal.

The Commission believes that the additional recordkeeping requirements that the proposed amendments would impose in connection with the determinations required to be made when the credit rating of a security is down-graded should not cause any substantial burden on funds. Other amendments to the rule simply clarify existing fund obligations.

The proposal would limit a money market fund in its investments in the securities of any one issuer, and money market funds and their shareholders should benefit from the proposal as a result of the reduced exposure of funds to interest rate and market risks, and therefore, losses. The Commission recognizes that the yield that has been realized by some funds may be reduced to the extent that they are required to limit their investment in lower-rated, higher yielding securities, but believes that the benefit of reduced risks to funds and their investors outweigh the possibility of reduced yield.

In connection with the amendments to Rule 482, those investment companies that could no longer advertise a seven-day yield may incur some costs in establishing procedures to calculate the performance measures prescribed by the rule (thirty-day yield and total return quotations), but those should not be substantial because computer software packages are available to make this computation.<sup>82</sup> The computation of total return should not be costly because it is based on net asset values already calculated by funds on a daily basis.

The Commission requests comment on the number of funds that would be affected by the proposed changes. The Commission requests specific comment on its assessment of the costs and benefits associated with the proposal, including specific estimates of costs and benefits.

## VI. Summary of Initial Regulatory Flexibility Analysis

An Initial Regulatory Flexibility Analysis in accordance with 5 *U.S.C.* 603 has been prepared concerning the proposed amendments. The analysis states that the proposed amendments to Rule 2a-7 are prompted by the significant changes which have occurred in the money markets since Rule 2a-7 was adopted in 1983. Money market funds are investing a greater amount of assets in commercial paper, and there have been instances of defaults of commercial paper, some of which was held by money market funds. In addition, there are some money market funds that do not use the exemption provided by Rule 2a-7 and therefore are not subject to the risk-limiting conditions of the rule. Further, fund marketing and disclosure documents have encouraged investor expectations that money market funds are relatively secure investments and that fund investment policies are designed to maintain a stable net asset value.

The analysis summarizes the proposed amendments to Rule 2a-7 and the related rules and forms. The amendments to Rule 2a-7 would tighten the conditions of the rule relating to the diversity and quality of money market fund investments, and would make it illegal for any investment company to hold itself out as a money market fund or the equivalent, unless it met the risk-limiting conditions of the rule. Money market funds would also be required to make

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<sup>82</sup> Non-money market mutual funds have been performing this calculation since July 1, 1988.

prominent cover page prospectus disclosure that the shares of the fund are neither insured nor guaranteed by the U.S. government, and that the fund may not be able to maintain its stabilized price per share.

The analysis states that the objectives of the proposed amendments are to (i) reduce the exposure of a money market fund to market and interest rate risks, and thus reduce the chance that a money market fund will break a dollar; (ii) require investment companies that hold themselves out as money market funds or the equivalent to meet certain risk-limiting conditions of the rule; and (iii) notify investors that money market funds are subject to investment risk and that fund shares are not insured or guaranteed by the U.S. government.

The analysis states that as of May 1, 1990, 86 money market funds met the Commission's definition of small entity found in Rule 0-10 of the 1940 Act [*17 CFR 270.0-10*]. Of these 86 funds, 50 were tax free funds. Tax free funds would not be subject to certain of the proposed amendments to Rule 2a-7.

The reporting, recordkeeping and other compliance requirements of the proposed amendments should not be significantly greater than currently imposed by Rule 2a-7. The analysis also states that the additional costs, if any, of the proposed amendments should not be any greater for small money market funds than the costs to other money market funds. The analysis further states that the Commission believes there are no duplicative, overlapping or conflicting rules.

The analysis discusses the significant alternatives to the proposed amendments that would accomplish their objectives and while minimizing any significant economic impact of the proposals on small funds. For example, the analysis states that the Commission considered the establishment of different compliance or reporting requirements or timetables that would take into account the resources available to small money market funds. In addition, the analysis states that the Commission considered the simplification of compliance and reporting requirements under Rule 2a-7 for small money market funds. The use of performance rather than design standards was considered. Lastly, the Commission considered the alternative of exempting small money market funds from one or more of the conditions of the rule. The analysis concludes that these alternatives would not accomplish the objectives of the rule, nor would the alternatives be consistent with the statutory mandate of the Commission under the 1940 Act. A copy of the analysis may be obtained by contacting Richard Pfordte, Office of Disclosure and Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 450 Fifth Street N.W., Washington, D.C. 20549.

## VII. Statutory Authority

The Commission is proposing to amend Rule 2a-7 under the exemptive authority set forth in Sections 6(c) [*15 U.S.C. 80a-6(c)*], 22(c) [*15 U.S.C. 80a-22(c)*], 34(b) [*15 U.S.C. 80a-33(b)*], and 38(a) [*15 U.S.C. 80a-37(a)*] of the Investment Company Act of 1940. The authority citations for the amendments to the rules and forms precede the text of the amendments.

## VIII. Text of Proposed Rule and Form Amendments

List of Subjects in 17 CFR Parts 230, 239, 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities

For the reasons set out in the preamble, the Commission is proposing to amend Chapter II, Title 17 of the Code of Federal Regulations as follows:

### Part 230—General Rules and Regulations, Securities Act of 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: *15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78l, 78m, 78n, 78o, 78w, 79t, and 80a-37*, as amended, unless otherwise noted.

2. Section 230.482 is amended by revising paragraphs (a)(6) and (d) to read as follows:

§ 230.482 Advertising by an investment company as satisfying requirements of section 10.

(a) \* \* \*

(6) In the case of an advertisement containing performance data of an open-end management investment company or a separate account registered under the 1940 Act as a unit investment trust offering variable annuity contracts (“trust account”), it includes a legend disclosing that the performance data quoted represents past performance and that the investment return and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost; provided, however, that an advertisement may omit legend disclosure pertaining to the fluctuation of the principal value of an investment in a money market fund described in paragraph (d) of this section. In addition, if a sales load or any other nonrecurring fee is charged, the advertisement must disclose the maximum amount of the load or fee; if the sales load or fee is not reflected, the advertisement must also disclose that the performance data does not reflect its deduction, and that, if reflected, the load or fee would reduce the performance quoted.

\* \* \*

(d) In the case of an investment company that holds itself out to be a “money market” fund and meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of Rule 2a-7 under the Investment Company Act of 1940 [17 *CFR* 270.2a-7] (such an investment company being hereinafter referred to as a “money market fund”), any quotation of the money market fund’s yield contained in an advertisement shall be:

(1) A quotation of current yield based on the method of computation prescribed in Form N-1A (set forth in §§ 239.15A and 274.11A of this chapter), Form N-3 (set forth in §§ 239.17a and 274.11b of this chapter), or Form N-4 (set forth in §§ 239.17b and 274.11c of this chapter) and identifying the length of and the date of the last day in the base period used in computing that quotation; or

(2) A quotation of current yield described in clause (1) above and a corresponding quotation of effective yield based on the method of computation prescribed in Forms N-1A, N-3, or N-4; provided, however, that when both a quotation of current yield and effective yield are used in the same advertisement, each quotation shall relate to an identical base period and shall be given equal prominence.

\* \* \*

## Part 270—Rules and Regulations, Investment Company Act of 1940

4. In the authority citation to Part 270, the general authority continues to read as set forth below, the specific authority for Sections 270.2a-7, 270.2a-41 and 270.12d3-1 is revised as follows:

Secs. 38, 40, 54 *Stat.* 841, 842; 15 *U.S.C.* 80a-37, 80c-89; The Investment Company Act of 1940, as amended, 15 *U.S.C.* 80a-1 *et seq.*; unless otherwise noted;

\* \* \*

Sections 270.2a-7, 270.2a-41 and 270.12d3-1 also issued under Secs. 6(c) [15 *U.S.C.* 80a-6(c)], 22 [15 *U.S.C.* 80a-22], 34 [15 *U.S.C.* 80a-33], 38 [15 *U.S.C.* 80a-37], and 40 [15 *U.S.C.* 80a-39];

\* \* \*

5. By revising the section heading and Section 270.2a-7 to read as follows:

§ 270.2a-7 Money market funds.

(a) Definitions.

(1) “Amortized Cost Method” of valuation shall mean the method of calculating an investment company’s net asset value whereby portfolio securities are valued at the fund’s acquisition cost as adjusted for amortization of premium or accumulation of discount rather than at their value based on current market factors.

(2) “Demand Feature” or “Demand Instrument” shall mean a Put that entitles the holder to receive the principal amount of the underlying security or securities and which may be exercised either:

(A) at any time on no more than 30 days’ notice; or

(B) at specified intervals not exceeding Two Years and upon no more than 30 days’ notice.

(3) “Floating Rate Instrument” shall mean a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate (such as a bank’s designated prime lending rate) changes and which, at any time, can reasonably be expected to have a market value that approximates its par value.

(4) “Government security” shall mean any Government Security as defined in Section 2(a)(16) of the Act.

(5) “Eligible Quality” shall mean:

(i) a security which has been rated (or that has been issued by an issuer that has been rated) by all NRSROs that have issued a rating with respect to such security (or issuer) in one of the two highest rating categories (within which there may be sub-categories or gradations indicating relative standing); or

(ii) an Unrated Security which is of comparable quality to a security meeting the requirements of paragraph (a)(5)(i) of this section, as determined by the money market fund’s board of directors. An Unrated Security is not Eligible Quality if any Short-term debt security (or, if the remaining maturity is more than one year, any long-term debt security) issued by the same issuer currently has a rating of less than Eligible Quality from any NRSRO;

provided, however, that:

(A) a Demand Instrument is not Eligible Quality unless both the Short-term and long-term debt of the issuer are Eligible Quality, except that a Demand Instrument that has an Unconditional Demand Feature may be determined to be Eligible Quality based solely on whether the issuer’s Short-term debt is Eligible Quality; and

(B) the board of directors may base its determination that a Standby Commitment is Eligible Quality upon a finding that the issuer of the commitment presents a minimal risk of default.

(6) “NRSRO” shall mean any nationally recognized statistical rating organization, as that term is used in Rule 15c3-1(c)(2)(vi)(F) under the Securities Exchange Act of 1934 [17 *CFR* 240.15c3-1(c)(2)(vi)(F)], that is not an affiliated person, as defined in Section 2(a)(3)(C) of the Act [15 *U.S.C.* 80a-2(a)(3)(C)], of the issuer of, or any insurer, guarantor or provider of credit support for, the instrument.

(7) “Penny-Rounding Method” of pricing shall mean the method of computing an investment company’s price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(8) A “Put” shall mean a right to sell a specified underlying security or securities within a specified period of time and at a specified exercise price, that may be sold, transferred or assigned only with the underlying security or securities.

(9) “Security Not Having the Highest Rating” shall mean any security that is rated by any NRSRO below its highest rating category or, in the case of an Unrated Security, would not be of comparable quality to a security receiving a NRSRO’s highest rating, as determined by the money market fund’s board of directors.

(10) “Short-term” shall mean a remaining maturity of 366 days or less.

(11) “Standby Commitment” shall mean a Put that entitles the holder to achieve same day settlement and to receive an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise.

(12) “Total Assets” shall mean, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.

(13) “Two Years” shall mean 730 or 731 days, as the case may be.

(14) An “Unconditional Put” or an “Unconditional Demand Feature” shall mean a Put or a Demand Feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

(15) An “Unrated Security” shall mean a security that:

(i) does not have a current rating assigned by any NRSRO and is issued by an issuer that does not have a current rating assigned by any NRSRO with respect to its unsecured Short-term debt; or

(ii) is a rated security that is the subject of an external credit support agreement that was not in effect when the security (or the issuer) was assigned its rating.

(16) A “Variable Rate Instrument” shall mean a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and which, upon such adjustment, can reasonably be expected to have a market value that approximates its par value.

(b) Holding Out. It shall be an untrue statement of material fact within the meaning of Section 34(b)(1) of the Act [15 U.S.C. 80a-33(b)(1)] for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act [15 U.S.C. 80a-24(b)] to:

(1) adopt “money market” as part of its name or title or the name or title of any security of which it is the issuer, or

(2) hold itself out to investors as, or adopt a name which suggests that it is, a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this section. For purposes of this paragraph, a name which suggests that a registered investment company is a money market fund or the equivalent thereof shall include one which uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) Share Price Calculations. The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund”), notwithstanding the requirements of Section 2(a)(41) of the Act [15 U.S.C. 80a-2(a)(41)] and of Rule 2a-4 [17 CFR 270.2a-4] and Rule 22c-1 [17 CFR 270.22c-1] thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; provided, however, that:

(1) The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.

(2) The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; provided, however, that the money market fund will not:

(i) purchase any instrument with a remaining maturity of greater than Two Years, or

(ii) maintain a dollar-weighted average portfolio maturity which exceeds ninety days.

(3) The money market fund will limit its portfolio investments, including Puts and repurchase agreements, to those United States dollar-denominated instruments which its board of directors determines present minimal credit risks and which are at the time of acquisition Eligible Quality.

(4)(i) Except for a money market fund holding itself out as distributing income exempt from federal income tax (“tax exempt fund”), immediately after the acquisition of any security (other than a Government security), the money market



fund will not have invested more than five percent of its Total Assets in securities issued by that issuer or, in the event that such security is a Security Not Having the Highest Rating, more than one percent of its Total Assets in securities issued by that issuer and more than five percent of its Total Assets in Securities Not Having the Highest Rating. For purposes of making calculations under this paragraph (4)(i), a repurchase agreement relating entirely to Government securities shall be deemed to be an acquisition of the underlying Government securities, provided that the obligation of the seller to repurchase the securities from the money market fund is collateralized fully by the Government securities. "Collateralized fully" shall mean that:

(A) the value of such Government securities (reduced by the transaction costs (including loss of interest) that the money market fund could reasonably expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the resale price provided in the agreement;

(B) the money market fund or its custodian either has actual physical possession of the collateral or, in the case of a security registered on a book entry system, the book entry is maintained in the name of the money market fund or its custodian, and the entry evidences the money market fund's right to possess the collateral in the event of a default by the seller; and

(C) the money market fund retains an unqualified right to sell the collateral in the event of a default by the seller.

(ii) In the case of a tax exempt fund, immediately after the acquisition of any Put, the tax exempt fund will not, with respect to 75 percent of its Total Assets, have invested more than 5% of its Total Assets in securities underlying Puts from the same institution.

(iii) For purposes of this paragraph:

(A) a Put will be considered to be from the party to whom the money market fund will look for payment of the exercise price;

(B) an Unconditional Put will be considered to be a guarantee of the underlying security or securities; and

(C) a guarantee of a security will not be deemed to be a security issued by the guarantor, provided that, the value of all securities issued or guaranteed by the guarantor shall not exceed ten percent of the money market fund's Total Assets.

(5)(i) In the event that:

(A) a portfolio security of a money market fund is downgraded by any NRSRO to the second highest rating category assigned by that NRSRO to that type of security, or the rating assigned to the issuer is downgraded by any NRSRO to the second highest rating category of that NRSRO; or

(B) the board of directors determines that an Unrated Security no longer is of comparable quality to a security rated by a NRSRO in the highest rating category but still is of Eligible Quality, the board of directors of the money market fund shall reassess promptly whether such security presents minimal credit risks and shall cause the money market fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders.

(ii) In the event:

(A) of a default of a portfolio security;

(B) a portfolio security of a money market fund ceases to be Eligible Quality; or

(C) the money market fund's board of directors determines that a security no longer presents minimal credit risks, the board of directors of the money market fund, absent a finding by the board of directors that such action would not be in the best interests of the money market fund, shall cause the money market fund to dispose of such security as soon as practicable, by sale, exercise of any Demand Feature or otherwise.

(iii) In the event of a default of a portfolio security which, immediately before the default accounted for one half of one percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically or by means of a facsimile transmission, followed by letter sent by first class mail and directed to the attention of the Director of the Division of Investment Management.

(6) In the case of a money market fund using the Amortized Cost Method:

(i) In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) Included within the procedures adopted by the board of directors shall be the following:

(A) procedures adopted whereby the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute which reflects current market conditions) from the money market fund's amortized cost price per share, shall be determined at such intervals as the board of directors deems appropriate and are reasonable in light of current market conditions; periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and maintenance of records of the determination of deviation and the board's review thereof;

(B) In the event such deviation from the money market fund's amortized cost price per share exceeds  $\frac{1}{2}$  of 1 percent, a requirement that the board of directors shall promptly consider what action, if any, should be initiated by the board of directors, and

(C) where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(7) In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one per cent, will not deviate from the single price established by the board of directors.

(8) The money market fund will record, maintain, and preserve permanently in an easily accessible place a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(5), (c)(6) and (c)(7) of this section, and the money market fund will record, maintain, and preserve for a period of not less than six years (the first two years in an easily accessible place) a written record of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth above, to be included in the minutes of the board of directors' meetings. The documents preserved pursuant to this condition shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act [15 U.S.C. 80a-30(b)] as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act [15 U.S.C. 80a-30(a)]. If any action was taken pursuant to paragraphs (c)(5)(ii) or (c)(6)(ii)(C) of this section, the money market fund will report such action on Form N-SAR [17 CFR 274.101] covering the period in which the action was taken and attach a statement to the form describing with specificity the nature and circumstances of such action. (d) Maturity of Portfolio Instruments. For the purposes of this rule, the maturity of a portfolio instrument shall be deemed to be the period remaining until the date noted on the face of the instrument as the date on which the principal amount must be paid, or in the case of an instrument called for redemption, the date on which the redemption payment must be made, except that:

- (1) An instrument that is issued or guaranteed by the United States government or any agency thereof which has a variable rate of interest readjusted no less frequently than every Two Years shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.
- (2) A Variable Rate Instrument, the principal amount of which is scheduled on the face of the instrument to be paid in Two Years or less, shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.
- (3) A Variable Rate Instrument that is subject to a Demand Feature shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.
- (4) A Floating Rate Instrument that is subject to a Demand Feature shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.
- (5) A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where no date is specified, but the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.
- (6) A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where no date is specified, but the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

6. By revising paragraphs (a), (b), and (c) of § 270.34b-1 as follows:

§ 270.34b-1 Sales literature deemed to be misleading.

\* \* \*

- (a) Sales literature containing any investment company performance data (except that of a money market fund described in paragraph (d) of Rule 482 [17 CFR 230.482(d)]) shall also contain the total return information required by paragraph (e)(3) of Rule 482 [17 CFR 230.482(e)(3)].
- (b) Sales literature containing a quotation of yield or other similar quotation purporting to demonstrate the income earned or distributions made by the company shall contain a quotation of current yield specified by paragraph (e)(1) of Rule 482 [17 CFR 230.482(e)(1)], or, in the case of a money market fund described in paragraph (d) of Rule 482, paragraph (d)(1) of Rule 482 [17 CFR 230.482(d)(1)].
- (c) Sales literature containing a quotation of tax equivalent yield or other similar quotation purporting to demonstrate the tax equivalent of income earned or distributions made by the company shall contain a quotation of tax equivalent yield specified by paragraph (e)(2) and current yield specified by paragraph (e)(1) of Rule 482, or, in the case of a money market fund described in paragraph (d) of Rule 482, paragraph (d)(1) of Rule 482 [17 CFR 230.482(d)(1)].

\* \* \*

## **Part 239—Forms Prescribed Under the Securities Act of 1933**

## **Part 274—Forms Prescribed Under the Investment Company Act of 1940**

7. The authority citation for Part 239 continues to read as follows:

Authority: The Securities Act of 1933, 15 U.S.C. 77a et seq., unless otherwise noted.

8. The authority citation for Part 274 continues to read as follows:

Authority: The Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., unless otherwise noted.

§ 239.15A Form N-1A, registration statement of open-end management investment companies.

§ 274.11A Form N-1A, registration statement of open-end management investment companies.

Note: Form N-1A is not codified in the Code of Federal Regulations.

9. Amending Form N-1A [*17 CFR 239.15A* and *274.11A*], Part A, Item 1, paragraph (a), by redesignating paragraph (vi) as paragraph (vii) and adding new paragraph (vi) to read as follows:

\* \* \*

## **PART A INFORMATION REQUIRED IN A PROSPECTUS**

Item 1. Cover Page

(a) \* \* \*

(vi) in the case of a Registrant holding itself out as a money market fund, a prominent statement that (A) the securities of the fund are neither insured nor guaranteed by the U.S. government and (B) there can be no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share; and

\* \* \*

10. Revising Form N-1A [*17 CFR 239.15A* and *274.11A*] Part B, paragraph (a) of Item 22 to read as follows:

\* \* \*

## **PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION**

\* \* \*

Item 22. Calculation of Performance Data

(a) Money Market Funds. If the Registrant holds itself out as a “money market” fund and meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of Rule 2a-7 [*17 CFR 270.2a-7*], and if it advertises a yield quotation or an effective yield quotation, furnish:

\* \* \*

§ 274.11b Form N-3, registration statement of separate accounts organized as management investment companies.

Note: Form N-3 is not codified in the Code of Federal Regulations.

11. Amending Form N-3 [*17 CFR 274.11b*], Part A, Item 1, paragraph (a), by redesignating paragraph (a)(ix) as paragraph (a)(x) and adding new paragraph (a)(ix) to read as follows:

\* \* \*

## **PART A INFORMATION REQUIRED IN A PROSPECTUS**

Item 1. Cover Page

(a) \* \* \*

## Releases

(ix) in the case of a Registrant holding itself out as a money market fund, a prominent statement that (A) the securities of the fund are neither insured nor guaranteed by the U.S. government and (B) there can be no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share; and

\* \* \*

12. Revising Form N-3 [17 CFR 274.11b], Part B, paragraph (a) of Item 25 to read as follows:

\* \* \*

### **PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION**

\* \* \*

Item 25. Calculation of Performance Data

(a) Money Market Accounts. For each account or sub-account that holds itself out as a “money market” account or sub-account and meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of Rule 2a-7 [17 CFR 270.2a-7], and that advertises a yield quotation or an effective yield quotation, furnish:

\* \* \*

§ 274.11c Form N-4, registration statement of separate accounts organized as unit investment trusts.

Note: Form N-4 is not codified in the Code of Federal Regulations

13. Revising Form N-4 [17 CFR 274.11b], Part B, paragraph (a) of Item 21 to read as follows:

\* \* \*

### **PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION**

\* \* \*

Item 21. Calculation of Performance Data

(a) Money Market Funded Sub-Accounts. For each sub-account that is funded by a “money market” fund that meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of Rule 2a-7 [17 CFR 270.2a-7], and for which the Registrant advertises a yield quotation or an effective yield quotation, furnish:

\* \* \*

By the Commission.

Jonathan G. Katz  
Secretary  
July 17, 1990

**APPENDIX: CONVERSION TABLE**

Note: The Conversion Table is not codified in the Code of Federal Regulations

<b>Proposed Rule</b>	<b>Is Found in</b>	<b>Current Rule</b>
(a)		(c)
(a)(1)		(c)(1)
(a)(2)		(c)(5)
(a)(3)		(c)(8)
(a)(4)	new	***
(a)(5)	new	***
(a)(6)		(c)(9)
(a)(7)		(c)(2)
(a)(8)		(c)(3)
(a)(9)	new	***
(a)(10)	new	***
(a)(11)		(c)(4)
(a)(12)	new	***
(a)(13)	new	***
(a)(14)		(c)(6)
(a)(15)	new	***
(a)(16)		(c)(7)
(b)	new	***
(c)		(a)
(c)(1)		(a)(1)
(c)(2)		(a)(2)(iii), (a)(3)(ii)
(c)(2)(i)		(a)(2)(iii)(A), (a)(3)(ii)(A)
(c)(2)(ii)		(a)(2)(iii)(B), (a)(3)(ii)(B)
(c)(3)		(a)(2)(iv), (a)(3)(iii)
(c)(4)	new	***
(c)(5)(i)	new	***
(c)(5)(ii)	new	***
(c)(5)(iii)	new	***
(c)(6)		(a)(2)
(c)(6)(i)		(a)(2)(i)
(c)(6)(ii)		(a)(2)(ii)
(c)(6)(ii)(A)		(a)(2)(ii)(A)
(c)(6)(ii)(B)		(a)(2)(ii)(B)
(c)(6)(ii)(C)		(a)(2)(ii)(C)
(c)(7)		(a)(3)
(c)(8)		(a)(2)(vi), (a)(2)(vii)
(d)		(b)
(d)(1)		(b)(1)
(d)(2)		(b)(2)
(d)(3)		(b)(3)
(d)(4)		(b)(4)
(d)(5)		(b)(5)
(d)(6)		(b)(6)

## ADOPTION OF REVISIONS TO RULES REGULATING MONEY MARKET FUNDS

Release Nos. 33-6882; IC-18005

February 20, 1991

**ACTION:** Final amendments to rules and forms.

**SUMMARY:** The Commission is adopting amendments to rules and forms under the Securities Act of 1933 and the Investment Company Act of 1940 affecting money market funds. The amendments tighten the risk-limiting conditions of Rule 2a-7, the rule that permits money market funds to use the amortized cost method of valuing portfolio securities and the penny-rounding method of computing price per share, and require that all mutual funds that hold themselves out as money market funds meet these conditions. The amendments require a money market fund to disclose prominently on the cover page of its prospectus and in its sales literature and advertisements that an investment in the fund is not guaranteed or insured by the U.S. Government and that there is no assurance that the fund will be able to maintain a stable net asset value. The amendments are designed both to reduce the likelihood that a money market fund will not be able to maintain a stable net asset value, and to increase investor awareness that investing in a money market fund is not without risk.

**EFFECTIVE DATE:** The amendments to Rules 2a-7, 2a41-1, 12d3-1 and 34b-1 and Form N-SAR under the Investment Company Act of 1940 and Rule 482 under the Securities Act of 1933, and to Item 22 of Form N-1A, Item 25 of Form N-3 and Item 21 of Form N-4 will be effective June 1, 1991. The amendments to Item 1 of Form N-1A and Item 1 of Form N-3 will be effective: (1) for investment companies whose registration statements become effective on or after May 1, 1991, and investment companies with fiscal years ending on December 31, as to prospectuses used on or after May 1, 1991; and (2) for all other investment companies, upon use of any prospectus contained in any post-effective amendment filed on or after May 1, 1991.

**FOR FURTHER INFORMATION CONTACT:** Kenneth J. Berman, Special Counsel, or Eli A. Nathans, Attorney, (202) 272-2107, Office of Disclosure and Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission ("Commission") is adopting several amendments to rules and forms affecting money market funds, including Rule 2a-7 [17 CFR 270.2a-7] under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et. seq.] ("1940 Act"). (Unless otherwise noted, all references to Rule 2a-7, as amended, or any paragraph thereof, will be to 17 CFR 270.2a-7.) Rule 2a-7 is used by most money market funds to maintain a stable net asset value of \$1.00 per share.

The Commission is adopting amendments to Rule 2a-7 to require a money market fund to: (1) limit its investment in the securities of any one issuer to no more than five percent of fund assets, measured at the time of purchase (the "five percent diversification test"), except for certain investments held for not more than three business days; (2) limit its investment in securities which are "Second Tier Securities" to no more than five percent of fund assets, with investment in the Second Tier Securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars; and (3) limit investments to securities that are determined to have "minimal credit risks" and are "Eligible Securities." "Eligible Securities" are defined as securities rated by the Requisite NRSROs in one of the two highest short-term rating categories and comparable unrated securities. "Second Tier Securities" are Eligible Securities that are not "First Tier Securities." "First Tier Securities" are defined as securities which are rated by at least two nationally recognized statistical rating organizations ("NRSROs")<sup>1</sup> or by the only NRSRO that has rated the security (the "Requisite NRSROs") in the highest short-term rating category, or comparable unrated securities.

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<sup>1</sup> The term "nationally recognized statistical rating organization" is used in the Commission's uniform net capital rule [17 CFR 240.15c3-1(c)(2)(vi)(E), (F) and (H)]. The Commission's Division of Market Regulation responds to requests for NRSRO designation through no-action letters. Currently, the Division of Market Regulation has designated five NRSROs: Duff and Phelps, Inc. ("D&P"), Fitch Investors Services, Inc. ("Fitch"), Moody's Investors Service Inc. ("Moody's"), Standard & Poor's Corp. ("S&P"), and, with respect to debt issued by banks, bank holding companies, United Kingdom building societies, broker-dealers and broker-dealers' parent companies, and bank-supported debt, IBCA Limited and its affiliate, IBCA Inc. ("IBCA").

The amendments also (1) limit fund investments to securities with a remaining maturity of not more than thirteen months (except that money market funds that do not use the amortized cost method of valuation may invest in U.S. Government securities that have a remaining maturity of not more than twenty-five months); (2) require a fund to maintain a dollar-weighted average portfolio maturity of not more than ninety days; (3) require a fund, in the event that a portfolio security goes into default or the rating of a portfolio security is downgraded so that it is no longer an Eligible Security, and in certain other circumstances, to reassess promptly whether the security presents minimal credit risks, determine whether continuing to hold the security is in the best interest of the fund, and record such actions in fund records; and (4) require a fund to notify the Commission if it holds defaulted securities which amount to one half of one percent or more of fund assets. Finally, the amendments to Rule 2a-7 make it unlawful for any registered investment company to use the term “money market” in its name or hold itself out as a “money market fund” unless it meets the risk limiting conditions of the rule. Funds that hold themselves out as distributing income that is exempt from regular federal income tax (“tax exempt funds”) are exempted from the five percent diversification test for First Tier Securities, the five percent limit on investments in Second Tier Securities and the one percent limit on investment in the Second Tier Securities of any one issuer.

The Commission is also adopting amendments to Rule 482 [17 CFR 230.482] under the Securities Act of 1933 [15 U.S.C. 77a et seq.] (“1933 Act”), Rule 34b-1 under the 1940 Act [17 CFR 270.34b-1], and Forms N-1A [17 CFR 274.11A and 239.15A], N-3 [17 CFR 274.11b and 239.17a], and N-4 [17 CFR 274.11c and 239.17b] under the 1933 and 1940 Acts to: (1) require the cover page of money market fund prospectuses, and fund advertisements and sales literature, to disclose prominently that an investment in a money market fund is neither insured nor guaranteed by the U.S. Government and that there is no assurance that the fund will be able to maintain a stable per share net asset value; and (2) revise the definition of a “money market fund” for purposes of those funds eligible to quote a seven-day yield in advertisements and sales literature to include only those funds that meet the risk-limiting conditions.

Finally, the Commission is adopting amendments to Rules 2a41-1 and 12d3-1 under the 1940 Act [17 CFR 270.2a41-1 and 270.12d3-1] and to instructions to Form N-SAR [17 CFR 274.101] to conform certain cross-references to specified paragraphs of Rule 2a-7.

## I. Background

On July 17, 1990, the Commission proposed amendments to rules and forms under the 1933 Act and the 1940 Act affecting money market funds, including Rule 2a-7 under the 1940 Act.<sup>2</sup> Rule 2a-7 permits money market funds to maintain a stable price per share,<sup>3</sup> through the use of the amortized cost method of valuation<sup>4</sup> and the penny-rounding method of pricing.<sup>5</sup> But for Rule 2a-7, Section 2(a)(41) of the 1940 Act [15 U.S.C. 80a-2(a)(41)], together with Rules 2a-4 and 22c-1 under the 1940 Act [17 CFR 270.2a-4 and 270.22c-1], would require a money market fund to calculate its current net asset value per share by valuing portfolio securities for which market quotations are readily available at

<sup>2</sup> Investment Company Act Rel. No. 17589 (July 17, 1990) [55 FR 30239 (July 25, 1990)] (the “Proposing Release”). Money market funds are open-end management investment companies investing in short-term debt instruments. There are currently 710 money market funds with over \$536 billion in assets in approximately 21.3 million shareholder accounts. IBC/Donoghue’s Money Fund Report, (Feb. 8, 1991) (the “Money Fund Report”). Data derived from the Money Fund Report is as of February 5, 1991. The information with respect to shareholder accounts is derived from the Investment Company Institute Mutual Fund Factbook 102 (30th ed. 1990). See the Proposing Release at nn. 3 through 7 and 15 through 18, and accompanying text, for a summary of the development of money market funds.

<sup>3</sup> Most money market funds maintain a stable price of \$1.00 per share. The stable \$1.00 price has encouraged investors to view money market funds as an alternative to bank deposit and checking accounts, even though money market funds lack federal deposit insurance.

<sup>4</sup> Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. The definition of the term “amortized cost method” has been amended to substitute the term “accretion” for “accumulation” in order to reflect current finance and accounting terminology. Paragraph (a)(1) of Rule 2a-7, as amended.

<sup>5</sup> Share price is determined under the penny-rounding method by valuing securities at market value, fair value, or amortized cost (as described in note 6 and accompanying text, *infra*) and rounding the per share net asset value to the nearest cent on a share value of a dollar, as opposed to the nearest one tenth of one cent. Paragraph (a)(11) of Rule 2a-7, as amended. See also Investment Company Act Rel. No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] (hereinafter, “Release 13380”) at n. 6, and Investment Company Act Rel. No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] (hereinafter, “Release 12206”) at n. 5.



market value, and other securities and assets at fair value as determined in good faith by the board of directors (“mark-to-market”).<sup>6</sup>

Rule 2a-7 was adopted in 1983.<sup>7</sup> It contains a number of conditions designed to reduce the likelihood that the net asset value of a money market fund as determined by the amortized cost method will deviate materially from its net asset value as determined by the mark-to-market method.<sup>8</sup> The rule also requires a fund’s board of directors to take promptly such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable any deviation between a fund’s amortized cost and its mark-to-market value if the deviation could result in material dilution or unfair results to investors.<sup>9</sup> Currently, money market funds that rely on Rule 2a-7 can invest only in “high quality” debt securities, i.e., securities rated in one of the top two quality categories by any NRSRO.<sup>10</sup> Funds using the rule are prohibited from investing in instruments with a maturity of greater than one year and from maintaining a dollar-weighted average portfolio maturity that exceeds 120 days.<sup>11</sup> The rule’s conditions have had the effect of maintaining the quality of securities held by money market funds, thus reducing the likelihood that a fund will hold securities that will substantially decline in value and that a fund will break a dollar.

As discussed in the Proposing Release, the Commission decided to reexamine the conditions contained in Rule 2a-7 in light of developments in the commercial paper market since the rule was adopted.<sup>12</sup> In June 1989 and March 1990, several money market funds held commercial paper of issuers that defaulted. The shareholders of these money market funds were not adversely affected only because each fund’s investment adviser (or an affiliate) purchased the defaulted paper from the fund at its amortized cost or principal amount.

The Commission proposed amendments to Rule 2a-7 that would have required a money market fund to limit fund investments in securities that had received less than the highest rating from any NRSRO to five percent of fund assets (the “five percent quality test”). Investment in any single lower-rated issuer would have been limited to one percent of fund assets (the “one percent diversification test”).<sup>13</sup> The amendments would have reduced the maximum permitted dollar-weighted average portfolio maturity to ninety days. The amendments would also have required money market funds to disclose to investors that investment in the fund is not federally insured or guaranteed. The proposal had two principal purposes: to provide additional safeguards to reduce the likelihood that a money market fund would have to break a dollar, and to increase investor awareness that investments in a money market fund are not “risk free.”

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<sup>6</sup> The Commission has adopted an interpretive position permitting open-end investment companies that hold a significant amount of debt securities to use the cost amortization method of valuation with respect to debt securities that mature in sixty days or less unless the particular circumstances dictate otherwise (i.e., due to the impairment of the creditworthiness of an issuer). Investment Company Act Rel. No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)] (hereinafter, “Release 9786”).

<sup>7</sup> Rule 2a-7 was proposed in Release 12206, *supra* note 5, and adopted in Release 13380, *supra* note 5. Since its adoption, Rule 2a-7 has been amended only once, in 1986, to permit money market funds to acquire put options and standby commitments. *See* Investment Company Act Rel. No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (hereinafter, “Release 14983”).

<sup>8</sup> If the net asset value of a fund, as determined by the mark-to-market method of pricing, were to drop significantly below the net asset value as determined by the amortized cost method, investors who redeemed their investments would receive more than their pro rata share of the fund’s assets, the interests of other shareholders would be diluted, and purchasing investors would pay too much for their shares.

<sup>9</sup> The board is required to consider promptly what action should be initiated where the deviation between the amortized cost and the mark-to-market value exceeds one half of one percent, including whether to reduce the share price to less than \$1.00 (“breaking a dollar”).

<sup>10</sup> The rule limits money market fund investment to these securities because they are subject to less credit risk than lower quality securities, and are therefore less likely to decrease in value while they are held by the fund.

<sup>11</sup> These conditions limit fund exposure to the risk that the quality of a security might decline over time or that market interest rates would rise, resulting in a decline in the value of the portfolio securities.

<sup>12</sup> *See* the Proposing Release, *supra* note 2, at nn. 15 through 20, and accompanying text.

<sup>13</sup> These securities were referred to in the Proposing Release as “Securities Not Having the Highest Rating.” Rule 2a-7, as amended, refers to securities that are subject to the adopted investment limitations as “Second Tier Securities.” While the basis for identifying a Second Tier Security is somewhat different from the proposed test for Securities Not Having the Highest Rating, for ease of reference the term Second Tier Securities is also used in this Release to refer to securities that under the amendments as proposed would have been Securities Not Having the Highest Rating.

The Commission received comments on the proposed amendments from 289 commenters, including sixty-nine issuers of commercial paper, eight commercial paper dealers and related trade groups, thirty-five investment companies (including the Investment Company Institute), three NRSROs, and 169 individual investors.<sup>14</sup> The comment letters reflect a wide variety of views on almost every topic discussed in the Proposing Release. Commenters representing the mutual fund industry generally supported most aspects of the Commission proposal, and in some cases would go further than the proposed amendments in restricting the types of securities in which money market funds may invest. Individual investors almost unanimously supported placing restrictions on money market fund investment in lower-rated commercial paper. Issuers and commercial paper dealers almost uniformly opposed the proposed restrictions on purchases of securities that had not received the highest rating from a NRSRO.

Upon consideration of the comments and further analysis, the Commission is adopting the amendments with several changes, many of which were suggested by the commenters. The five percent diversification test is being adopted substantially as proposed, with the proviso that a fund may invest more than five percent of its assets in the First Tier Securities of a single issuer for up to three business days after purchase in order to allow a fund more flexibility temporarily to invest large inflows of cash in a single high quality issuer. The one percent diversification and five percent quality tests for Second Tier Securities (collectively, the “Second Tier Security tests”) have also been adopted substantially as proposed. However, the standards for determining which securities are subject to the Second Tier Security tests have been modified. Under the proposal, a security would have been a First Tier Security only if all NRSROs rating the security had given it the highest rating. Under the rule as amended, a security qualifies as a First Tier Security if two NRSROs (or one, if only one NRSRO has rated the security) (the “Requisite NRSROs”) have given it the highest rating, or if it is an unrated security of comparable quality.<sup>15</sup> Where the security is rated by only one NRSRO, or is unrated, the acquisition by the fund of the security must expressly be approved or ratified by the fund’s board of directors. Tax exempt funds are exempted from the five percent diversification and the Second Tier Security tests.<sup>16</sup> The amendments also limit fund investments to securities with a remaining maturity of not more than thirteen months (except that a fund that does not use the amortized cost method may invest in U.S. Government securities with a remaining maturity of not more than twenty-five months), and require a fund to maintain a dollar-weighted average portfolio maturity of not more than ninety days. Finally, the amendments also make it unlawful for any registered investment company to use the term “money market” in its name (or in the name of any of its redeemable securities) or hold itself out as a “money market fund” unless it meets the risk limiting conditions of the rule.

## II. Discussion

### A. Preliminary Matters

Rule 2a-7 limits a money market fund to investing in securities that its board of directors determines present “minimal credit risks” and that are “high quality” as defined in the rule.<sup>17</sup> While the amendments revise the definition of high quality, they do not revise the requirement that a money market fund’s board of directors (or its delegate) evaluate the creditworthiness of the issuer of any portfolio security and any entity providing a credit enhancement for a portfolio security. Possession of a certain rating by a NRSRO is not a “safe harbor.” Where the security is rated, having the requisite NRSRO rating is a necessary but not sufficient condition for investing in the security and cannot be the sole factor considered in determining whether a security has minimal credit risks. To underscore this point, a parenthetical has been added to the rule stating that the determination of whether an instrument presents minimal credit risks “must be based on factors pertaining to credit quality in addition to the rating assigned . . . by a NRSRO.”<sup>18</sup>

<sup>14</sup> The comment letters and a summary of the comments prepared by the Commission staff are included in File No. S7-13-90.

<sup>15</sup> Corresponding changes have been made to the definition of “Eligible Securities” (which in the proposal were referred to as “Eligible Quality” securities). See Section II.B.3. of this Release, *infra*, and paragraph (a)(5) of Rule 2a-7, as amended.

<sup>16</sup> However, a tax exempt fund may invest only in Eligible Securities. Paragraph (c)(3) of Rule 2a-7, as amended.

<sup>17</sup> The rule as originally adopted used the term “high quality.” The Proposing Release used the term “Eligible Quality.” Rule 2a-7, as amended, used the term “Eligible Security.” See note 15, *supra*.

The board generally can delegate to the fund’s investment adviser the responsibility for determining that individual portfolio securities present minimal credit risks, but only under guidelines established by the board. In certain instances, these determinations must be expressly approved or ratified by the board (and not its delegate). See Section II.F. of this Release, *infra*.

<sup>18</sup> Paragraph (c)(3) of Rule 2a-7, as amended.

The extensiveness of the evaluation will vary with the type and maturity of the security involved and the board's (or its delegate's) familiarity with the issuer of the security. For example, little credit analysis of a Government security would be expected. A different analysis may be appropriate for a security with a remaining maturity of seven days than for one of the same issuer with a remaining maturity of one year. In a letter dated May 8, 1990, the Division of Investment Management provided guidance on elements of a minimal credit risk analysis.<sup>19</sup> As stated in the May 8 Letter and reiterated in the Proposing Release, these elements are only examples. The focus of any minimal credit risk analysis must be on those elements that indicate the capacity of the issuer to meet its short-term debt obligations.

The amendments adopted in this Release place additional restrictions on money market funds in selecting portfolio securities, including commercial paper. The Commission believes these amendments are necessary to ensure that money market funds meet investors' expectations for safety, soundness and convenience by maximizing the likelihood that these funds will be able to maintain a stable net asset value under the pricing procedures they are permitted to use. Rule 2a-7 and the amendments adopted today were developed in response to the characteristics of a specific type of registered investment company with a specific type of share pricing standard. The Commission wishes to emphasize that the amendments are not intended to limit the ability of investment companies not holding themselves out as money market funds to invest in lower-rated securities, including lower-rated commercial paper. Nor are the amendments intended to suggest that these investment limitations are necessarily appropriate for any other types of investment vehicles.

## B. Portfolio Quality and Diversification

### 1. Five Percent Diversification Test

Most money market funds taking advantage of the exemptions provided by Rule 2a-7 are "diversified" investment companies within the meaning of Section 5(b)(1) of the 1940 Act.<sup>20</sup> Section 5(b)(1) provides that a diversified investment company, with respect to seventy-five percent of its assets, may not invest more than five percent of its assets in securities of any issuer, other than cash, cash items, Government securities,<sup>21</sup> and securities of other investment companies.<sup>22</sup> The remaining twenty-five percent of the fund's assets (the "twenty-five percent basket") may be invested in any manner. The Commission proposed to amend Rule 2a-7 to limit any money market fund (except a tax exempt fund) to investing no more than five percent of its total assets<sup>23</sup> in the securities—except Government securities—of any one issuer. The effect of this proposal would be to eliminate the twenty-five percent basket.

Most commenters, including most mutual fund commenters, supported the proposed five percent diversification test as appropriate for a money market fund and indicated that, despite the flexibility provided by Section 5(b)(1) with respect to the twenty-five percent basket, in practice, most taxable money market funds limit their investment in non-U.S. Government issuers to approximately five percent or less of total assets. The Commission has decided to adopt the five percent diversification test as proposed, with a provision designed to permit funds to make certain temporary investments in excess of the five percent limit, and with the clarifications noted below.<sup>24</sup>

#### a. Three Day Safe Harbor

<sup>19</sup> Letter to Registrants (pub. avail. May 8, 1990) (hereinafter, the "May 8 Letter").

<sup>20</sup> 15 U.S.C. 80a-5(b)(1). Several tax exempt funds which concentrate in the obligations of state and local governments are not diversified within the meaning of Section 5(b)(1). As discussed *infra*, the new diversification requirements of the rule are not being applied to tax exempt funds at this time. See paragraph (c)(4)(i) of Rule 2a-7, as amended.

<sup>21</sup> The term "Government security" is defined in Section 2(a)(16) of the 1940 Act [15 U.S.C. 80a-2(a)(16)]. Paragraph (a)(8) of Rule 2a-7, as amended, incorporates this definition.

<sup>22</sup> Section 5(b)(1) also prohibits diversified funds, with respect to seventy-five percent of their assets, from investing in securities that comprise more than 10% of the outstanding voting securities of an issuer.

<sup>23</sup> "Total Assets" is defined in paragraph (a)(18) of Rule 2a-7, as amended, to mean, with respect to a fund using the amortized cost method, the total amortized cost of its assets, and with respect to any other money market fund, the total market-based value of its assets.

<sup>24</sup> Paragraph (c)(4)(i)(A) of Rule 2a-7, as amended. For purposes of the diversification and quality tests, subsidiaries and parent companies are treated as separate issuers. In the case of banks having more than one branch, all branches are treated as the same issuer.

The five percent diversification test, as adopted, permits a fund to invest more than five percent of its total assets in the First Tier Securities of a single issuer for a period of up to three business days after the purchase thereof.<sup>25</sup> This change from the proposal has been made in response to commenters who asserted that the twenty-five percent basket often is useful in managing portfolio liquidity and large cash inflows; they urged that the ability to invest a large percentage of fund assets in a single high quality issuer on a temporary basis is an efficient way to assure liquidity in the event of unexpected redemptions by shareholders or to invest unanticipated cash inflows. The Commission believes that a three day limit will permit a fund to realize these efficiencies without being exposed to the risks associated with investing more than five percent of fund assets in a single issuer for an indefinite period of time. For example, a fund that holds First Tier Securities that will mature in three business days may avail itself of an opportunity to purchase additional securities of the same issuer rather than disposing of the securities it holds or waiting for them to mature. Funds which are diversified investment companies would still be subject to the diversification requirements of Section 5(b)(1) of the 1940 Act, however, and the three day safe harbor could therefore be used only with respect to twenty-five percent of the net assets of the fund.

#### b. Diversification as to Put Agreements

Rule 2a-7 has been clarified to reflect the applicability of the five percent diversification test to puts. Except in the case of tax exempt funds, no more than five percent of a fund's assets may be invested in securities issued by or subject to puts from any single issuer.<sup>26</sup> However, an unconditional put is not subject to this test if no more than ten percent of the fund's total assets is invested in securities issued or guaranteed by the issuer of the unconditional put.<sup>27</sup>

#### c. Diversification as to Bank Instruments

The amended rule requires that a money market fund (except a tax exempt fund) not invest more than five percent of its assets in the securities of any one issuer. This limitation applies to investments in bank instruments that are "securities" under Section 2(a)(36) of the 1940 Act [15 U.S.C. 80a-2(a)(36)]. Bank instruments that are securities include time deposits (such as certificates of deposit), bankers' acceptances, letters of credit and similar instruments,<sup>28</sup> but do not include customary demand deposits.<sup>29</sup>

#### d. Repurchase Agreements

The proposed amendments provided that for purposes of the five percent diversification test, a repurchase agreement collateralized by Government securities would be deemed to be an acquisition of the underlying securities if it was

<sup>25</sup> *Id.* The term "business day" is defined in paragraph (a)(2) of Rule 2a-7, as amended, as any day other than a Saturday, Sunday or a customary national business holiday. Paragraph (c)(4)(i)(A) specifies that a fund may not make more than one investment within this safe harbor at any time.

<sup>26</sup> Paragraph (c)(4)(ii) of Rule 2a-7, as amended. Tax exempt funds would continue to be subject to the diversification requirement with respect to puts in the current rule, i.e., the five percent diversification test for puts must be met with respect to seventy-five percent of the fund's assets. *Id.* However, the rule, as amended, makes clear that in determining compliance with this condition, the tax exempt fund must aggregate securities issued by and subject to puts from the same institution.

<sup>27</sup> Paragraph (c)(4)(iii)(C) of Rule 2a-7, as amended. For purposes of Rule 2a-7, unconditional puts are considered to be guarantees. Thus, Rule 2a-7, as amended, treats unconditional puts and guarantees in the same manner as Rule 5b-2 under the 1940 Act [17 CFR 270.5b-2]. See the Proposing Release, *supra* note 2, at n. 31. An unconditional put includes a bank letter of credit or other unconditional credit enhancement under which the holder of the instrument subject to the put could recover amounts due on the instrument. Paragraph (a)(19) of Rule 2(a)(7), as amended.

<sup>28</sup> See International Venture Finance, Ltd. (pub. avail. June 2, 1983) (certificates of deposit subject to federal deposit insurance are securities within the meaning of Section 2(a)(36) of the 1940 Act). *Cf.* Investment Company Act Rel. No. 11421 (Oct. 31, 1980) [45 FR 73915 (Nov. 7, 1980)] (bank certificates of deposit and bankers' acceptances are among the types of securities excluded from the provisions of rule 17j-1 under the 1940 Act [17 CFR 270.17j-1]). See also note 24, *supra*.

<sup>29</sup> *Cf.* Section 6-04 of Regulation S-X [17 CFR 210.6-04] (demand deposits included as a "cash item" on investment company balance sheets).

“collateralized fully.”<sup>30</sup> One commenter requested that the status of repurchase agreements collateralized by non-Government securities be clarified.

The rule, as adopted, extends the approach taken with respect to repurchase agreements collateralized by Government securities to other repurchase agreements.<sup>31</sup> After giving effect to the securities collateralizing the repurchase agreement, a fund may not invest more than five percent of its assets in any one issuer, including the issuer of securities collateralizing the repurchase agreement. Where the underlying securities are not Government securities, they also must be of the highest quality at the time the repurchase agreement is entered into, i.e., rated in the highest grade by the “Requisite NRSROs.”<sup>32</sup> This is to assure that in the event that the fund has to realize on the collateral, it will be holding only the highest quality securities. Fund directors should be aware of the risks of investing in repurchase agreements that are collateralized by instruments with remaining maturities of greater than one year. If the fund were required to realize on the collateral underlying the repurchase agreement, these instruments would have to be taken into account in calculating the fund’s dollar-weighted average portfolio maturity. The fund would have to dispose of the collateral as soon as possible if the instruments constituting the collateral caused the fund’s average portfolio maturity to exceed ninety days or did not satisfy the remaining maturity condition of the rule.<sup>33</sup>

## 2. Diversification and Quality Test for Second Tier Securities

The Commission proposed to prohibit a taxable money market fund from investing more than five percent of its total assets in Second Tier Securities, with investment in the Second Tier Securities of any one issuer being limited to no more than one percent of total assets.<sup>34</sup> In proposing these limitations the Commission stated that, in light of recent experiences of money market funds, a substantial investment in these securities may create an inappropriate risk for funds seeking to maintain a stable price per share. While most commenters representing the mutual fund industry supported

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<sup>30</sup> See the Proposing Release, *supra* note 2, at n. 30. A repurchase agreement may be regarded as a security issued by the entity promising to repurchase the underlying security at a later date. See Release 13380, *supra* note 5, at n. 23. The conditions that the Commission proposed for repurchase agreements collateralized by Government securities reflected prior pronouncements by the Commission and the Division of Investment Management. *Id.* See also Investment Company Act. Rel. No. 13005 (Feb. 2, 1983) [48 FR 5894 (Feb. 9, 1983)] (hereinafter, “Release 13005”) in which the Division of Investment Management stated that a repurchase agreement entered into with a broker-dealer would not violate Section 12(d)(3) of the 1940 Act [15 U.S.C. 80a-12(d)(3)] if it was “fully collateralized” and a fund board of directors had evaluated the creditworthiness of the broker-dealer with which it proposed to engage in a repurchase agreement transaction to determine that the broker-dealer did not present a serious risk of becoming involved in bankruptcy proceedings. As noted in Release 13005, a money market fund’s board of directors (or its delegate) has a similar duty to evaluate creditworthiness of the broker-dealer or other institution that is party to the repurchase agreement under Rule 2a-7 to assure that all securities purchased present minimal credit risks. See paragraph (c)(3) of Rule 2a-7, as amended.

<sup>31</sup> Paragraph (c)(4)(i) of Rule 2a-7, as amended, provides that for purposes of the five percent diversification test, the repurchase agreement is deemed an acquisition of the underlying securities provided that the agreement is “collateralized fully.” Only that portion of the repurchase agreement which is collateralized fully would be subject to the special treatment discussed in this section. Any agreement or portion of an agreement which is not collateralized fully would be treated as an unsecured loan. As such, the loan itself would have to meet the quality requirements set out in the rule, the five percent diversification test, and, if applicable, the limitations placed on investment in Second Tier Securities. See Release 13380, *supra* note 5, at n. 31. Paragraph (a)(3) of Rule 2a-7, as amended, defines “collateralized fully.” This definition has been adopted substantially as proposed. Certain duplicative language in the clause describing the requirements in connection with securities registered on a book entry system has been deleted from paragraph (a)(3)(ii). In order for a fund to retain the unqualified right to possess and sell the collateral, as required by paragraph (a)(3)(iii), its rights would have to be evidenced in an appropriate fashion. For example, in the case of U.S. Treasury bills, entry of the name of the fund or its custodian as owner on the book entry system maintained by a Federal Reserve Bank would evidence these rights. See 31 CFR 350.4.

<sup>32</sup> Paragraph (a)(3)(iv) of Rule 2a-7, as amended. The “Requisite NRSRO” concept is discussed in Section II.B.3. of this Release, *infra*. Repurchase agreements typically relate to long-term debt securities; the securities would have to be rated “AAA” or its equivalent. The rule does not require that the underlying securities comply with the provisions of the rule relating to remaining maturity; the maturity of the repurchase agreement is determined by reference to the date on which the underlying securities are required to be repurchased. See paragraph (d)(5) of Rule 2a-7, as amended. Since any non-Government securities would have to be rated in the top grade, the question of the applicability of the Second Tier Security tests to the collateral does not arise.

<sup>33</sup> See Release 13380, *supra* note 5, at n. 29. Long-term instruments, including Government securities, expose a fund to greater interest rate risk than short-term instruments. See Section II.C. of this Release, *infra*.

<sup>34</sup> In each case compliance with the limitations would be determined at the time of acquisition.

or did not oppose these limitations on Second Tier Securities (or suggested additional limitations), all of the commercial paper dealers and issuers of Second Tier Securities that commented on the proposals strongly opposed them.<sup>35</sup>

Commenters opposing the proposal argued that these diversification and quality tests would raise the borrowing costs of second tier issuers by reducing the amount of their short-term paper bought by money market funds, and expressed concern that many funds, especially smaller funds, would not invest in any Second Tier Securities. Several of these commenters also argued that the Commission's concerns over the creditworthiness of second tier issuers were misplaced. These commenters urged the Commission to rely instead on increased prospectus disclosure concerning the risks posed when a money market fund invests in a substantial amount of Second Tier Securities. Many commenters also argued that the proposed limitations would discourage funds from performing independent credit research, since the benefits of research are often realized by investment in lower-rated securities that fund managers conclude have minimal credit risks. Commenters asserted also that the one percent diversification test would not permit a fund to make a sufficient investment in any one issuer of Second Tier Securities to justify the level of credit analysis that would be required to determine that the investment presented minimal credit risks. Commenters also noted that, because commercial paper is usually sold in minimum denominations of one million dollars, the one percent diversification test would preclude smaller money market funds from investing in Second Tier Securities.

In contrast, the Investment Company Institute ("ICI") and substantially all of the individual investor commenters urged the Commission to prohibit money market funds from investing in any Second Tier Securities.<sup>36</sup> The ICI argued that "past experience indicates that [Second Tier Securities] may undergo rapid deterioration and therefore may involve risks inappropriate for funds seeking to maintain a stable net asset value." Commenters favoring the Second Tier Security tests noted that a few funds with riskier investment policies breaking a dollar might lead to a loss of investor confidence in the entire money market industry. The ICI asserted that "in determining the quality standards for money market fund portfolio securities the exclusive focus must be on the protection of money market fund shareholders, who seek safety by investing in funds whose objective is the maintenance of a stable net asset value."

The Commission continues to believe that the recent history of defaults in the commercial paper market and the extent to which these defaults have affected funds warrant taking measures to assure that investors' expectations of the relative safety of investment companies holding themselves out as money market funds continue to be met. Almost all money market funds attempt to maintain a stable net asset value, and this policy is understood by investors to imply a high level of investor safety. Investors have come to equate investments in these funds to "money." Because holding money does not entail any credit risks, the credit risks to which holders of money market shares are exposed should be minimized to the lowest level practicable.<sup>37</sup>

After considering the comments received and after weighing the increased risks and benefits of allowing money market funds to invest a greater percentage of their assets in Second Tier Securities, the Commission has decided to adopt the Second Tier Security tests substantially as proposed, with one change to the one percent diversification test. As amended,

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<sup>35</sup> The proposed exemption of tax exempt funds from the five percent diversification and Second Tier Security tests was generally supported by commenters, who stated that these funds often would have difficulties meeting the tests due to the limited number of tax exempt issuers in certain markets. Paragraph (c)(4)(i) of Rule 2a-7, as amended, adopts the exemption. The definition of tax exempt fund has been amended to clarify that it includes a fund that distributes income exempt from "regular" federal income tax. *See* paragraph (a)(17) of Rule 2a-7, as amended. A fund that distributes income that is subject to the alternative minimum tax would therefore be considered a tax exempt fund for this purpose.

The Commission requested comment on the possibility of excluding money market funds aimed at institutional investors from the risk-limiting conditions of Rule 2a-7. Comment was divided, and the Commission has decided not to create such an exemption at this time. The Commission is concerned that, if an institutional fund were to break a dollar, there might be a loss of confidence in the money market fund industry. An institutional investor exception is being considered in the Division of Investment Management's current study of the Investment Company Act. *See* Investment Company Act Rel. No. 17534 (June 15, 1990) [55 FR 25322 (June 21, 1990)].

<sup>36</sup> The ICI, however, urged the Commission to permit money market funds to invest up to ten percent of their assets in split rated paper (i.e., paper that had received the highest rating from at least one NRSRO, but not from other NRSROs rating the paper), with investment in any split rated issuer being limited to three percent of fund assets. *See* discussion of the treatment of split rated paper in Section II.B.3 of this Release, *infra*.

<sup>37</sup> In addition, these limitations are necessary in order to assure that shareholders of funds using the amortized cost or penny-rounding method will not suffer any dilution of the value of their investment. *See* note 8, *supra*.

Rule 2a-7 limits money market fund investment in Second Tier Securities to no more than five percent of fund assets.<sup>38</sup> Paragraph (c)(4)(i)(B) of Rule 2a-7, as amended, limits the amount a money market fund may invest in the Second Tier Securities of a single issuer to the greater of one percent of the fund's total assets or one million dollars. The alternative one million dollar test is intended to allow smaller money market funds to invest in Second Tier Securities.<sup>39</sup> The three day safe harbor discussed above applies only to First Tier Securities and thus it would not permit a fund to exceed the diversification limits for Second Tier Securities.

As explained in the Proposing Release, compliance with the five percent diversification and Second Tier Security tests is measured at the time the fund purchases the security. Thus a fund would not be required subsequently to dispose of a security because of a change in the percentage of fund assets the security represents or in the fund's overall investment in Second Tier Securities.<sup>40</sup> In addition, to facilitate determining compliance with the Second Tier Security tests, Rule 2a-7, as amended, specifies that in calculating the percentage of fund assets invested in Second Tier Securities, a fund should only include securities that were Second Tier Securities at the time they were acquired (at original purchase or at any subsequent roll-over) and need not take into account rating changes subsequent to the acquisition of the security.<sup>41</sup>

### 3. Treatment of Split Rated Securities

This section (insofar as it discusses the term "Eligible Security") and all subsequent sections of the Release describe changes that are applicable to both taxable and tax exempt funds.<sup>42</sup>

Currently, Rule 2a-7 permits a money market fund to purchase a security as long as at least one NRSRO rates it within the top two categories of its rating system. Some securities have different ratings from different NRSROs (i.e., "split ratings"). Split ratings may result from the failure of one NRSRO to perceive quality problems or improvements perceived by another NRSRO, or may reflect differences among NRSROs as to the emphasis placed on different criteria. Under the proposed amendments, the relative quality of a security would have been determined by reference to the rating received from each NRSRO rating the security and a split rated security would be treated as having the lower rating. The lower rating would have determined whether a fund could purchase the securities and whether they would be subject to the Second Tier Security tests.

Many commenters, including those supporting the principal elements of the proposals, argued that this approach would give too much influence to a single NRSRO, which effectively could veto the ratings of all other NRSROs. Many mutual fund commenters also complained about the expense and burden of keeping current as to ratings of all of the NRSROs.

Commenters suggested a number of alternatives. In response to the comments, the Commission has decided to adopt an approach suggested by the ICI and several other commenters. Under this approach, a security would be an Eligible

<sup>38</sup> Paragraph (c)(4)(i)(B)(2) of Rule 2a-7, as amended. Paragraph (a)(14) of Rule 2a-7, as amended, defines a Second Tier Security as any Eligible Security that is not a "First Tier Security." Paragraph (a)(6) of Rule 2a-7, as amended, defines a First Tier Security as a security that is rated by the "Requisite NRSROs" in the highest rating category, or if unrated, which is of comparable quality. See, Section II.B.3 of this Release, *infra*, discussing the definition of the term "Requisite NRSROs." and its effect on split rated securities.

<sup>39</sup> The five percent diversification and five percent quality tests would still apply, and thus a fund could not purchase one million dollars of Second Tier Securities if it would result, immediately after the purchase of the securities, in the fund having more than five percent of its total assets invested either in securities of that issuer or in Second Tier Securities.

<sup>40</sup> Paragraph (c)(4)(i) of Rule 2a-7, as amended.

<sup>41</sup> Thus, a fund would not be required to "drop" a First Tier Security into the five percent Second Tier Security "basket" due to a downgrade. Paragraph (c)(4)(i)(B) of Rule 2a-7, as amended. However, a fund board of directors (or its delegate) will be required to assess promptly whether a security which has ceased to be a First Tier Security presents minimal credit risks and cause the fund to take such action as is determined to be in the best interest of the fund. See note 70 and accompanying text, *infra*, and paragraph (c)(5)(i) of Rule 2a-7, as amended. If the security is no longer a Second Tier Security because of a rating downgrade, it must be disposed of unless the board of directors determines that holding it is in the fund's best interest. See Section II.E.1 of this Release, *infra*, and paragraph (c)(5)(ii) of Rule 2a-7, as amended.

<sup>42</sup> While tax exempt funds are not subject to the Five Percent Diversification and Second Tier Security tests, they are, like taxable funds, only permitted to invest in Eligible Securities. See paragraph (c)(3) of Rule 2a-7, as amended, and notes 15 and 16 and accompanying text, *supra*.

Security, and either a First Tier or Second Tier Security, if the “Requisite NRSROs” have agreed on the relevant rating.<sup>43</sup> In the case of a security that has been rated by only one NRSRO, that rating determines the status of the security during the time it is held by a money market fund.<sup>44</sup> However, the acquisition of a security rated by only one NRSRO must be approved or ratified by the fund’s board of directors.<sup>45</sup> If a security has been rated by more than one NRSRO, it must have received the requisite rating from at least two NRSROs.<sup>46</sup> Thus, if a security has received the highest rating from two NRSROs, it is a First Tier Security even if other NRSROs have given it a lower rating.

The adopted approach to split rated securities relies on the agreement of at least two NRSROs rather than unanimity of all the NRSROs that have rated the security. It will preclude a security from being a First Tier Security based on the opinion of only one NRSRO when other NRSROs have given it less than the highest rating. Conversely, it will preclude a single NRSRO from preventing a security from being an Eligible Security or a First Tier Security in the face of a consensus of at least two other NRSROs. Finally, where a security has received the applicable ratings from the Requisite NRSROs, a fund will not be required to monitor the actions of all the NRSROs unless the security has been rated by only one NRSRO.<sup>47</sup> A money market fund could limit the number of NRSROs it must follow by adopting a policy of only investing in securities rated by at least two NRSROs.<sup>48</sup>

### C. Maturity of Portfolio Securities

#### 1. Ninety-Day Dollar Weighted Average Maturity

The Commission is adopting proposed rule amendments to require a money market fund to maintain a dollar weighted average portfolio maturity of not more than ninety days, as opposed to the 120 days now permitted.<sup>49</sup> The change will decrease the exposure of money market fund investors to interest rate risk.

Most commenters supported the change. These commenters stated that almost all funds already limit their maturities to an even greater extent than the amendments would require.<sup>50</sup> As explained in the Proposing Release, the ninety-day

<sup>43</sup> Paragraphs (a)(5)(i), (a)(6), (a)(13) and (a)(14) of Rule 2a-7, as amended. Rule 2a-7, as amended, reflects the fact that some NRSROs rate specific security issues while others provide a rating of the issuer that is applicable to all of the issuer’s debt within a specific class (e.g., short-term or long-term). This approach is also reflected in the definition of “Unrated Securities.” See Section II.D. of this Release and paragraph (a)(20) of Rule 2a-7, as amended.

<sup>44</sup> Paragraph (a)(13) of Rule 2a-7, as amended, defines the term “Requisite NRSROs.” Where a security is rated by only one NRSRO, neither a money market fund nor the issuer is required to solicit ratings from other NRSROs to make the security eligible for investment by the fund. In addition, where only one NRSRO has issued a rating with respect to the security at the time it is purchased or rolled over, under paragraph (a)(13) that NRSRO determines the status of the security regardless of any subsequent ratings by other NRSROs. If a security is rated by only one NRSRO when purchased, a change in the security’s status (i.e., from First Tier to Second Tier) will trigger the reassessment requirement only when the NRSRO that rated the security when it was originally acquired lowers its rating. However, where the security is a Second Tier Security, a reassessment of its credit risk by the fund’s board of directors would be required if the fund’s investment adviser becomes aware that any other NRSRO subsequently rated the security below its second highest rating. See Section II.E. of this Release, *infra*.

<sup>45</sup> Paragraphs (c)(3) and (e) of Rule 2a-7, as amended.

<sup>46</sup> *Id.* Paragraph (a)(6) of Rule 2a-7, as amended. Similarly if at least two NRSROs have rated the security in one of their two highest rating categories for short-term debt obligations, the security is an Eligible Security. Paragraph (a)(5) of Rule 2a-7, as amended.

<sup>47</sup> A money market fund will have to determine whether any other NRSRO has rated a security that, when purchased, was rated by only one NRSRO, in two situations: (1) when it proposes to buy that security, to confirm that it is not rated by other NRSROs; and (2) when it proposes to “roll over” that security to determine whether another NRSRO has given it a lower rating. See note 44, *supra*, and paragraph (a)(13) of Rule 2a-7, as amended. However, a reassessment of the security’s credit risk would be required if the investment adviser becomes aware that a NRSRO has given the security less than its second highest rating. See Section II.E. of the Release, *infra*.

<sup>48</sup> Currently the Commission’s Division of Market Regulation has designated five NRSROs. See note 1, *supra*.

<sup>49</sup> Paragraph (c)(2)(iii) of Rule 2a-7, as amended.

<sup>50</sup> As of February 5, 1991 the average portfolio maturity of taxable money market funds was 53 days and the average maturity of tax exempt funds was 50 days. See the Money Fund Report, *supra*, note 2. One commenter noted that the danger that a long portfolio maturity might cause a fund to break a dollar has been demonstrated. In 1987, municipal money market instruments fluctuated by 240 basis points over a sixty day period, a fluctuation large enough to cause a fund with a ninety-day average dollar weighted average maturity to break a dollar. The commenter suggested that the maximum portfolio maturity be reduced to sixty days. However, the Commission believes that a ninety day period should provide money market fund investors with additional safeguards without unduly limiting the flexibility of money market funds to adjust fund maturities to levels that are appropriate in view of market conditions.



limit is a maximum.<sup>51</sup> A money market fund must maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value or price per share.<sup>52</sup> Thus, in delegating portfolio management responsibilities to the fund's investment adviser, the board should adopt guidelines with respect to portfolio maturity designed to assure that this objective is met.

## 2. Extension of Maximum Maturity Period for Any Security

The proposed amendments would have extended the current limit on the maximum remaining maturity of any portfolio security from one year<sup>53</sup> to two years. Most commenters addressing this issue criticized this proposal as inconsistent with other changes proposed by the Commission. Commenters stated that a two-year maximum would increase the exposure of funds to both credit risk and interest rate risk. One commenter supported the proposed extension, arguing that, in the context of the ninety-day average limit, increasing maximum allowed maturities would have little effect on the overall risk exposure of a fund while allowing it to enhance yield. Several commenters stated that if the Commission was concerned by the degree of risk involved in increasing the permitted maturity period of securities, it could limit purchases of longer maturity instruments to Government securities. In view of the increased credit risks of securities with longer maturities, the Commission has decided to limit investment in securities with longer maturities to Government securities.<sup>54</sup> However, since the value of Government securities with a remaining maturity in excess of thirteen months may be subject to price fluctuations due to changes in interest rates (which could result in significant deviations between amortized cost and market values), Rule 2a-7, as amended, permits their purchase only by a money market fund that uses market-based values in calculating its net asset value (including funds that rely on Release 9786 to value portfolio securities).<sup>55</sup>

With respect to securities other than Government securities, as suggested by several commenters, the rule extends the maximum permitted maturity of individual securities to thirteen months. This change has been made in order to accommodate funds purchasing annual tender bonds, and securities on a when-issued or delayed delivery basis. These securities often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them. Since the purchaser must "book" the security on the day it agrees to purchase it, the maturity period begins on that day.<sup>56</sup> The revised rule allows funds to invest in securities with a remaining maturity of no more than thirteen months (397 days).<sup>57</sup>

## 3. Variable Rate Demand Instruments

Many commenters objected to the provision of the current rule that the remaining maturity of a variable rate instrument with a demand feature be deemed equal to the longer of (i) the period remaining until the next interest readjustment or (ii) the period remaining until the principal amount can be recovered through demand. Several commenters urged the Commission to revise the standard to provide that the maturity period is the shorter of the two periods. One

<sup>51</sup> See the Proposing Release, *supra* note 2, at n. 61.

<sup>52</sup> See paragraph (c)(2) of Rule 2a-7, as amended.

<sup>53</sup> The current rule defines one year as 365 days, but provides that in the case of an instrument that was issued as a one year instrument, but has up to 375 days until maturity, one year means 375 days. This provision was designed to accommodate certain government agency securities that have this characteristic. See Release 13380, *supra* note 5, at n. 13.

<sup>54</sup> Paragraph (c)(2) of Rule 2a-7, as amended. In order to accommodate Government securities purchased on a delayed delivery or when issued basis as discussed *infra*, paragraph (c)(2)(ii) provides that a fund not using the amortized cost method may invest in a Government security with a remaining maturity of 762 calendar days (25 months). In addition, funds may invest in Government securities that have final maturities in excess of twenty-five months provided that the interest rate is adjusted at least every twenty-five months. See paragraph (d)(1) of Rule 2a-7, as amended.

<sup>55</sup> See note 6, *supra*.

<sup>56</sup> The remaining maturity of an instrument is measured from the trade date or such other date upon which the fund's interest in the security is subject to market action. See Release 13380, *supra* note 5, at n. 11. At the suggestion of one commenter, this language has been incorporated into the rule at paragraph (d). Thus, for securities purchased under normal settlement procedures, the length of maturity would be calculated starting on the trade date. For instruments such as "when issued" or "delayed delivery" securities, if the commitment to purchase is based upon either a set price or yield, then the maturity will be calculated based upon the commitment date. *Id.*

<sup>57</sup> Paragraph (c)(2)(i) of Rule 2a-7, as amended.

commenter recommended that the maturity period simply be made equal to the period remaining until the next interest readjustment, ignoring any demand feature.

The current treatment of variable rate instruments derives from a concern that measuring maturity only from interest rate readjustments does not reflect the risk that the quality of a variable rate instrument might decline.<sup>58</sup> Therefore, retaining the current approach continues to be appropriate generally.<sup>59</sup>

#### D. Unrated Securities, Long-Term Securities, and Demand Instruments

Rule 2a-7 permits a fund to invest in unrated securities that the board of directors deems to be of comparable quality to instruments that are “Eligible Securities” by virtue of the ratings assigned them.<sup>60</sup> The Commission has modified the rule to clarify that a security that is not itself rated is not an Unrated Security if its issuer has received ratings for outstanding securities that are comparable in priority and security with the security.<sup>61</sup> In response to commenter suggestions that the lack of a rating often indicates that a security would not have received the first or second highest rating from any NRSRO, paragraph (c) of Rule 2a-7, as amended, requires that the fund’s board of directors approve or ratify the acquisition of each unrated security.<sup>62</sup>

Currently, securities with one of the two highest long-term ratings are considered “high quality” securities.<sup>63</sup> Thus, where long-term ratings are used to determine whether securities are “high quality,” money market funds may only invest in securities rated “AA” (or its equivalent) and above.<sup>64</sup> Commenters recommended that the Commission permit funds to purchase long-term securities with one of the three highest ratings, i.e., those rated “A” or above. Several commenters stated that most issuers with long-term ratings in the three highest categories are rated in the highest short-term category, and the remainder are rated in the second highest category.

The Commission agrees that the correct yardstick of quality is the rating given to the issuer’s short-term debt, since at the time a money market fund invests in a long-term security, its remaining maturity will be less than thirteen months.<sup>65</sup> Where the issuer has rated short-term debt outstanding that is now comparable in terms of priority and security to the long-term security, the fund must base its determination of whether the long-term security is an Eligible Security or a First Tier Security on the short-term rating, regardless of the long-term rating.<sup>66</sup> The Commission is not convinced that issuers with a single “A” long-term rating, but no short-term rating, will in all cases be appropriate investments for money market funds. Where the issuer does not have rated short-term debt outstanding, the long-term security is treated

<sup>58</sup> See Release 13380, *supra* note 5, at n. 27. The Commission also believed that variable rate demand notes might not be readily marketable. The term “Variable Rate Instrument” is defined in paragraph (a)(21) of Rule 2a-7, as amended.

<sup>59</sup> Paragraph (d)(2) of Rule 2a-7, as amended.

<sup>60</sup> Paragraph (c)(3) of Rule 2a-7, as amended. The definition of Eligible Security includes certain unrated securities. See paragraph (a)(5)(iii) of Rule 2a-7, as amended.

<sup>61</sup> Paragraph (a)(20) of Rule 2a-7, as amended, excludes from the definition of “Unrated Security” those securities issued by an issuer that has a rating with respect to a comparable class of short-term debt obligations (or a security within that class). Therefore, such a security would, under paragraphs (a)(5)(i) and (ii) and (a)(6) of the rule, be a rated security and would be an Eligible Security or First Tier Security only if the comparable class of securities (or the issuer with respect to a comparable class) received from the Requisite NRSROs a Short-term rating in one of the two highest categories (or, in the case of a First Tier Security, the highest category).

<sup>62</sup> Paragraphs (c)(3) (second sentence) and (e) of Rule 2a-7, as amended. See note 78 and accompanying text, *infra*, for a discussion of approval and ratification procedures. Government securities, which are generally unrated, are excluded from this provision.

<sup>63</sup> “Short-term” is defined to mean a remaining maturity of 366 days or less and “Long-term” is defined to mean a remaining maturity greater than 366 days. Paragraphs (a)(15) and (a)(9), respectively, of Rule 2a-7, as amended. This corresponds to the categorization of debt instruments used by the NRSROs. Thus, an “intermediate-term” note with a remaining maturity of two years is treated as long-term debt.

<sup>64</sup> Under the current rule, funds must determine that an instrument with a conditional demand feature (or its issuer) has a “high quality” long-term rating. See paragraphs (a)(2)(iv) and (a)(3)(iii) of Rule 2a-7, as currently in effect [17 CFR 270.2a-7 (a)(2)(iv) and 270.2a-7 (a)(3)(iii)]. In addition, if a security with a remaining maturity of one year or less has a long-term rating, it must be “high quality” for the security to be eligible for fund investment. See Release 13380, note 5, at n. 34.

<sup>65</sup> As discussed *infra*, Rule 2a-7, as amended, contains specific provisions for categorizing an instrument whose remaining maturity is determined by reference to a demand feature.

<sup>66</sup> Similarly, where the issuer has a short-term rating, the fund must rely on that rating. See paragraphs (a)(5)(ii) and (a)(6) of Rule 2a-7, as amended.

as unrated,<sup>67</sup> but may not be purchased if it has a long-term rating from any NRSRO that is below the second highest category.<sup>68</sup>

The amendments, as adopted, also clarify the categorization of demand instruments as Eligible Securities and First Tier Securities.<sup>69</sup> As under the current rule, a demand instrument that has an Unconditional Demand Feature may be determined to be an Eligible Security or a First Tier Security based solely on whether the Unconditional Demand Feature is an Eligible Security or a First Tier Security, as the case may be. Where the demand instrument does not have an Unconditional Demand Feature, in addition to having the requisite short-term ratings, the long-term debt securities of the issuer of the demand instrument (or the demand instrument itself) must be rated by the Requisite NRSROs in one of the two highest rating categories for long-term debt obligations, or, if unrated, determined to be of comparable quality by the money market fund's board of directors.

## E. Changes in Credit Risk and Quality

### 1. Disposition of Portfolio Securities

The Commission proposed to require that where a money market fund holds a security that is in default, is no longer “Eligible Quality,” or no longer presents “minimal credit risks,” the fund must dispose of the security “as soon as practicable” absent a specific finding by the board that this would not be in the best interests of the fund. In the event securities were downgraded by a NRSRO but remained “Eligible Quality” securities, a prompt reassessment would have to be made as to whether the security presents minimal credit risks. The Commission is adopting these requirements, modified as discussed below.

As amended, the rule requires a prompt reassessment in two circumstances. First, a reassessment is required by the board of directors (or its delegate) where a security ceases to be a First Tier Security, either because it no longer has the highest rating from the Requisite NRSROs or, if unrated, is not deemed to be of comparable quality to a First Tier Security.<sup>70</sup> Second, a reassessment is required where the fund's investment adviser becomes aware that any NRSRO has rated a Second Tier Security or an Unrated Security below its second highest rating.<sup>71</sup> This reassessment must be undertaken promptly by the board and not its delegate.<sup>72</sup> This requirement to reassess a security that receives less than the second highest rating from any NRSRO has been added to assure that a money market fund will remain sensitive to, and take appropriate action in response to, perceived changes in the credit quality of Second Tier and Unrated Securities after they

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<sup>67</sup> Paragraph (a)(20)(ii) of Rule 2a-7, as amended, defining the term “Unrated Security.”

<sup>68</sup> Paragraph (a)(5) of Rule 2a-7, as amended. This provision is designed to provide an independent check on a fund's quality determination. *See* Release 13380, *supra* note 5, at n. 34.

<sup>69</sup> As proposed, these provisions appeared in the definition of “Eligible Quality.” They now appear in paragraphs (c)(3)(i) and (ii) of Rule 2a-7, as amended.

<sup>70</sup> One commenter requested clarification that, if a security were downgraded from a First Tier Security to a Second Tier Security, but the fund's holding of the security did not exceed the quality and diversification limits for Second Tier Securities, prompt reassessment on the part of the fund would not be required. The rule is being clarified, but not in the direction urged by the commenter. The rule, as amended, requires that if a security ceases to be a First Tier Security, a reassessment is required. Similarly, if one of the Requisite NRSROs indicates that it is reconsidering an issuer's rating, a fund may wish to consider reassessing the security's credit risks, although the fact that a security's rating is being reconsidered would not constitute a rating downgrade for purposes of the rule. Where a First Tier Security is rated by only one NRSRO when acquired, but is subsequently given lower ratings by other NRSROs, it would continue to be a First Tier Security, and no reassessment would be required by the rule. *See* note 44, *supra*, and accompanying text. However, for purposes of acquiring an additional position in the security or, upon maturity, rolling it over, the security would not be a First Tier Security. If the NRSRO that had rated the security at the time it was acquired reduces its rating, a reassessment is required and, if it is no longer an Eligible Security, it must be disposed of as soon as practicable. *See* paragraphs (c)(5)(i) and (c)(5)(ii) of Rule 2a-7, as amended.

Clarification was also requested as to whether the downgrading of other securities of an issuer would prompt the reexamination requirement. The rule does not require reexamination of the security held by the fund in this circumstance, except where the categorization of a portfolio security as an Eligible Security or a First Tier Security was based on the rating of the down-graded security. Paragraph (c)(5) of Rule 2a-7, as amended.

<sup>71</sup> The rule does not require, and the Commission does not expect, investment advisers to subscribe to every rating service publication in order to comply with this requirement. The Commission would expect an investment adviser to become aware of a subsequent rating if it is reported in the national financial press or in publications to which the adviser subscribes.

<sup>72</sup> Paragraph (e) of Rule 2a-7, as amended. A telephonic board of directors meeting could be promptly convened to discuss the security.

have been acquired by the fund. However, the rule provides that a reassessment by the board of directors is not required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five business days of the adviser becoming aware of the new rating, provided the board is subsequently notified of the adviser's actions.

The amendment requiring that defaulted securities or securities that are no longer Eligible Securities be disposed of, absent certain determinations, has been adopted substantially as proposed. Several commenters suggested that the proposed amendment could be interpreted as requiring the fund to dispose of a defaulted securities or a security that is no longer an Eligible Security in a "fire sale" environment that would not be in the best interest of the fund. The Commission would expect the board to take market conditions into account in determining whether to continue to hold a defaulted security or a security that is no longer Eligible Quality in its portfolio.<sup>73</sup> To clarify this, paragraph (c)(5)(ii) of Rule 2a-7, as amended, specifies that in determining that disposing of a security would not be in the best interest of the fund, the board may take into account "among other factors, market conditions that could affect the orderly disposition of the security." In addition, the rule now specifies that, where the board has not determined that holding the security is in the best interest of the fund, it must be sold "as soon as practicable consistent with achieving an orderly disposition of the security."<sup>74</sup>

## 2. Commission Notification

The Commission is adopting the proposed requirement that a money market fund holding one or more defaulted portfolio securities that, immediately before the default, accounted for one half of one percent or more of fund assets, promptly notify the Commission of this fact and of the action the fund intends to take. At the request of several commenters, the paragraph, as adopted, does not require that the Commission be notified in the event of an "immaterial default unrelated to the financial condition of the issuer." This is intended to avoid Commission notification where the default is technical in nature, such as where the obligor has failed to provide a required notice or information on a timely basis.<sup>75</sup>

## 3. Reporting Requirements

The Commission also proposed to require funds to report on Form N-SAR actions taken in connection with defaults of portfolio securities, changes in credit quality or a deviation of the net asset value of the portfolio from market value. In response to comments that such reporting would be of little value and might inhibit board deliberations, the Commission has limited this requirement to reporting actions that were taken with respect to defaulted securities held during the period covered by the report and identifying securities held on the last day of the period covered by the report that are no longer Eligible Securities.<sup>76</sup> Information concerning the determination by a fund board that a portfolio security no longer represents a minimal credit risk would not have to be reported on Form N-SAR.

## F. Portfolio Management Responsibilities

On several occasions the Commission has stated that the portfolio management requirements imposed by Rule 2a-7 may be delegated by the board of directors to the fund's investment adviser, provided that the board retains sufficient oversight.<sup>77</sup> In response to commenter concern over the scope of the board's responsibility, new paragraph (e) of Rule 2a-7 clarifies the responsibilities of the board to guide and monitor the investment adviser when the board delegates responsibilities for portfolio determinations. The paragraph states that the board may delegate to the investment adviser or an officer of the fund all of the responsibilities it has under the rule other than the determination that the fund should

<sup>73</sup> The decision to hold the security would have to actually be made by the board, and not its delegate. *See* Section II.F. of this Release, *infra*.

<sup>74</sup> *Id.*

<sup>75</sup> Similar changes have been made in paragraph (c)(5)(ii)(A) of Rule 2a-7, as amended, which requires that certain actions be taken in the event of a default. The Commission is not adopting the suggestion of several commenters that the notice requirement be limited to payment defaults. Certain non-payment defaults, such as a breach of a net worth covenant, could cause the value of a security to deviate materially from its amortized cost.

<sup>76</sup> Paragraph (c)(8) of Rule 2a-7, as amended. Conforming changes have been made to the instructions to Item 77N of Form N-SAR.

<sup>77</sup> *See, e.g.*, Release 13380, *supra* note 5, and the Proposing Release, *supra* note 2.

maintain a stable net asset value (paragraph (c)(1)), the establishment of amortized cost method procedures to achieve this objective (paragraphs (c)(6)(i) and (c)(6)(ii)), certain determinations with respect to Second Tier Securities, Unrated Securities, and certain securities that have been downgraded by NRSROs (paragraphs (c)(5)(i)(B) and (c)(5)(ii)), and in connection with the penny-rounding method of pricing, the duty to supervise the delegate (paragraph (c)(7)). In addition, credit risk determinations with respect to Unrated Securities and securities that have been rated by only one NRSRO must be approved or ratified by the fund's board of directors.<sup>78</sup> The requirements of paragraph (e) are substantially consistent with previously stated Commission positions concerning the circumstances under which the board may delegate its responsibilities.<sup>79</sup>

### G. Investment Companies Holding Themselves Out as Money Market Funds

The Commission is adopting, substantially as proposed, a new paragraph (b) to Rule 2a-7 to make it unlawful for a registered investment company to (1) adopt "money market" or similar terms as part of its name or title, or the name or title of any redeemable security of which it is the issuer, or (2) hold itself out to investors as a money market fund, or the equivalent of a money market fund, unless the company meets the risk-limiting conditions of paragraphs (c)(2) (maturity), (c)(3) (quality) and (c)(4) (diversification) of Rule 2a-7, as amended.<sup>80</sup>

A fund that determines not to comply with the risk-limiting conditions of Rule 2a-7, as amended, will be required to change its name to the extent it includes the term "money market" or similar terms.<sup>81</sup> Pursuant to paragraph (b) of the rule, as amended, a fund which invests in short-term instruments but which does not wish to hold itself out as a money market fund may call itself any name that would accurately convey its character without being misleading.<sup>82</sup>

One commenter argued that the Commission lacked rulemaking authority under Section 38(a) of the Act [*15 U.S.C. 80a-37(a)*] to adopt paragraph (b). The Commission disagrees. Section 34(b) of the Act makes it unlawful for any person to make any untrue statement of a material fact in any document filed with the Commission or transmitted pursuant to the Act, or the keeping of which is required by Section 31(a) of the Act [*15 U.S.C. 80a-30(a)*], or to omit to state any fact necessary in order to prevent the statements made therein, in light of the circumstances under which they were made, from being materially misleading. Through Sections 9(b) and 42 [*15 U.S.C. 80a-9(b)* and *41*] of the Act, the Commission has the authority to enforce these prohibitions. Section 38(a) provides that the Commission has the authority to adopt rules and regulations "as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this title."<sup>83</sup> The Commission believes that this is ample authority to adopt a rule interpreting the application

<sup>78</sup> Paragraph (c)(3) of Rule 2a-7, as amended. It would not be necessary to convene the board of directors every time the fund acquires such a security. The board of directors could establish an approved list of securities, provided that it periodically makes the requisite credit risk determinations with respect to the securities on the list. In addition, the adviser could acquire a security in accordance with guidelines established by the board, but the board would have to ratify the acquisition at its next meeting.

<sup>79</sup> *Id.* Written copies of the guidelines established by the board in delegating portfolio management responsibilities must be maintained by the fund. Paragraph (c)(8) of Rule 2a-7, as amended.

<sup>80</sup> An investment company holding itself out as a money market fund would not be required to use the amortized cost method of valuation or the penny-rounding method of pricing. Nor would the rule require a fund that does not meet the risk-limiting conditions of the rule to change its investment policies. The rule would only require such a fund to meet the risk-limiting conditions of the rule if it continues to hold itself out as a money market fund.

The prohibition on using the term "money market" in the name of a security has been limited to redeemable securities. Paragraph (b) of Rule 2a-7, as amended. The term "redeemable security" is defined in Section 2(a)(32) of the 1940 Act [*15 U.S.C. 80a-2(a)(32)*].

<sup>81</sup> See paragraph (b) of Rule 2a-7, as amended, and the Proposing Release, *supra* note 2, at n. 65.

<sup>82</sup> The rule amendments adopt a significantly more restrictive view of the term money market fund than currently permitted by Guide 1 to Form N-1A, which states that if a registrant has a name indicating that it is a money market fund, it should have investment policies requiring investment of at least 80% of its assets in debt securities maturing in thirteen months or less. The Commission does not believe that funds previously relying on the staff guideline have misled investors. However, the Division of Investment Management is withdrawing this portion of Guide 1 effective on the date the amendments to Rule 2a-7 become effective.

<sup>83</sup> Section 38(a) of the Act provides that:

The Commission shall have the authority from time to time to make, issue, amend and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this title, including rules and regulations defining accounting, technical, and trade terms used in this title, and prescribing the form or forms in which information required in registration statements, applications, and reports to the Commission shall be set forth. For the purposes of its rules or regulations the Commission may classify persons, securities, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, or matters.

of Section 34(b) to specific circumstances.<sup>84</sup> In addition, to the extent that paragraph (b) affects the registration statements of money market funds, Section 8(b) of the Act [15 U.S.C. 80a-8(b)] provides the Commission authority to prescribe the form of registration statements by adopting such rules as are necessary or appropriate in the public interest or for the protection of investors.<sup>85</sup>

As discussed in the Proposing Release, fund marketing and disclosure documents have encouraged investor expectations that money market funds are secure investments.<sup>86</sup> These expectations are reflected in the risk-limiting conditions of Rule 2a-7 that are today being amended. The Commission believes that there is a significant danger of misleading investors if an investment company holds itself out as a money market fund when it engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7. It is therefore necessary and appropriate in the public interest and for the protection of investors for the Commission to adopt a new paragraph (b) of Rule 2a-7 prohibiting an investment company from holding itself out as a “money market fund” unless it meets the risk-limiting conditions of Rule 2a-7.

#### H. Money Market Fund Prospectus Disclosure

The proposed amendments to Forms N-1A and N-3 require the cover page of a money market fund prospectus to disclose prominently (i) that the shares of the money market fund are neither insured nor guaranteed by the U.S. Government and (ii) that there is no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share. The proposal was widely supported by commenters and is being adopted substantially as proposed.<sup>87</sup>

Several commenters urged that the prescribed legend appear in money market fund sales literature and advertisements. In view of the important role that advertising and sales literature play in marketing money market funds, the Commission has adopted this suggestion.<sup>88</sup>

#### I. Funds Eligible to Quote Seven-Day Yields

The Commission is adopting the proposed amendment to Rule 482 under the 1933 Act to prohibit funds that do not meet the risk-limiting conditions stated in Rule 2a-7 from quoting a seven-day yield figure.<sup>89</sup> These funds, which under Rule 2a-7, as amended, may not hold themselves out as money market funds, are treated as other types of mutual funds that quote thirty-day yield figures accompanied by total return figures. While money market funds that follow the risk-limiting provisions of Rule 2a-7 are unlikely to incur capital losses or gains, the same may not hold true for funds not

<sup>84</sup> See, e.g., Rule 34b-1 under the Act. Contrary to the commenter’s assertion, the plain language of Section 38(a) does not differ in substance from provisions of the other securities acts that grant the Commission authority to adopt rules necessary and appropriate to implement provisions of those acts. See, e.g., Section 19(a) of the 1933 Act [15 U.S.C. 77s(a)]; Section 23(a)(1) of the 1934 Act [15 U.S.C. 78w(a)(1)].

<sup>85</sup> If, as the commenter argued, Section 38(a) only “elaborates on” authority specifically granted by sections of the Act such as Sections 6(c), 17(d) or 17(e) [5 U.S.C. 80a-6c, 17(d) and 17(e)], the portion of Section 38(a) that grants the Commission authority to adopt “such rules and regulations and orders as are necessary or appropriate to the exercise of powers conveyed elsewhere in this title . . .” would be superfluous because the authority specifically granted by the cited sections requires no “elaboration.” See Sutherland Stat. Const. § 46.06 (4th Ed.) (“A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant, and so that one section will not destroy another unless the provision is the result of obvious mistake or error.” (citations omitted)).

<sup>86</sup> See, e.g., Money Market Funds: A Part of Every Financial Plan (publication of the Investment Company Institute), a pamphlet prepared by the major investment company trade association for distribution to the general public.

<sup>87</sup> Several technical revisions have been made. As proposed, the statement must disclose that the “securities of the fund are neither insured nor guaranteed by the U.S. Government.” This has been changed to “an investment in the fund is neither insured nor guaranteed . . .” to reduce the likelihood that a reader would be confused between the securities issued by the fund and its portfolio securities. Second, a parenthetical has been added to the second part of the legend to take into account funds that stabilize their net asset value at a price other than \$1.00. Third, an instruction has been added to permit a money market fund not stabilizing its net asset value to omit the second part of the legend. Finally, as proposed, the amendments require that the legend be “prominent” but do not require a certain type size.

<sup>88</sup> Paragraph (a)(7) of Rule 482, and the first paragraph of Rule 34b-1, as amended.

<sup>89</sup> Paragraph (d) of Rule 482, as amended.

following the risk-limiting provisions. These funds, therefore, must also provide total return figures to investors which reflect the effect of capital losses or gains.<sup>90</sup>

### III. Transition Period

The amendments to Rules 2a-7, 2a41-1, 12d3-1 and 34b-1 and Form N-SAR under the 1940 Act<sup>91</sup> and Rule 482 under the 1933 Act will become effective on June 1, 1991. If a money market fund has policies changeable only if authorized by a shareholder vote that are less restrictive than the rule as amended, but compliance with the amended rule will not violate these policies, the Commission believes that compliance with Rule 2a-7, as amended, would not require a shareholder vote under Sections 8(b)(1) and (2) of the Act. To avoid confusing shareholders, however, funds should consider submitting to shareholders at the next shareholder meeting proposals that will conform the fund's stated policies to the fund's actual policies in light of the revisions to Rule 2a-7. The rule does not require funds to dispose of securities owned at the time of the adoption of the rule to comply with the quality and diversification requirements of the rule as amended. Moreover, the Commission will not object if a fund does not dispose of securities owned at the time of the adoption of the rule to comply with the amended rule's maximum maturity provisions.

The amendments to Rules 482 under the 1933 Act and 34b-1 under the 1940 Act regarding advertisements and sales literature also become effective on June 1, 1991.<sup>92</sup> All advertisements and sales literature used after that date must include the new legend.

The Commission is staggering the effective dates of the amendments to Item 1 of Forms N-1A and N-3 so that a fund will not be required to revise its registration statement to add the new cover page legend until its next post-effective amendment.<sup>93</sup> The amendments to Item 1 of Form N-1A and Item 1 of Form N-3 will be effective: (1) for investment companies whose registration statements become effective on or after May 1, 1991, and investment companies with fiscal years ending on December 31, as to prospectuses used on or after May 1, 1991; and (2) for all other investment companies, upon use of any prospectus contained in any post-effective amendment filed on or after May 1, 1991. If the registration statement of a fund discloses investment policies that are less restrictive than those required by the rule amendments, the Commission will not object if the fund does not, upon the effective date of the amendments to Rule 2a-7, revise its disclosure provided the current disclosure is not misleading. For example, if a fund's registration statement states that the fund may invest in an unlimited amount of Second Tier Securities, a revision would not be necessary. However, if the registration statement states that a fund will invest twenty percent of its assets in Second Tier Securities, revision would be necessary.

It is possible that, upon the adoption of the amendments to Rule 2a-7, some funds may choose no longer to hold themselves out as money market funds rather than comply with the rule's limitations. These funds would no longer be eligible to quote a seven-day yield under Rule 482(d) and would be required to revise their registration statements and sales material. These funds also may have to revise their fundamental organizational documents. If the extent of the changes that any such fund would be required to make, or other circumstances, made it impossible for the fund to comply with the amended rules by their effective date, the Commission staff would entertain requests for "no action" relief.

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<sup>90</sup> The Commission is also adopting conforming amendments to Item 22(a) of Form N-1A, Item 25(a) of Form N-3, and Item 21(a) of Form N-4, which set forth the yield formulas used by money market funds and money market-funded separate accounts issuing variable annuity contracts. The Commission is also making conforming amendments to Rule 34b-1 under the 1940 Act, the rule governing mutual fund sales literature.

<sup>91</sup> The amendments to Rules 2a41-1 and 12d3-1 conform certain references to paragraphs of Rule 2a-7 to the amended rule.

<sup>92</sup> The amendments to Item 22 of Form N-1A, Item 25 of Form N-3 and Item 21 of Form N-4 do not require a fund that continues to hold itself out as a money market fund to amend its registration statement. However, as noted below, a fund that elects not to hold itself out as a money market fund will have to amend its response to the applicable item of its registration statement if it plans to continue to advertise its performance.

<sup>93</sup> The Commission would not object if the post-effective amendment filed to add the cover page legend is filed pursuant to Rules 485(b) or 486(b) [17 *CFR* 230.485(b) and 230.486(b)] if all other conditions for filing under paragraph (b) are met.

## IV. Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis regarding the proposed rule and form amendments was published in the proposing release. One comment was received. The Commission has prepared a Final Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603, a copy of which may be obtained by contacting Eli A. Nathans, Mail Stop 10-6, Securities and Exchange Commission, 450 Fifth Street N.W., Washington, D.C. 20549.

## V. Statutory Authority

The Commission is amending Rule 2a-7 under the exemptive and rulemaking authority set forth in Sections 6(c) [15 U.S.C. 80a-6(c)], 8(b) [15 U.S.C. 80a-8(b)], 22(c) [15 U.S.C. 80a-22(c)], 34(b) [15 U.S.C. 80a-33(b)], and 38(a) [15 U.S.C. 80a-37(a)] of the Investment Company Act of 1940. The authority citations for the amendments to the rules and forms precede the text of the amendments.

## VI. Text of Rule and Form Amendments

List of Subjects in 17 CFR Parts 230, 239, 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities

For the reasons set out in the preamble, the Commission is amending Chapter II, Title 17 of the Code of Federal Regulations as follows:

### Part 230—General Rules and Regulations, Securities Act of 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78l, 78m, 78n, 78o, 78w, 79t, and 80a-37, as amended, unless otherwise noted.

2. Section 230.482 is amended by deleting the period at the end of the paragraph (a)(6) and by replacing it with a semicolon, by adding a new paragraph (a)(7) and revising paragraph (d) to read as follows:

§ 230.482 Advertising by an investment company as satisfying requirements of section 10.

(a) \* \* \*

(7) In the case of an investment company that holds itself out to be a “money market” fund, it includes a prominent statement that (i) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (ii) there can be no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share (or, if other than \$1.00, the applicable net asset value); provided, however, that a money market fund not holding itself out as maintaining a stable net asset value may omit the portion of the statement required by paragraph (a)(7)(ii) of this section.

\* \* \*

(d) In the case of a “money market” fund, any quotation of the money market fund’s yield contained in an advertisement shall be:

(1) A quotation of current yield based on the method of computation prescribed in Form N-1A (set forth in §§ 239.15A and 274.11A of this chapter), Form N-3 (set forth in §§ 239.17a and 274.11b of this chapter), or Form N-4 (set forth in §§ 239.17b and 274.11c of this chapter) and identifying the length of and the date of the last day in the base period used in computing that quotation; or

(2) A quotation of current yield described in paragraph (d)(1) of this section and a corresponding quotation of effective yield based on the method of computation prescribed in Forms N-1A, N-3, or N-4; provided, that when both a quotation of current yield and effective yield are used in the same advertisement, each quotation shall relate to an identical base period and shall be given equal prominence.



\* \* \*

## Part 270—Rules and Regulations, Investment Company Act of 1940

3. In the authority citation to Part 270, the general authority continues to read as set forth below, the specific authority for Sections 270.2a-7, 270.2a41-1 and 270.12d3-1 is revised as follows:

Secs. 38, 40, *54 Stat. 841, 842; 15 U.S.C. 80a-37, 80c-89*; The Investment Company Act of 1940, as amended, *15 U.S.C. 80a-1 et seq.*; unless otherwise noted;

\* \* \*

Sections 270.2a-7, 270.2a41-1 and 270.12d3-1 also issued under Secs. 6(c) [*15 U.S.C. 80a-6(c)*], 22 [*15 U.S.C. 80a-22*], 34 [*15 U.S.C. 80a-33*], 38 [*15 U.S.C. 80a-37*], and 40 [*15 U.S.C. 80a-39*];

\* \* \*

4. By revising the section heading and Section 270.2a-7 to read as follows:

§ 270.2a-7 Money market funds.

(a) Definitions.

(1) “Amortized Cost Method” of valuation shall mean the method of calculating an investment company’s net asset value whereby portfolio securities are valued at the fund’s acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(2) “Business day” means any day, other than Saturday, Sunday, or any customary business holiday.

(3) “Collateralized fully” in the case of a repurchase agreement shall mean that:

(i) the value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the money market fund reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the resale price provided in the agreement; and

(ii) the money market fund or its custodian either has actual physical possession of the collateral or, in the case of a security registered on a book entry system, the book entry is maintained in the name of the money market fund or its custodian; and

(iii) the money market fund retains an unqualified right to possess and sell the collateral in the event of a default by the seller; and

(iv) the collateral consists entirely of Government securities or securities that, at the time the repurchase agreement is entered into, are rated in the highest rating category by the Requisite NRSROs.

(4) “Demand Feature” shall mean a Put that entitles the holder to receive the principal amount of the underlying security or securities and that may be exercised either:

(i) at any time on no more than 30 days’ notice; or

(ii) at specified intervals not exceeding 397 calendar days and upon no more than 30 days’ notice.

(5) “Eligible Security” shall mean:

(i) a security with a remaining maturity of 397 days or less that is rated (or that has been issued by an issuer that is rated with respect to a class of Short-term debt obligations, or any security within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in one of the two highest rating categories for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(ii) a security:

(A) that at the time of issuance was a Long-term security but that has a remaining maturity of 397 calendar days or less, and

(B) whose issuer has received from the Requisite NRSROs a rating, with respect to a class of Short-term debt obligations (or any security within that class) that is now comparable in priority and security with the security, in one of the two highest rating categories for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(iii) an Unrated Security that is of comparable quality to a security meeting the requirements of paragraphs (a)(5)(i) or (ii) of this section, as determined by the money market fund's board of directors; provided, however, that:

(A) the board of directors may base its determination that a Standby Commitment is an Eligible Security upon a finding that the issuer of the commitment presents a minimal risk of default; and

(B) a security that at the time of issuance was a Long-term security but that has a remaining maturity of 397 calendar days or less and that is an Unrated Security is not an Eligible Security if the security has a Long-term rating from any NRSRO that is not within the NRSRO's two highest categories (within which there may be sub-categories or gradations indicating relative standing).

(6) "First Tier Security" shall mean any Eligible Security that:

(i) is rated (or that has been issued by an issuer that is rated with respect to a class of Short-term debt obligations, or any security within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in the highest rating category for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(ii) is a security described in paragraph (a)(5)(ii) of this section whose issuer has received from the Requisite NRSROs a rating, with respect to a class of Short-term debt obligations (or any security within that class) that now is comparable in priority and security with the security, in the highest rating category for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(iii) is an Unrated Security that is of comparable quality to a security meeting the requirements of clauses (i) and (ii) of paragraph (a)(6) of this section, as determined by the fund's board of directors.

(7) "Floating Rate Instrument" shall mean a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate (such as a bank's designated prime lending rate) changes and which, at any time, can reasonably be expected to have a market value that approximates its par value.

(8) "Government security" shall mean any Government security as defined in Section 2(a)(16) of the Act.

(9) "Long-term" shall mean having a remaining maturity greater than 366 days.

(10) "NRSRO" shall mean any nationally recognized statistical rating organization, as that term is used in paragraphs (c) (2)(vi)(E), (F) and (H) of Rule 15c3-1 under the Securities Exchange Act of 1934 [17 CFR 240.15c3-1(c)(2)(vi)(E), (F) and (H)], that is not an affiliated person, as defined in Section 2(a)(3)(c) of the Act [15 U.S.C. 80a-2(a)(3)(c)], of the issuer of, or any insurer, guarantor or provider of credit support for, the instrument.

(11) "Penny-Rounding Method" of pricing shall mean the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(12) A "Put" shall mean a right to sell a specified underlying security or securities within a specified period of time and at a specified exercise price, that may be sold, transferred or assigned only with the underlying security or securities.

(13) “Requisite NRSROs” shall mean (a) any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer, or (b) if only one NRSRO has issued a rating with respect to such security or issuer at the time the fund purchases or rolls over the security, that NRSRO.

(14) “Second Tier Security” shall mean any Eligible Security that is not a First Tier Security.

(15) “Short-term” shall mean having a remaining maturity of 366 days or less.

(16) “Standby Commitment” shall mean a Put that entitles the holder to achieve same day settlement and to receive an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise.

(17) “Tax exempt fund” shall mean any money market fund that holds itself out as distributing income exempt from regular federal income tax.

(18) “Total Assets” shall mean, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.

(19) An “Unconditional Put” or an “Unconditional Demand Feature” shall mean a Put or a Demand Feature (including any guarantee, letter of credit or similar unconditional credit enhancement) that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

(20) An “Unrated Security” shall mean:

(i) a security with a remaining maturity of 397 days or less issued by an issuer that does not have a current Short-term rating assigned by any NRSRO:

(A) to the security, or

(B) to the issuer with respect to a class of Short-term debt obligations (or any security within that class) that is comparable in priority and security with the security; and

(ii) a security:

(A) that at the time of issuance was a Long-term security but that has a remaining maturity of 397 calendar days or less, and

(B) whose issuer has not received from any NRSRO a rating with respect to a class of Short-term debt obligations (or any security within that class) that now is comparable in priority and security with the security; and

(iii) a security that is a rated security and is the subject of an external credit support agreement that was not in effect when the security (or the issuer) was assigned its rating.

A security is not an Unrated Security if any Short-term debt obligation (“reference security”) that is issued by the same issuer and is comparable in priority and security with that security is rated by a NRSRO. The status of such security as an Eligible Security or First Tier Security shall be the same as that of the reference security.

(21) A “Variable Rate Instrument” shall mean a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and which, upon such adjustment, can reasonably be expected to have a market value that approximates its par value.

(b) Holding Out. It shall be an untrue statement of material fact within the meaning of Section 34(b) of the Act [15 U.S.C. 80a-33(b)] for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act [15 U.S.C. 80a-24(b)] to:

(1) adopt the term “money market” as part of its name or title or the name or title of any redeemable security of which it is the issuer, or

(2) hold itself out to investors as, or adopt a name which suggests that it is, a money market fund or the equivalent of a money market fund,

unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this section. For purposes of this paragraph, a name which suggests that a registered investment company is a money market fund or the equivalent thereof shall include one which uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) Share Price Calculations. The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund”), notwithstanding the requirements of Section 2(a)(41) of the Act [*15 U.S.C. 80a-2(a)(41)*] and of Rule 2a-4 [*17 CFR 270.2a-4*] and Rule 22c-1 [*17 CFR 270.22c-1*] thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; provided, however, that:

(1) Board Findings. The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.

(2) Portfolio Maturity. The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; provided, however, that the money market fund will not:

(i) except as provided in paragraph (c)(2)(ii) of this section, purchase any instrument with a remaining maturity of greater than 397 calendar days, or

(ii) in the case of a money market fund not using the Amortized Cost Method, purchase a Government security with a remaining maturity of greater than 762 calendar days; or

(iii) maintain a dollar-weighted average portfolio maturity that exceeds ninety days.

(3) Portfolio Quality. The money market fund will limit its portfolio investments, including Puts and repurchase agreements, to those United States dollar-denominated instruments that its board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to the rating assigned to such instruments by a NRSRO) and which are at the time of acquisition Eligible Securities. In the case of an Unrated Security (including a demand instrument) other than a Government Security, or a security that is an Eligible Security based on the rating of one NRSRO, the acquisition of each such security by the money market fund must be approved or ratified by the money market fund’s board of directors. For purposes of this section:

(i) a demand instrument that has an Unconditional Demand Feature may be determined to be an Eligible Security or a First Tier Security based solely on whether the Unconditional Demand Feature is an Eligible Security or First Tier Security, as the case may be; and

(ii) a demand instrument that does not have an Unconditional Demand Feature is not an Eligible Security or a First Tier Security unless it meets the requirements for being an Eligible Security or First Tier Security, as the case may be, and, in addition, the demand instrument or the Long-term debt securities of the issuer of the demand instrument have been rated by the Requisite NRSROs in one of the two highest rating categories for Long-term debt obligations (within which there may be sub-categories or gradations indicating relative standing), or, if unrated, are determined to be of comparable quality by the money market fund’s board of directors.

(4)(i) Portfolio Diversification: General. Except for a tax exempt fund, immediately after the acquisition of any security (other than a Government security):

(A) the money market fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security; provided, however that a fund may invest more than five percent of its Total Assets in the First Tier Securities of a single issuer for a period of up to three Business days after the purchase thereof (subject to Section 5(b)(1) of the Act [15 U.S.C. 80a-5(b)(1)] if the money market fund is a diversified investment company), provided, further, that the fund may not make more than one investment in accordance with the foregoing proviso at any time; and

(B) in the event that such security is a Second Tier Security, the money market fund shall not have invested more than (1) the greater of one percent of its Total Assets or one million dollars in securities issued by that issuer which, when acquired by the fund (either initially or upon any subsequent roll over) were Second Tier Securities, and (2) five percent of its Total Assets in securities which, when acquired by the fund (either initially or upon any subsequent roll over) were Second Tier Securities.

For purposes of making calculations under paragraph (4)(i)(A) of this section, a repurchase agreement shall be deemed to be an acquisition of the underlying securities, provided that the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully.

(ii) Portfolio Diversification: Puts. Immediately after the acquisition of any Put, no more than five percent of the money market fund's Total Assets may be invested in securities issued by or subject to Puts from the same institution, provided, however, that if the money market fund is a tax exempt fund, the foregoing condition shall only be applicable with respect to 75 percent of its Total Assets.

(iii) General. For purposes of paragraph (4) of this section:

(A) a Put will be considered to be from the party to whom the money market fund will look for payment of the exercise price;

(B) an Unconditional Put will be considered to be a guarantee of the underlying security or securities; and

(C) a guarantee of, or Unconditional Put with respect to, a security will not be deemed to be issued by the institution providing the guarantee or the Put, provided that the value of all securities held by the money market fund and issued or guaranteed by the issuer providing the guarantee or Put shall not exceed ten percent of the money market fund's Total Assets.

(5) (i) Security Downgrades. In the event that (A) a portfolio security of a money market fund ceases to be a First Tier Security (either because it no longer has the highest rating from the Requisite NRSROs or, in the case of an Unrated Security, the board of directors of the money market fund determines that it is no longer of comparable quality to a First Tier Security), or (B) the money market fund's investment adviser (or any person to whom the money market fund's board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated Security or Second Tier Security held by the money market fund has, since the security was acquired by the fund, been given a rating by any NRSRO below the NRSRO's second highest rating category, the board of directors of the money market fund shall reassess promptly whether such security presents minimal credit risks and shall cause the money market fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders; provided, however, that the reassessment required by paragraph (c) (5)(i)(B) of this section is not required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five Business days of the adviser becoming aware of the new rating and the board is subsequently notified of the adviser's actions.

(ii) Defaults and Other Events. In the event:

(A) of a default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer); or

(B) a portfolio security of a money market fund ceases to be an Eligible Security; or

(C) it has been determined that a security no longer presents minimal credit risks; absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which

determination may take into account, among other factors, market conditions that could affect the orderly disposition of the security), the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise.

(iii) Notice to the Commission. In the event of a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) which immediately before default accounted for  $\frac{1}{2}$  of 1 percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically or by means of a facsimile transmission, followed by letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management.

(6) Required Procedures: Amortized Cost Method. In the case of a money market fund using the Amortized Cost Method:

(i) In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) Included within the procedures adopted by the board of directors shall be the following:

(A) Written procedures providing that the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute which reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions; periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and maintenance of records of the determination of deviation and the board's review thereof; and

(B) In the event such deviation from the money market fund's amortized cost price per share exceeds  $\frac{1}{2}$  of 1 percent, a requirement that the board of directors shall promptly consider what action, if any, should be initiated by the board of directors; and

(C) Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors of existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(7) Required Procedures: Penny-Rounding Method. In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one per cent, will not deviate from the single price established by the board of directors.

(8) Record Keeping and Reporting. The money market fund will record, maintain, and preserve permanently in an easily accessible place a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(5), (c)(6), (c)(7) and (e) of this section, and the money market fund will record, maintain, and preserve for a period of not less than six years (the first two years in an easily accessible place) a written record of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth above, to be included in the minutes of the board of directors' meetings. The documents preserved pursuant to this condition shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act [*15 U.S.C. 80a-30(b)*] as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act [*15 U.S.C. 80a-30(a)*]. If any action was taken

pursuant to paragraphs (c)(5)(ii) (with respect to defaulted securities) or (c)(6)(ii)(B) of this section, the money market fund will attach an exhibit to the Form N-SAR [17 CFR 274.101] filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

(d) Maturity of Portfolio Instruments. For the purposes of this rule, the maturity of a portfolio instrument shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the instrument is subject to market action) until the date noted on the face of the instrument as the date on which the principal amount must be paid, or in the case of an instrument called for redemption, the date on which the redemption payment must be made, except that:

- (1) An instrument that is issued or guaranteed by the United States government or any agency thereof which has a variable rate of interest readjusted no less frequently than every 762 days shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.
- (2) A Variable Rate Instrument, the principal amount of which is scheduled on the face of the instrument to be paid in 397 calendar days or less shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.
- (3) A Variable Rate Instrument that is subject to a Demand Feature shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.
- (4) A Floating Rate Instrument that is subject to a Demand Feature shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.
- (5) A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where no date is specified, but the agreement is subject to a demand, the notice period applicable to a demand for the repurchase of the securities.
- (6) A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where no date is specified, but the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(e) Delegation. The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by the second sentence of paragraph (c)(3) (which may be delegated subject to ratification by the money market fund's board of directors) and paragraphs (c)(1), (c)(5)(i)(B), (c)(5)(ii), (c)(6)(i), (c)(6)(ii), and (c)(7) of this section) provided that the board:

- (1) establishes and periodically reviews written guidelines (including guidelines for determining whether instruments present minimal credit risks as required in paragraph (c)(3) of this section) and procedures under which the delegate makes such determinations; and
- (2) exercises adequate oversight (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security that requires notification of the Commission under paragraph (c)(5)(iii) of this section) to assure that the guidelines and procedures are being followed.

5. By revising paragraph (a) of § 270.2a41-1 as follows:

§ 270.2a41-1 Valuation of standby commitments by registered investment companies.

(a) A standby commitment as defined in Rule 2a-7(a)(16) under the Act [17 CFR 270.2a-7(a)(16)] may be assigned a fair value of zero, Provided, That:

\* \* \*

6. By revising paragraph (d)(8)(v) of § 270.12d3-1 as follows:

§ 270.12d3-1 Exemption of acquisitions of securities issued by persons engaged in securities related businesses.

\* \* \*

(d) \* \* \*

(8) \* \* \*

(v) Acquisition of puts, as defined in Rule 2a-7(a)(12) under the Act [*17 CFR 270.2a-7(a)(12)*], provided that, immediately after the acquisition of any put, the company will not, with respect to 75 percent of the total value of its assets, have invested more than five percent of the total value of its assets in securities underlying puts from the same institution. An unconditional put shall not be considered a put from that institution, provided, that, the value of all securities issued or guaranteed by the same institution and held by the investment company does not exceed ten percent of the total value of the company's assets. For the purposes of this section, a put will be considered to be from the party to whom the company will look for payment of the exercise price and an unconditional put, as defined in Rule 2a-7(a)(19) under the Act [*17 CFR 270.2a-7(a)(19)*], will be considered to be a guarantee of the underlying security or securities.

\* \* \*

7. By revising the first paragraph of § 270.34b-1 to read as follows:

§ 270.34b-1 Sales literature deemed to be misleading.

Any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act [*15 U.S.C. 80a-24(b)*] and that contains any investment company performance data (other than a report to shareholders under Section 30(d) of the Act [*15 U.S.C. 80a-29(d)*] containing only performance data for the period of the report (“sales literature”) shall have omitted to state a fact necessary in order to make the statements made therein not materially misleading unless the sales literature also contains performance data specified in paragraphs (a), (b), and (c) of this section, and the disclosure required by paragraph (a)(6) of this section and, in the case of an investment company that holds itself out as a “money market fund,” paragraph (a)(7) of Rule 482 under the Securities Act of 1933 [*17 CFR 230.482(a)(6)* and (7)].

\* \* \*

## Part 239—Forms Prescribed Under the Securities Act of 1933

### Part 274—Forms Prescribed Under the Investment Company Act of 1940

8. The authority citation for Part 239 continues to read as follows:

Authority: The Securities Act of 1933, *15 U.S.C. 77a, et seq.*, unless otherwise noted.

9. The authority citation for Part 274 continues to read as follows:

Authority: The Investment Company Act of 1940, *15 U.S.C. 80a-1 et seq.*, unless otherwise noted.

10. Amending Form N-1A [*17 CFR 239.15A* and *274.11A*], Part A, Item 1, paragraph (a), by deleting the word “and” at the end of paragraph (v), redesignating paragraph (vi) as paragraph (vii) and adding new paragraph (vi) and a new Instruction, to read as follows:

§ 239.15A Form N-1A, registration statement of open-end management investment companies.

§ 274.11A Form N-1A, registration statement of open-end management investment companies.



Note: Form N-1A is not codified in the Code of Federal Regulations.

\*\*\*

## PART A INFORMATION REQUIRED IN A PROSPECTUS

### Item 1. Cover Page

(a) \*\*\*

(vi) in the case of a Registrant holding itself out as a money market fund, a prominent statement that (A) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (B) there can be no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share (or, if other than \$1.00, the applicable net asset value); and

\*\*\*

Instruction: Registrants not holding themselves out as maintaining a stable net asset value may omit the disclosure required by paragraph (B) of Item 1(a)(vi).

\*\*\*

11. Revising Form N-1A [17 CFR 239.15A and 274.11A], Part B, paragraph (a) of Item 22 to read as follows:

\*\*\*

## PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION

\*\*\*

### Item 22. Calculation of Performance Data

(a) Money Market Funds. If the Registrant holds itself out as a “money market” fund and if it advertises a yield quotation or an effective yield quotation, furnish:

\*\*\*

12. Amending Form N-3 [17 CFR 239.17a and 274.11b], Part A, Item 1, paragraph (a), by deleting the word “and” at the end of paragraph (a)(viii), redesignating paragraph (a)(ix) as paragraph (a)(x) and adding new paragraph (a)(ix) to read as follows:

§ 239.17a Form N-3, registration statement for separate accounts organized as management investment companies.

§ 274.11b Form N-3, registration statement of separate accounts organized as management investment companies.

Note: Form N-3 is not codified in the Code of Federal Regulations.

\*\*\*

## PART A INFORMATION REQUIRED IN A PROSPECTUS

### Item 1. Cover Page

(a) \*\*\*

(ix) in the case of a Registrant holding itself out as a money market fund, a prominent statement that an investment in the fund is neither insured nor guaranteed by the U.S. Government; and

\* \* \*

13. Amending Form N-3 [17 CFR 239.17a and 274.11b], Part B, by revising paragraph (a) of Item 25 to read as follows:

#### **PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION**

\* \* \*

Item 25. Calculation of Performance Data

(a) Money Market Accounts. For each account or sub-account that holds itself out as a “money market” account or sub-account, and that advertises a yield quotation or an effective yield quotation, furnish:

\* \* \*

14. Amending Form N-4 [17 CFR 239.17B and 274.11c], Part B, by revising paragraph (a) of Item 21 to read as follows:

§ 239.17b Form N-4, registration statement for separate accounts organized as unit investment trusts.

§ 274.11c Form N-4, registration statement of separate accounts organized as unit investment trusts.

Note: Form N-4 is not codified in the Code of Federal Regulations

\* \* \*

#### **PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION**

\* \* \*

Item 21. Calculation of Performance Data

(a) Money Market Funded Sub-Accounts. For each sub-account that is funded by a “money market” fund, and for which the Registrant advertises a yield quotation or an effective yield quotation, furnish:

\* \* \*

15. Amending Form N-SAR [17 CFR 274.101] by revising Instruction to Sub-item 77N, to read as follows

§ 274.101 Form N-SAR, semi-annual report of registered investment companies.

Note: Form N-SAR is not codified in the Code of Federal Regulations

\* \* \*

#### **GENERAL INSTRUCTIONS**

\* \* \*

Instructions to Specific Items

\* \* \*

ITEM 77: Attachments

\* \* \*

SUB-ITEM 77N: Actions required to be reported pursuant to Rule 2a-7

A Registrant relying on Rule 2a-7 [17 CFR 270.2a-7] to use the amortized cost method of valuation is required by paragraph (c)(8) of that rule: 1) to report actions that were taken with respect to defaulted securities held during the period covered by the report; 2) to report actions taken with respect to deviations from the money market fund's amortized cost price per share that may result in material dilution or other unfair results to investors or existing shareholders; and 3) to identify securities held on the final day of the reporting period that are no longer Eligible Securities, as defined by paragraph (a)(5) of that rule. If any such action was taken during the reporting period, or if such securities are held on the last day of the reporting period, this item should be checked and an exhibit attached, listing the securities and specifically describing the nature and circumstances of the action.

\* \* \*

16. Amending Guide 1 (Name of Registrant) to Form N-1A by deleting the second paragraph and Guide 1 (Name of Registrant) to Form N-3, by deleting the last sentence of the first paragraph.

The Guides to Forms N-1A and N-3 are not codified in the Code of Federal Regulations.

By the Commission.

Jonathan G. Katz

Secretary

February 20, 1991

**APPENDIX: CONVERSION TABLE**

Note: The conversion table is not codified in the Code of Federal Regulations.

<b>Amended Rule</b>	<b>Is Found in</b>	<b>Prior Rule</b>
(a)		(c)
(a)(1)		(c)(1)
(a)(2)	new	***
(a)(3)	new	***
(a)(4)		(c)(5)
(a)(5)	new	***
(a)(6)	new	***
(a)(7)		(c)(8)
(a)(8)	new	***
(a)(9)	new	***
(a)(10)		(c)(9)
(a)(11)		(c)(2)
(a)(12)		(c)(3)
(a)(13)	new	***
(a)(14)	new	***
(a)(15)	new	***
(a)(16)		(c)(4)
(a)(17)	new	***
(a)(18)	new	***
(a)(19)	new	***
(a)(20)	new	***
(a)(21)	new	***
(b)	new	***
(c)		(a)
(c)(1)		(a)(1)
(c)(2)		(a)(2)(iii), (a)(3)(ii)
(c)(2)(i)		(a)(2)(iii)(A), (a)(3)(ii)(A)
(c)(2)(ii)	new	***
(c)(2)(iii)		(a)(2)(iii)(B), (a)(3)(ii)(B)
(c)(3)		(a)(2)(iv), (a)(3)(iii)
(c)(3)(i)	new	***
(c)(3)(ii)	new	***
(c)(3)(iii)	new	***
(c)(4)	new	***
(c)(5)	new	***
(c)(6)		(a)(2)
(c)(6)(i)		(a)(2)(i)
(c)(6)(ii)		(a)(2)(ii)
(c)(6)(ii)(A)		(a)(2)(ii)(A)
(c)(6)(ii)(B)		(a)(2)(ii)(B)
(c)(6)(ii)(C)		(a)(2)(ii)(C)
(c)(7)		(a)(3)
(c)(8)		(a)(2)(vi), (a)(2)(vii)
(d)		(b)
(d)(1)		(b)(1)
(d)(2)		(b)(2)
(d)(3)		(b)(3)
(d)(4)		(b)(4)
(d)(5)		(b)(5)
(d)(6)		(b)(6)
(e)	new	***

## PROPOSED REVISIONS TO RULES REGULATING MONEY MARKET FUNDS

Release Nos. 33-7038; IC-19959

December 17, 1993

**ACTION:** Proposed amendments to rules and forms.

**SUMMARY:** The Securities and Exchange Commission is proposing for public comment 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 tighten the risk-limiting conditions imposed on tax exempt money market funds by Rule 2a-7 under the Investment Company Act of 1940; impose additional disclosure requirements on tax exempt funds; and make certain other changes to the Commission rules and forms applicable to all money market funds. The amendments are designed both to reduce the likelihood that a tax exempt fund will not be able to maintain a stable net asset value and to increase investor awareness of the risks of investment in a money market fund.

**DATES:** Comments must be received on or before April 6, 1994.

**ADDRESSES:** Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All comment letters should refer to File No. S7-34-93. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

**FOR FURTHER INFORMATION CONTACT:** Kenneth J. Berman, Deputy Office Chief, or Martha H. Platt, Senior Attorney, (202) 272-2107, Office of Disclosure and Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission ("Commission") today is proposing for comment amendments to rules and forms affecting money market funds ("funds"), including Rule 2a-7 [17 *CFR* 270.2a-7] (the "rule") under the Investment Company Act of 1940 [15 *U.S.C.* 80a-1 *et seq.*] ("1940 Act").<sup>1</sup> The proposed amendments primarily relate to funds that hold themselves out as distributing income that is exempt from regular federal income tax.

In addition to the amendments being proposed to Rule 2a-7, amendments are being proposed to the following rules and forms: 17 *CFR* 210.12-12; 17 *CFR* 230.134; 17 *CFR* 270.2a41-1; 17 *CFR* 270.12d3-1; 17 *CFR* 270.17a-9; 17 *CFR* 270.31a-1; Form N-1A [17 *CFR* 239.15A and 274.11A]; Form N-3 [17 *CFR* 239.17a and 274.11b]; and Form N-SAR [17 *CFR* 274.10f]. The Commission is also publishing three new or revised staff guides to Forms N-1A and N-3 which do not appear in the Code of Federal Regulations.

New rule text being proposed is shaded and text proposed to be deleted is struck through in Section XII of this Release, but will not appear so in the Federal Register.

### EXECUTIVE SUMMARY

In February 1991, the Commission amended the rules and forms governing money market funds. These amendments focussed primarily on taxable money market funds and required that such funds limit their investments in the securities of any one issuer (other than Government securities)<sup>2</sup> to five percent of fund assets (the "Five Percent Diversification Test"), and limit fund investment in "second tier securities" (as defined in the rule) to no more than five percent of fund

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<sup>1</sup> Unless otherwise noted, all references to Rule 2a-7, or to any paragraph of the rule, will be to the applicable paragraph of 17 *CFR* 270.2a-7 as currently in effect. When a paragraph is renumbered in the rule as it is proposed to be amended, citations will be both to Rule 2a-7 "as proposed to be amended" and to the current rule.

<sup>2</sup> Under paragraph (a)(8) of Rule 2a-7 (paragraph (a)(13) of Rule 2a-7 as proposed to be amended), the term "Government security" means those securities issued or guaranteed by the United States or its instrumentalities—the definition of that term given in Section 2(a)(16) of the 1940 Act [15 *U.S.C.* 80a-2(a)(16)]. It does not include securities issued or guaranteed by state governments or instrumentalities.

assets, with investment in the second tier securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars (the “Second Tier Security Tests”).

The Commission is now proposing to amend Rule 2a-7 to provide tax exempt fund investors with protections similar to those afforded taxable fund investors by the 1991 amendments. The proposed amendments take into account the different characteristics of “national” funds, which have as their primary objective distributing income exempt from federal taxation, and “single state” funds, which have as their primary objective distributing income exempt not only from federal taxation, but the income taxes of a specific state.

### **Diversification**

The proposed amendments would require that national funds comply with the Five Percent Diversification Test. Single state funds would not be subject to the Five Percent Diversification Test, but would be required to provide additional prospectus disclosure to alert investors to the increased risks presented by these funds.

### **Credit Quality**

To address the increased risks that may result from lack of diversification, the proposed amendments would require that single state funds invest only in “first tier securities” (as defined in the rule). National funds would be limited to investing five percent of fund assets in second tier securities that are “conduit securities” (as proposed to be defined in the rule) with investment in the conduit securities of any one issuer that are second tier securities being limited to one percent of fund assets.

### **Puts and Demand Features**

A “put” permits security holders to demand repayment of a security within a specified period of time. A “demand feature” is a put that can be exercised on relatively short notice. A substantial portion of tax exempt fund portfolios are subject to puts and demand features. The proposed amendments would provide that a fund could not invest more than ten percent of its assets in securities subject to puts from, or directly issued by, the same institution. Currently, the rule imposes this put diversification limitation on seventy-five percent of a tax exempt fund’s assets, and applies a five percent limitation to a “conditional put” from a single institution. In addition, the proposed amendments would: (a) limit the percentage of fund assets that may be subject to puts of a single institution that are second tier securities to five percent of fund assets; (b) require puts that are demand features to be rated by a nationally recognized statistical rating organization (“NRSRO”); and (c) specify the types of conditions that can apply to a conditional put.

### **Asset Backed Securities and “Synthetic” Securities**

The rule amendments would accommodate Rule 2a-7 to asset backed and synthetic securities—types of securities in which many money market funds currently invest. To provide an independent evaluation of the risks posed by these structures, funds would be limited to investing in asset backed and synthetic securities that have been rated by a NRSRO. In addition, the amendments would specify how the rule’s diversification requirements and security maturity limitations would apply to these securities.

### **Continuing Credit Risk Analysis**

The Commission is also proposing amendments to improve fund procedures for analyzing certain securities. A significant portion of tax exempt portfolios is comprised of instruments that are long-term, but are subject to demand features that

shorten their maturity. The amendments would require credit risks to be reviewed on an ongoing basis to assure that the securities continue to present minimal credit risks. The amendments would require funds to establish written procedures designed to assure that they have access to sufficient financial and other pertinent information concerning the issuer of the underlying security to permit the fund to perform a credit analysis of the issuer in certain circumstances. If this information cannot be obtained in these circumstances, the fund would be required to dispose of the security.

### **Interest Rate Risk Analysis**

Under Rule 2a-7, the maturities of certain securities with adjustable interest rates may be determined by reference to the date on which the next interest rate adjustment occurs if the security can reasonably be expected to have a market value that approximates its par value upon readjustment of its interest rate. The Commission is proposing to amend Rule 2a-7 to specify that the instrument must reasonably be expected to have a market value that approximates its par value after each interest rate adjustment over the life of the instrument or until the instrument's principal can be recovered through demand. The proposed amendments also would require that the fund periodically review whether the security can reasonably be expected to have a market value that approximates its par value upon readjustment of its interest rate. In addition, funds would be required to retain records documenting the credit analyses currently required by Rule 2a-7 and the diversification analyses proposed to be required for asset backed securities.

### **Other Amendments to Rule 2a-7**

The Commission is also proposing amendments that would address fund investment in repurchase agreements and whether an instrument is "U.S. dollar denominated" (as required by the rule), and would eliminate the requirement that a fund's board of directors approve or ratify the acquisition of every security that is not rated by at least two NRSROs.

### **Disclosure**

The Commission is proposing amendments to Form N-1A to require that a single state fund disclose in its prospectus risks related to the geographic concentration of its investments and lack of diversification. The Commission is also publishing for comment a draft Staff Guide that discusses certain disclosures that should be made by tax exempt funds.

### **Exemptive Rule**

The Commission is proposing new Rule 17a-9 under the 1940 Act to permit an affiliate of a fund to repurchase from the fund securities that are no longer eligible securities at the higher of their amortized cost value or market value, without having to seek prior Commission approval.

### **Recordkeeping**

The Commission is proposing amendments to Rule 31a-1 under the 1940 Act to require money market funds to maintain records identifying the provider of any put or guarantee with respect to a portfolio security, as well as other information necessary to identify, value, and account for each investment.

## **I. Background**

### **A. Money Market Funds and Rule 2a-7**

Money market funds are management investment companies registered under the 1940 Act that have as their investment objective generation of income and preservation of capital and liquidity through investment in short-term, high-quality securities. Currently, 932 money market funds have total assets of \$578 billion.<sup>3</sup> Seventeen percent of money market fund assets (\$101 billion) are held by 325 funds that have as their principal investment objective the distribution of income exempt from federal income taxes ("tax exempt funds").<sup>4</sup> Almost one third of the assets held by tax exempt funds (\$31 billion) is held by 158 funds that seek to distribute income that is also exempt from the income taxes of a specific state or

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<sup>3</sup> See IBC/Donoghue's Money Fund Report at p. 2, July 30, 1993 ("Money Fund Report").

<sup>4</sup> *Id.* Money market fund investments are held in over twenty-three million investor accounts, of which over 1.4 million accounts hold tax exempt funds. Investment Company Institute Mutual Fund Fact Book at 60-61 (33d ed. 1993). See Investment Company Act Rel. No. 17589 (July 17, 1990) [55 FR 30239 (July 25, 1990)] ("Release 17589") at nn. 3-7 and 15-20 and accompanying text for a summary of the development of money market funds, which were first introduced in the early 1970s.

locality (“single state funds”).<sup>5</sup> The balance is held by funds that do not limit their investments to securities exempt from the income taxes of a specific state (“national funds”).

Unlike other investment companies, money market funds seek to maintain a stable share price, typically at \$1.00 per share.<sup>6</sup> To do so, most funds use the amortized cost method of valuation (“amortized cost method”)<sup>7</sup> and the penny-rounding method of pricing (“penny-rounding method”)<sup>8</sup> permitted by Rule 2a-7. The 1940 Act and applicable rules generally require investment companies to calculate current net asset value per share by valuing portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by the board of directors.<sup>9</sup> Rule 2a-7 exempts money market funds from these provisions but contains conditions designed to minimize the deviation between a fund’s stabilized share price and the market value of its portfolio.<sup>10</sup>

In February 1991, the Commission amended the rules and forms governing money market funds (the “1991 Amendments”)<sup>11</sup> to respond to developments in the commercial paper market since Rule 2a-7 was adopted in 1983.<sup>12</sup> Among other things, the 1991 Amendments permit funds to invest only in “eligible securities,” defined generally as securities that are rated in one of the highest two short-term rating categories by the “requisite NRSROs,”<sup>13</sup> or comparable unrated securities. Taxable funds must further limit their investments in the securities of any one issuer

<sup>5</sup> Money Fund Report, *supra* note 3, at 2. Single state funds are available for thirteen states: Arizona, California, Connecticut, Florida, Massachusetts, Michigan, Minnesota, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Virginia. *Id.*

<sup>6</sup> The stable \$1.00 price has encouraged investors to view money market funds as an alternative to bank deposits and checking accounts, even though money market funds lack federal deposit insurance.

<sup>7</sup> Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. Paragraph (a)(1) of Rule 2a-7.

<sup>8</sup> Share price is determined under the penny-rounding method by valuing securities at market value, fair value, or amortized cost and rounding the per share net asset value to the nearest cent on a share value of a dollar, as opposed to the nearest one tenth of one cent. Paragraph (a)(11) of Rule 2a-7 (paragraph (a)(16) of Rule 2a-7 as proposed to be amended). *See also* Investment Company Act Rel. No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] (“Release 13380”) (adopting Rule 2a-7) at n.6, and Investment Company Act Rel. No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] (“Release 12206”) (proposing Rule 2a-7) at n.5.

<sup>9</sup> *See* Section 2(a)(41) of the 1940 Act [15 U.S.C. 80a-2(a)(41)], together with Rules 2a-4 and 22c-1 thereunder [17 CFR 270.2a-4 and 270.22c-1].

<sup>10</sup> If shares are sold or redeemed based on a net asset value which has been either understated or overstated in comparison to the amount at which portfolio instruments could have been sold, the interests of either existing shareholders or new investors will be diluted. *See* Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Commerce, 76th Cong., 3rd Sess. 136-138, 288 (1940), and Release 17589, *supra* note 4, at n.7.

<sup>11</sup> Investment Company Act Rel. No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)] (“Release 18005”). The 1991 Amendments were proposed in Release 17589, *supra* note 4, and became effective on June 1, 1991.

<sup>12</sup> Before the 1991 Amendments, rule 2a-7 permitted funds to invest in “high quality” securities, that is, securities that had received at least the second highest rating from one NRSRO. *See* Release 13380, *supra* note 8, at n.34. In the summer of 1989 and the spring of 1990, several taxable funds held approximately \$125 million in defaulted commercial paper issued by Mortgage and Realty Trust or Integrated Resources Inc.; in the fall of 1990 several funds held commercial paper issued by MNC Financial Corp. that was downgraded to below high quality, resulting in a significant decline in its market price. In all three cases, the commercial paper had the second highest rating from one NRSRO when purchased by the funds and thus was eligible for fund investment under Rule 2a-7 as then in effect. Shareholders of funds that held these commercial paper issues were not adversely affected, however, because each fund’s investment adviser purchased the paper from the funds at amortized cost or principal amount or otherwise agreed to indemnify the fund. *See* Release 17589, *supra* note 4, at n.18 and accompanying text.

<sup>13</sup> “Requisite NRSROs” are defined as: (1) any two NRSROs that have issued a rating with respect to an instrument or class of debt obligations of an issuer, or (2) if only one NRSRO has issued a rating with respect to such instrument or issuer at the time the fund purchases or rolls over the security, that NRSRO. Paragraph (a)(13) of Rule 2a-7 (paragraph (a)(19) of Rule 2a-7 as proposed to be amended).

The term NRSRO is defined in paragraph (a)(10) of Rule 2a-7 (paragraph (a)(15) of Rule 2a-7 as proposed to be amended) to have the same meaning as in the Commission’s uniform net capital rule [17 CFR 240.15c3-1(c)(2)(vi)(E), (F) and (H)]. The Commission’s Division of Market Regulation responds to requests for NRSRO designation through no-action letters. Currently, the Division of Market Regulation has designated six NRSROs: Duff and Phelps, Inc. (“D&P”), Fitch Investors Services, Inc. (“Fitch”), Moody’s Investors Service Inc. (“Moody’s”), Standard & Poor’s Corp. (“S&P”), and two specialized NRSROs: IBCA Limited and its subsidiary, IBCA Inc. (“IBCA”), which is recognized as a NRSRO only with respect to its ratings of debt issued by banks, bank holding companies, United Kingdom building societies, broker-dealers and broker-dealers’ parent companies, and bank-supported debt, and Thomson BankWatch, Inc. (“TBW”), which is recognized as a NRSRO only with respect to ratings for debt issued by banks, bank holding companies, non-bank banks, thrifts, broker-dealers, and broker-dealers’ parent companies.



(other than Government securities) to five percent of fund assets,<sup>14</sup> and limit fund investment in second tier securities<sup>15</sup> to no more than five percent of fund assets, with investment in the second tier securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars.<sup>16</sup>

The Five Percent Diversification Test and the Second Tier Security Tests were not made applicable to tax exempt funds.<sup>17</sup> In proposing the 1991 Amendments, the Commission explained that it did not propose to subject tax exempt funds to these tests because doing so could require many of them to substantially restructure their portfolios and, perhaps, lose some of their tax advantages.<sup>18</sup> Since the adoption of the 1991 Amendments, the Commission has closely examined the characteristics of short-term tax exempt securities, the markets in which they trade, and tax exempt fund portfolios to determine what, if any, revisions to Rule 2a-7 should be proposed to provide tax exempt fund investors with protections similar to those afforded taxable fund investors by the 1991 Amendments.<sup>19</sup>

## B. Tax Exempt Funds

Tax exempt funds, like taxable funds, offer individual investors a means to participate in the short-term debt markets while achieving the benefits of diversification.<sup>20</sup> Both taxable and tax exempt funds maintain stable share prices and distribute dividends that reflect current short-term interest rates. Significant differences exist in the securities in which these two types of funds invest.

Taxable funds invest primarily in high quality commercial paper, short-term securities issued by the Federal government, and bank instruments, such as certificates of deposit. These securities, by their terms, mature one year or less from the time of issuance, and their purchase by funds is generally based on the credit quality of the issuers.

Tax exempt funds typically hold instruments that by their terms are long-term. A large percentage (approximately sixty percent of the assets held by single state funds, and seventy percent of the assets held by national funds) of the securities in tax exempt fund portfolios consists of variable rate demand notes and similar instruments (“VRDNs”). VRDNs are long-term securities that have interest rates that periodically adjust to reflect short-term rates and are subject to “demand features,” generally provided by third parties.<sup>21</sup> The adjustable rates and demand features are designed to give these instruments the characteristics of short-term instruments in order to make them permissible investments under Rule 2a-7’s maturity limitations.<sup>22</sup> A demand feature may also enhance or, if unconditional, serve as a substitute for the credit

<sup>14</sup> Paragraph (c)(4)(i) of Rule 2a-7. A limited exception is provided for certain securities held for not more than three business days.

<sup>15</sup> A “second tier security” is an eligible security that is not a “first tier security.” Paragraph (a)(14) of Rule 2a-7 (paragraph (a)(20) of Rule 2a-7 as proposed to be amended). A first tier security is generally a security that is rated by the requisite NRSROs in the highest rating category for short-term debt obligations, and comparable unrated securities. Paragraph (a)(6) of Rule 2a-7 (paragraph (a)(11) of Rule 2a-7 as proposed to be amended).

<sup>16</sup> Paragraph (c)(4)(i)(B) of Rule 2a-7. The 1991 Amendments also shortened the maximum dollar-weighted portfolio maturity that a fund may maintain from 120 to ninety days, and codified the actions that a fund must take in certain events, including defaults and rating downgrades. *See* paragraphs (c)(2) and (c)(5) of Rule 2a-7. The 1991 Amendments also require that the cover page of fund prospectuses and certain fund advertisements and sales literature state prominently that investment in a fund is not guaranteed or insured by the U.S. Government and that there can be no assurance that a fund can maintain a stable net asset value per share. *See* Form N-1A, item 1(a)(vi); Form N-3, item 1(a)(ix); and Rule 482(a)(7) under the Securities Act of 1933 (“1933 Act”) [17 *CFR* 230.482(a)(7)].

<sup>17</sup> Tax exempt funds are subject to a diversification test with respect to puts, as they had been prior to the adoption of the 1991 Amendments. Paragraph (c)(4)(ii) of Rule 2a-7 (paragraph (c)(4)(iii) of rule 2a-7 as proposed to be amended).

<sup>18</sup> Release 17589, *supra* note 4, at Section II.6. Single state funds were thought to present particular problems because they must concentrate their investments in debt securities issued by a single state (or by issuers located within that state), making diversification more difficult to achieve. *Id.* at n.73.

<sup>19</sup> In proposing the 1991 Amendments, the Commission requested comment on the appropriate regulation of tax exempt funds. Seventeen commenters responded, including thirteen fund complexes, one NRSRO, and three trade associations. These comment letters, as well as other letters concerning tax exempt funds and Rule 2a-7 cited in this Release, have been placed in the “S7” public comment file applicable to this proposal and are available in the Commission’s Public Reference Room in Washington, D.C.

<sup>20</sup> Money market securities are often sold in large denominations which makes direct investment impracticable for many individual investors.

<sup>21</sup> The demand feature permits the fund to demand payment of the principal amount of the instrument at relatively short intervals, usually seven days (but at least annually) and on no more than thirty days’ notice.

<sup>22</sup> *See* paragraphs (c)(2) and (d) of Rule 2a-7.

of the underlying issuer, providing the basis for making the instruments eligible for fund investment under Rule 2a-7's credit quality limitations.<sup>23</sup>

Largely because of the growth of tax exempt funds and the limited types of securities that distribute tax free income, the demand for short-term tax exempt securities has exceeded supply,<sup>24</sup> resulting in the creation by various financial institutions of derivative or "synthetic" short-term tax exempt instruments.<sup>25</sup> These instruments usually are subject to demand features designed to make them eligible for fund investment.

One consequence of the use of demand features is that tax exempt fund portfolios largely consist of securities guaranteed by banks and other financial institutions. While these securities pay tax free dividends because they are issued by state, municipal or other entities that may issue tax exempt securities, their credit quality largely depends on banks. Investors who believe that the designation "tax exempt" signifies that portfolio securities are issued by state or local governments that are unlikely to default on their obligations may not appreciate that the credit quality of portfolio securities (and the ability of a tax exempt fund to maintain a stable net asset value) is largely dependent on the financial health of foreign and domestic banks and other put providers.<sup>26</sup>

A significant portion of tax exempt fund portfolios is also dependent on the financial health of corporate issuers rather than state or local governments. At one time, general obligation notes issued by state and local governments were the most prevalent type of tax exempt security. Today, a significant percentage of tax exempt securities are so-called "conduit securities"—that is, tax exempt instruments issued by a statutory authority or special purpose entity that have as their ultimate obligor a corporation.<sup>27</sup> Conduit securities held by tax exempt funds are often subject to demand features.

The implications of the dependence of tax exempt funds on conduit securities subject to demand features was illustrated in July 1991, when New Jersey insurance regulators seized Mutual Benefit Life Insurance Company ("MBLI"). Until immediately before it was seized, MBLI's debt was rated in the highest short-term rating category by Standard & Poor's Corporation ("S&P"), and several tax exempt funds held conduit securities issued by various housing development projects subject to demand features and other credit enhancements provided by MBLI. When MBLI could not honor its put obligations, advisers to funds holding MBLI-backed securities took various actions to prevent shareholder losses that

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<sup>23</sup> The credit quality of these instruments is determined largely by the quality of the providers of the demand features (generally banks or other financial institutions), rather than the quality of the underlying issuer. See paragraphs (c)(3)(i) and (c)(3)(ii) of Rule 2a-7.

<sup>24</sup> See "Return of Supply Problems Imminent, Stein Roe Manager Says," Global Guaranty, May 24, 1993 (derivatives provide one solution but many present unacceptable tax risks); "Nuveen Money Market Manager Seeks Diamonds in the Rough," Global Guaranty, May 10, 1993 (VRDN and semi-annual put bond market is shrinking); "Vanguard's Huge Money Market Fund Turns to Derivatives," Global Guaranty, Apr. 5, 1993 (shrinking supply in some markets fuels creation of synthetics, desire for diversification in states with sufficient supply also creates demand); "Risks Associated With Derivatives for Tax-Exempt Money Funds," Moody's Special Comment, May 3, 1993 (managers of tax-exempt money market funds have had increasing difficulty over last few years in finding high quality securities that also meet liquidity needs).

<sup>25</sup> Synthetic instruments are typically created by placing long-term fixed rate bonds of a single issuer in a trust. The holder of the interest in the trust is paid interest at a variable rate that reflects short-term interest rates (and is always less than the fixed rate of the bonds). The balance of the coupon payments are allocated to the sponsor or to pay administrative expenses. These instruments have demand features which allow holders to demand their principal back at periodic intervals, generally from a third party such as a bank. *Id.* Scarcity of supply has not been an issue for taxable funds since, in the absence of high quality corporate issuers, they can generally invest in U.S. government securities. Nonetheless, securities that can be characterized as "synthetics," such as asset backed securities, have been developed for taxable funds. See *infra* Section II.C.4.

<sup>26</sup> As discussed *infra* in Section III.B, the Commission is publishing a new staff guide that would require a fund to disclose in its prospectus that the credit quality of the fund's portfolio depends on the financial health of put providers if more than forty percent of the fund's portfolio is subject to puts.

<sup>27</sup> These types of securities are generally issued to finance business development (industrial development bonds), the construction of health care facilities and nursing homes, and housing development.

would have occurred had the funds been required to price their shares at less than \$1.00 (“break a dollar”).<sup>28</sup> The advisers either repurchased the MBLI-backed instruments from the funds at their amortized cost or obtained a replacement guarantor.

## II. Proposed Revisions to Rule 2a-7

The proposed amendments to Rule 2a-7 are designed to minimize the risk that tax exempt funds will not be able to maintain a stable price of \$1.00. Because of the differences between taxable and tax exempt funds, the Commission is proposing to apply somewhat different risk-limiting conditions to tax exempt funds.

### A. Proposed Issuer Diversification Conditions

To limit risk, mutual funds generally diversify their portfolios by spreading the risk of loss among a number of securities. This practice reduces the likelihood that a fund will suffer significant losses if the issuer of one of its portfolio securities has financial difficulties that affect the value of its securities because only a small portion of the portfolio will be affected. For this reason, Rule 2a-7 requires taxable funds to limit investment in a single issuer to five percent of fund assets and investment in the second tier securities of a single issuer to one percent of fund assets.

Although the 1991 Amendments did not extend diversification requirements to tax exempt funds, many tax exempt funds elect to meet the diversification requirements of Section 5(b)(1) of the 1940 Act.<sup>29</sup> Many single state funds, and some national funds, are not diversified under Section 5(b)(1). These funds meet only the Internal Revenue Code’s diversification requirements for “Regulated Investment Companies” (“RICs”), which require a RIC to be diversified as to fifty percent of its assets.<sup>30</sup> For these funds, a credit problem with respect to a single security could result in a significant decrease in the value of fund assets.

#### 1. National Funds

The proposed amendments would extend the Five Percent Diversification Test to national funds.<sup>31</sup> National funds typically are diversified within the meaning of section 5(b)(1) and do not use the “twenty-five percent basket” (the portion of a diversified fund’s assets that may be invested in a single issuer) to invest more than five percent of their assets in a

<sup>28</sup> Without these actions, the amortized cost value of the affected funds’ portfolios may have deviated by more than one half of one percent from market value, and the affected funds would have been required to sell and redeem shares at a price of less than \$1.00. Under paragraphs (c)(6)(ii)(B) and (C) of Rule 2a-7, if the value of the fund portfolio securities decline such that the market value per share is less than 99.5 cents, the fund board must promptly consider what action, if any, should be initiated by the board and, if the board believes that the extent of any deviation may have dilutive or unfair results, cause the fund to take appropriate action to eliminate or reduce the deviation. These actions may include reducing the fund’s share price or net asset value to less than \$1.00. In addition, once a demand feature is dishonored, in the absence of a suitable substitute demand feature, the remaining maturity of the instrument must be measured by reference to its final maturity. As a result, several funds would have violated the requirement that average weighted portfolio maturity not exceed ninety days. See paragraph (c)(2) of Rule 2a-7 and Release 17589, *supra* note 4, at nn. 16-18 and accompanying text.

<sup>29</sup> Section 5(b)(1) provides that a diversified investment company may not, with respect to seventy-five percent of its assets, invest more than five percent of its assets in instruments of any issuer, other than cash, cash items, Government securities (as defined in Section 2(a)(16) of the 1940 Act [15 U.S.C. 80a-2(a)(16)]) and securities of other investment companies. The remaining twenty-five percent of the fund’s assets (the “twenty-five percent basket”) may be invested in any manner. If an investment company invests more than five percent of its assets in any issuer, the entire investment is placed in the twenty-five percent basket, and then aggregated with other investments that are greater than five percent to determine whether the fund is in compliance with Section 5(b)(1). The investment company may not invest more than twenty-five percent of its assets in a single issuer by splitting its investment into two lots between the twenty-five percent basket and the diversified portion of its portfolio. See Lybrand, Ross Bros. & Montgomery (Oct. 24, 1941) (pub. avail. Nov. 22, 1991). Section 5(b)(1) also prohibits diversified funds, with respect to seventy-five percent of their assets, from investing in securities that comprise more than ten percent of the outstanding voting securities of an issuer.

<sup>30</sup> At the close of each quarter of its taxable year the RIC must have invested: (1) at least fifty percent of its total assets in (A) cash and cash items, government securities and other RIC securities, and (B) other securities, limited for any issuer to not greater than five percent of the RIC’s total assets; and (2) not more than twenty-five of its total assets in the securities of any one issuer (except government securities and the securities of other RICs) or in securities of two or more issuers that are controlled by the RIC and that are engaged in similar businesses. See section 851 of the Internal Revenue Code [26 U.S.C. 851]. A fund must qualify as a RIC to receive pass-through tax treatment for income.

<sup>31</sup> A shareholder vote is not required under Section 13(a)(1) of the 1940 Act [15 U.S.C. 80a-13] when a non-diversified fund becomes diversified within the meaning of Section 5(b) of the 1940 Act.

single issuer. Comment is requested on the effect that the proposed requirement would have on the portfolios of national funds.<sup>32</sup>

## 2. Single State Funds

The Commission is not proposing to extend the Five Percent Diversification Test to single state funds. Single state funds invest generally in the securities of a single state (or other issuers within a single state) with the objective of distributing income that is free from both federal and state (and local) income tax. Because these investment policies limit the universe of issuers in whose securities they may invest, most single state funds invest more than five percent of their assets in a single issuer, and many are not diversified within the meaning of Section 5(b)(1) of the 1940 Act.

Commenters stated that single state funds would have great difficulty in complying with a Five Percent Diversification Test. In many cases, they asserted, an insufficient number of high quality issuers exist within a particular state to permit a single state fund to meet a diversification requirement and to continue to meet its objective of distributing dividends exempt from federal and state income taxes. On the other hand, lack of diversification may present increased risks not characteristic of other types of money market funds.

Instead of extending the Five Percent Diversification Test to single state funds, the Commission is proposing to limit single state fund investments to first tier securities. A relatively small percentage of all single state funds' assets are currently invested in second tier securities,<sup>33</sup> but these lower quality investments represent the greatest credit-related risk to single state funds. Requiring that single state funds only invest in the highest quality securities minimizes the additional risks that may accompany lower levels of diversification.

The Commission is proposing two additional rule amendments to address the risks related to the relative lack of diversification in single state funds. First, single state funds would be subject to the put diversification provisions discussed below. Second, single state funds would be required to alert investors to the risks inherent in greater concentration in their prospectuses.<sup>34</sup> Because a significant percentage of single state fund portfolios are subject to unconditional demand features from banks and other financial institutions, put diversification will provide some assurance that the credit risks of single state fund portfolios will be diversified, although not to the same extent as other money market funds.

The Commission requests comment on whether requiring single state funds to restrict their investments to first tier securities is an adequate counterbalance to the risks presented by reduced diversification. Will the proposed credit quality conditions assure that single state funds provide the degree of safety expected by investors? As an alternative, should single state funds be required to meet the diversification requirements of Section 5(b)(1) of the 1940 Act? As another alternative, should single state funds be required to meet the diversification standards set forth in the definition of a RIC, not only on a quarterly basis as required by the Internal Revenue Code but with respect to each security when it is purchased?<sup>35</sup>

Finally, are there alternative requirements that could be imposed on single state and national funds that would better satisfy the safety objectives of Rule 2a-7? For example, tax exempt securities are often issued to finance specific types of projects (whether for a public or private purpose) such as transportation, higher education, or health care. Fund

<sup>32</sup> A sufficient amount of outstanding securities issued by a sufficient number of tax exempt issuers appears to be available to enable national funds to meet the proposed test. National funds have almost \$70 billion in assets (*See Money Fund Report, supra* note 3); according to the Public Securities Association ("PSA"), total short-and long-term municipal issuance in 1992 alone was \$278 billion, and there are an estimated 50,000 municipal issuers. While much of this issuance is probably not eligible for money market fund investment because of its maturity or credit quality, the Commission's recent examinations of a number of tax exempt funds revealed that most national funds already meet the Five Percent Diversification Test and that those that do not could do so with relatively modest adjustments to their portfolios.

<sup>33</sup> Recent inspections conducted by the Division of Investment Management suggest that approximately 8.4 percent of single state fund assets is invested in second tier securities.

<sup>34</sup> *See infra* Section III.A.

<sup>35</sup> *See supra* note 30 and accompanying text. Under this approach, the fund would be diversified at the five percent level as to fifty percent of its assets and could invest not more than twenty-five percent of assets in a single issuer, other than government securities and securities of other RICs.

concentration in securities issued by a particular type of project creates risks because economic, business or political developments affecting one such project may likewise affect the other projects.<sup>36</sup> A change in the Federal formula for Medicare reimbursements, for example, may affect the financial condition of all health care projects. The Commission requests comment on whether Rule 2a-7 should limit the extent to which tax exempt funds may concentrate their investments in securities related to the projects, facilities, or commercial enterprises of a particular industry to further insulate funds from investment risk. If such an approach is adopted, what level of concentration should be permitted? Should the concentration level for single state funds be more restrictive than the level for other tax exempt funds?

### 3. Pre-Refunded Bonds

A significant portion of tax exempt fund assets consist of pre-refunded bonds—that is, bonds the payment of which is funded and secured by escrowed Government securities.<sup>37</sup> The Commission is proposing to allow funds to “look through” such bonds to the escrowed securities. This treatment would be allowed only for securities that have been pre-refunded with escrowed Government securities when the escrow arrangements satisfy certain conditions designed to assure that the bankruptcy of the issuer of the pre-refunded bonds will not affect payments on the bonds from the escrow account.<sup>38</sup> In addition, a fund could invest no more than twenty-five percent of its assets in the pre-refunded bonds of the same issuer.<sup>39</sup> Because these securities would, in effect, be treated as Government securities, they would not be subject to any diversification limitation (other than the twenty-five percent limitation).

Comment is requested on whether any other measures should be taken to facilitate compliance with the Five Percent Diversification Test. For example, given their record of safety, should securities backed by the full faith and credit of state governments be treated as Government securities for purposes of the rule’s diversification tests?<sup>40</sup>

### 4. Diversification Safe Harbor; Three-Day Safe Harbor

The diversification requirements of Rule 2a-7 differ in some respects from those of Section 5(b)(1) and the rules under that section. Although the Rule 2a-7 requirements are more strict, circumstances may occur when a money market fund is in compliance with Rule 2a-7, but not in compliance with Section 5(b)(1).<sup>41</sup> Therefore, the Commission is proposing to add a provision to Rule 2a-7 stating that money market funds complying with the rule’s diversification requirements are deemed to be diversified under Section 5(b)(1).<sup>42</sup>

<sup>36</sup> See Investment Company Act Rel. No. 9785 (May 31, 1977) [42 FR 29130 (June 7, 1977)] (“Release 9785”) (stating that tax-exempt funds must disclose concentration policy if twenty-five percent or more of the fund’s assets are invested in securities that relate to similar type projects).

<sup>37</sup> As noted *supra* in note 2, under paragraph (a)(13) of Rule 2a-7 as proposed to be amended, the term “Government security” means those securities issued or guaranteed by the United States or its instrumentalities—the definition of that term given in Section 2(a)(16) of the 1940 Act.

<sup>38</sup> See paragraphs (a)(18) (definition of “refunded security”) and (c)(4)(iv)(B) (acquisition of a refunded security deemed to be acquisition of Government security) of Rule 2a-7 as proposed to be amended. This change codifies for both taxable and tax exempt money market funds the no-action position in T. Rowe Price Tax-Free Funds (pub. avail. June 24, 1993), regarding treatment of these securities for purposes of Section 5(b)(1) of the 1940 Act. This is consistent with the rule’s treatment of fully collateralized repurchase agreements. Paragraph (c)(4)(i) of Rule 2a-7 (paragraph (c)(iv)(A) of Rule 2a-7 as proposed to be amended).

<sup>39</sup> Paragraph (c)(4)(iv)(B) of Rule 2a-7 as proposed to be amended. This twenty-five percent limitation was a condition specified in T. Rowe Price Tax-Free Funds, *supra* note 38.

<sup>40</sup> See *infra* note 47 and accompanying text.

<sup>41</sup> One difference that may cause this to occur is the timing of the measurement of diversification. Compliance with Section 5(b)(1) is measured on a quarterly basis (Rule 5b-1 [17 CFR 270.5b-1]), while compliance with Rule 2a-7 is measured at the time the security is purchased (paragraph (c)(4)(i)). In addition, under Section 5(b)(1), conditional puts from a single issuer are subject to a five percent limit (outside of the twenty-five percent basket), while under Rule 2a-7 as proposed to be amended, they would be subject to a ten percent limit. Paragraph (c)(4)(iii) of Rule 2a-7 as proposed to be amended.

<sup>42</sup> Paragraph (c)(4)(vi) of Rule 2a-7 as proposed to be amended. This safe harbor would not be available to single state funds that are diversified investment companies under Section 5(b)(1), because Rule 2a-7, as proposed to be amended, would not impose diversification requirements on these funds other than with respect to puts. The safe harbor would be available to these funds to assure that compliance with Rule 2a-7’s put diversification requirements satisfies Section 5(b)(1).

Rule 2a-7 currently permits a fund to invest more than five percent of its assets in the First Tier Securities of a single issuer for up to three business days (the “three-day safe harbor”) and does not contain any limitation on the percentage of fund assets that can be invested in accordance with this provision. Since the provision is primarily applicable to taxable funds, and since most taxable funds are diversified companies within the meaning of Section 5(b)(1), a fund could not use this provision to invest more than twenty-five percent of its assets in the securities of a single issuer. To assure that the proposed diversification safe harbor does not have the effect of allowing a national or taxable fund to invest more than twenty-five percent of its assets in a single issuer at any time, the proposed amendments would limit to twenty-five percent the percentage of fund assets that may be invested under the safe harbor at any one time.<sup>43</sup>

## B. Quality Limitations on Portfolio Securities

Rule 2a-7 requires both taxable and tax exempt funds to invest only in eligible securities: those securities receiving at least the second highest rating from the requisite NRSROs or comparable unrated securities.<sup>44</sup> Taxable funds also must comply with the Second Tier Security Tests. The Commission is proposing to limit single state funds to first tier securities and to apply to national funds the Second Tier Security Tests only with respect to conduit securities.

### 1. Single State Funds

As discussed above, the Commission is not proposing to extend the diversification requirements imposed on other money market funds to single state funds.<sup>45</sup> A single state fund could therefore hold a substantial portion of its assets in the securities of one issuer. If such an issuer encountered financial difficulties or defaulted, there would be a substantial likelihood that the fund would have to break a dollar. To reduce the risk of this occurring, the Commission is proposing to limit single state funds to investing in first tier securities. The Commission requests comment on whether those single state funds that can meet the Five Percent Diversification Test (or alternative diversification standard) should be permitted to invest in second tier securities, subject to the limitations discussed below.

### 2. National Funds

While their securities are not risk-free, state and municipal governments have rarely experienced defaults.<sup>46</sup> Generally, state and local governments have resources (such as taxing powers) that are not available to corporate issuers.<sup>47</sup> Moreover, some market participants believe that credit problems involving major municipalities are detected further in advance than in the taxable market, with the result that a tax exempt fund can dispose of its investment before a crisis occurs. Therefore, the Commission is not proposing to extend the Second Tier Securities Tests except to conduit securities, as described below.

Unlike traditional state and municipal securities, conduit securities are issued to finance non-governmental “private purpose” projects, such as retirement homes, private hospitals, local housing projects, and industrial development projects with respect to which the ultimate obligor is not a governmental entity.<sup>48</sup> Conduit securities are not backed by the taxing authority of any state or municipality or a revenue source from any essential public facility. The credit risks of these

<sup>43</sup> Paragraphs (c)(4)(i) and (ii) of Rule 2a-7 as proposed to be amended.

<sup>44</sup> See *supra* note 13 and accompanying text and paragraph (a)(5) of Rule 2a-7 (paragraph (a)(9) of Rule 2a-7 as proposed to be amended).

<sup>45</sup> See *supra* Section II.A.2. Single state funds would be required to dispose of portfolio securities that become second tier after acquisition unless the fund board concludes that holding a security is in the best interest of the fund. Paragraph (c)(5) of Rule 2a-7 as proposed to be amended.

<sup>46</sup> The default rate for all municipal issues between 1986 and 1991 was 0.4 percent; Moody’s Investors Service, Inc. found the default rate for corporate debt during the same period was almost two percent. See “Current Regulations Adequately Protect Muni Investors, PSA Tells MSRB; PSA Study Shows Low Incidence of Default Among Non-Rated Issues,” Municipal Market Developments (PSA), Mar. 1993.

<sup>47</sup> Tax exempt notes are usually backed either by the general taxing power of a government or a reliable revenue source, such as the proceeds of a particular tax (in the case of tax anticipation notes) or of a bond issuance (in the case of bond anticipation notes). No state general obligation has defaulted since the late 1800s. See N. Cohen, Municipal Default Patterns—An Historical Study, Fall-Winter 1988 at 6 (Enhance Reinsurance Company 1988). However, risks to the timely payment of principal and interest can result from state budget and political dynamics. See “State of Confusion—California’s Budget Crisis Is Over With . . . or Is It?” *Barron’s*, Sept. 7, 1992, at 18-19.

<sup>48</sup> In addition, certain types of quasi-governmental entities, such as special tax districts, serve as conduits for the issuance of securities used to fund the construction of housing developments and associated infrastructure by private firms.

securities are significantly higher than those of traditional state and municipal securities.<sup>49</sup> Because there does not appear to be any reason to treat conduit securities differently from the securities of comparable issuers that are offered to taxable funds, the Commission is proposing to apply the Second Tier Securities Tests to conduit securities.<sup>50</sup> The effect of this new provision would be to preclude a tax exempt fund 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.<sup>51</sup>

A conduit security would be defined as a security issued through a state or territory of the United States, or any political subdivision or public instrumentality thereof, which is not (1) payable from the revenues of such governmental unit; (2) unconditionally guaranteed by such governmental unit; (3) related to a project or facility owned and operated by such governmental unit; or (4) related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project owned and under the control of such governmental unit.<sup>52</sup> For purposes of the rule's diversification provisions, the issuer of a conduit security would be the ultimate obligor for payment of principal and interest, not the "shell" or special purpose entity through which the issuance is made.<sup>53</sup> Comment is requested on the scope of this definition and whether it is too broad or too narrow in view of the objective of subjecting securities of non-governmental issuers to the Second Tier Securities Tests. Commenters are encouraged to submit alternative definitions, having particular regard to the objective of allowing portfolio managers readily to identify conduit securities without obtaining legal and other expert opinions. For example, should conduit securities be defined by reference to the provisions of the Internal Revenue Code governing "private activity bonds" (Section 141 of the Internal Revenue Code).

The Commission requests comment on whether tax exempt second tier securities that are not conduit securities present a level of risk that would warrant extending the Second Tier Security Tests to them.<sup>54</sup> Could modified forms of the Second Tier Security Tests be developed for all securities held by tax exempt funds and, if so, what would be the effect of these alternatives on investors, funds and issuers? For example, should the Second Tier Security Tests be applied to all securities other than those backed by the full faith and credit of a state? A relatively high percentage of tax exempt fund securities are rated by only one NRSRO and are rated generally by no more than two.<sup>55</sup> Does this suggest that split-rated securities

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<sup>49</sup> For example, the default rate for unrated conduit securities related to health care facilities was 6.3 percent between 1986 and 1991. *See* Public Securities Assoc., *An Examination of Non-Rated Municipal Defaults 1986-1991*, Jan. 8, 1993, at 4. By contrast, the default rate for investment grade corporate issues is between one and two percent, according to the Bond Investors Association, and the default rate for municipal general obligations was zero between 1980 and 1991. *See* U.S. Securities and Exchange Commission Division of Market Regulation, *Staff Report on the Municipal Securities Market*, Sept. 1993, at App.B, n.4 and accompanying text.

<sup>50</sup> No more than five percent of a fund's assets could be subject to second tier puts from the same institution. Paragraph (c)(4)(iii) of Rule 2a-7 as proposed to be amended. *See infra* notes 84-85 and accompanying text.

<sup>51</sup> Credit quality determinations for a conduit security would generally be made by reference to the underlying corporate or project issuer, unless the conduit security is subject to an unconditional demand feature. Similarly, unless the conduit security is itself rated, a fund would rely on the ratings of the corporate issuer to determine if the conduit security was a first or second tier security. Credit quality determinations with respect to conduit securities subject to demand features would be made by reference to the provider of the demand feature, and, in the case of a conditional demand feature, the long-term rating of the underlying corporate or project issuer. *See infra* note 67 and paragraphs (c)(3)(i) and (ii) of Rule 2a-7 as proposed to be amended. In addition, for purposes of calculating compliance with the one percent limit on second tier securities of a single issuer, the issuer of the conduit security (that is, the corporation or project)—not the issuer of the credit enhancement—would be treated as the issuer. *See* paragraph (c)(4)(iv)(C) of Rule 2a-7, as proposed to be amended.

<sup>52</sup> Paragraph (a)(7) of Rule 2a-7 as proposed to be amended.

<sup>53</sup> Paragraph (c)(4)(iv)(C) of Rule 2a-7 as proposed to be amended. The Commission has applied this approach in interpreting Section 5(b)(1) of the 1940 Act. *See* Release 9785, *supra* note 36, at nn. 2-3 and accompanying text.

<sup>54</sup> While the historical data suggests that tax exempt securities have low levels of default, some observers expect an increase in municipal fiscal distress. *See* "Insured Issuance Soars to Record Level," *Municipal Market Developments* (PSA), Mar. 1993 (record levels of insured municipal issuance attributable in part to deteriorating fiscal condition of state and local governments).

<sup>55</sup> *See* Investment Company Act Rel. No. 18080 (Apr. 8, 1991) [*56 FR 14901* (Apr. 12, 1991)].

held by tax exempt funds should be treated differently from those held by taxable funds and that the definition of the term “requisite NRSROs” should be modified for tax exempt funds?<sup>56</sup>

### 3. NRSRO Ratings Comparability

Rule 2a-7 relies on the pre-existing rating categories of the six NRSROs in defining securities eligible for fund investment.<sup>57</sup> That is, the rule categorizes NRSRO-rated securities based on the two highest short-term rating categories of the NRSROs, although the rule recognizes that certain NRSROs have developed sub-categories indicating relative standing.<sup>58</sup> The approach is designed to provide a “buffer” of one investment grade category between a second tier and a more speculative security, and thus better assure that funds have an opportunity to dispose of a downgraded security before the security becomes less than investment grade.

The short-term rating categories of the different NRSROs with respect to taxable securities appear to be roughly comparable in terms of the NRSROs’ descriptions of the categories and the percentage of instruments that fall into each rating category.<sup>59</sup> While split-ratings do occur in the short-term taxable securities markets, it does not appear that this has occurred in a systematic way.<sup>60</sup>

Industry commenters have observed that the correlation among NRSRO tax exempt rating categories does not appear to have been as consistent as the correlation among taxable ratings.<sup>61</sup> The Commission requests comment on whether NRSRO ratings categories are comparable and if not, how the rule could be amended to address the lack of comparability. For example, should the rule adopt a variation of the “high quality” terminology of the original rule without attempting to define the generic rating levels that identify an eligible or first tier security? Should each sub-category be treated as a separate rating category? Should Rule 2a-7 specify the ratings that are considered by the Commission to be first tier and those that are considered to be second tier? Commenters addressing these questions are urged to provide data illustrating the correlation (or lack of correlation) among the various NRSRO rating categories.

## C. Puts and Demand Features

### 1. Background

<sup>56</sup> See Release 18005, *supra* note 11, at nn. 42-48 and accompanying text, discussing the approach taken in the 1991 Amendments to securities that have different ratings from different NRSROs (“split-rated securities”). The Investment Company Institute (“ICI”) has recommended that split-rated tax exempt securities rated by two NRSROs be treated as having the higher of the two ratings (the treatment afforded under Rule 2a-7 prior to the adoption of the 1991 Amendments). When more than two NRSROs rate a security, the rating of the majority of the NRSROs would determine its category. The ICI asked that this treatment of split-rated securities also apply to taxable money market funds to facilitate compliance with Rule 2a-7. See Letter of Matthew Fink, Senior Vice President and General Counsel, Investment Company Institute, to Marianne Smythe, Director, Division of Investment Management (Mar. 25, 1991) (“ICI Letter”) (available in S7 file; see *supra* note 19).

<sup>57</sup> See *supra* notes 12-13 and accompanying text.

<sup>58</sup> For example, S&P has developed a sub-category (A-1+) of its highest category (A-1) that is used to designate issuers with “extremely strong safety characteristics.” Standard & Poor’s Commercial Paper Guide (Nov. 1993).

<sup>59</sup> See Appendix A to this Release.

<sup>60</sup> A split-rating may be the result of the failure of one NRSRO to perceive quality problems (or improvements) that another NRSRO has reflected in its ratings; it may also reflect differences among NRSROs as to the emphasis placed on different credit factors.

<sup>61</sup> Two commenters suggested that the S&P rating of SP-2 indicates lower credit quality than the second highest rating categories of the other NRSROs. See Letters to Jonathan G. Katz from Citibank, at 5 (Sept. 20, 1990) and the Government Finance Officers Association, at 6 (Sept. 24, 1990) and Appendix B to this Release. NRSROs use several rating scales for tax-exempt instruments. Moody’s assigns notes “MIG” (“Moody’s Investment Grade”) ratings, while S&P employs an “SP” rating scale, and Fitch uses an “F” scale. VRDNs are assigned “VMIG” (“Variable Moody’s Investment Grade”) ratings by Moody’s, along a scale identical with the MIG scale, to reflect the strength of the unconditional put feature. VRDNs rated by Moody’s often also carry a long-term rating. The long-term rating indicates the long-term strength of the put provider when the put is unconditional, and of the issuer of the underlying securities when the put is conditional. S&P also assigns VRDNs a short-term and a long-term rating. Unlike Moody’s, however, it employs the commercial paper rating scale (A-1, A-2, etc.) to indicate the quality of the unconditional put. Fitch employs the F rating scale for VRDNs as well as for notes. Moody’s and S&P employ commercial paper ratings with respect to tax-exempt commercial paper issuers; Fitch employs the same F scale used for notes and VRDNs.



A “put” is a right to sell a specified underlying security within a specified period of time and at a specified exercise price that may be sold, transferred, or assigned only with the underlying security.<sup>62</sup> A demand feature is a put that may be exercised at specified intervals not exceeding 397 calendar days and upon no more than 30 days’ notice.<sup>63</sup> Demand features can serve three purposes: to shorten the maturity of a variable or floating rate security (“adjustable rate securities”),<sup>64</sup> to enhance the instrument’s credit quality, and to provide a source of liquidity.<sup>65</sup>

Limiting the use of demand features to shorten maturity to adjustable rate securities is designed to assure that the market based value of the security will not deviate significantly from its amortized cost value between the exercise dates of the demand feature. Investment Company Act Rel. No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (“Release 14983”) at n.9 and accompanying text.

Demand features may be conditional or unconditional.<sup>66</sup> Under Rule 2a-7, a demand feature used as a substitute for the credit quality of the underlying security must be an “unconditional put,” defined to include any guarantee, letter of credit (“LOC”) or similar unconditional credit enhancement that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security.<sup>67</sup>

Rule 2a-7 permits funds to acquire “standby commitments,” which are puts that entitle the holder to achieve same day settlement and to receive an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise.<sup>68</sup> Standby commitments are generally arrangements with broker-dealers that allow funds to put the security back to the broker at an agreed upon price, and were developed to provide tax exempt funds with liquidity.<sup>69</sup> A standby commitment cannot be used to enhance the credit quality or to shorten the maturity of the instrument unless it meets the requirements of a demand feature.<sup>70</sup>

The use of puts, demand features and standby commitments by tax exempt funds raises questions with respect to the nature and valuation of tax exempt fund portfolio securities and the conditions that should be placed on the use of these features under Rule 2a-7. Money market fund portfolios are generally limited to highly liquid short-term debt securities<sup>71</sup>

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<sup>62</sup> Paragraph (a)(17) of Rule 2a-7 as proposed to be amended. The definition of “put” would be amended to specify that the put must enable the holder to receive the principal amount or amortized cost of the instrument, plus accrued interest. This would conform the definition to that of a “standby commitment” (paragraph (a)(16) of Rule 2a-7 and paragraph (a)(23) of Rule 2a-7 as proposed to be amended) and reflect the usual terms of these instruments.

<sup>63</sup> See paragraph (a)(4) of Rule 2a-7 (paragraph (a)(8) of Rule 2a-7 as proposed to be amended).

<sup>64</sup> Paragraphs (d)(3) and (4) of Rule 2a-7. Initially, Rule 2a-7 provided that only demand features that ran to the issuer of the security could be used to shorten maturities. See Release 13380, *supra* note 8, at n.9. This was changed by the amendments to Rule 2a-7 adopted in 1986 in response to market developments.

<sup>65</sup> A money market fund is limited to investing no more than ten percent of its assets in illiquid securities. See Release 13380, *supra* note 8, at nn. 37-38 and accompanying text. See also Investment Company Institute (pub. avail. Dec. 9, 1992). The Commission has reiterated that fund boards of directors have particular responsibilities with regard to the acquisition and valuation of illiquid securities. See Release 14983, *supra* note 64, at n.22 and accompanying text.

<sup>66</sup> Both conditional and unconditional puts may operate as demand features to shorten maturities of adjustable rate securities. As discussed *infra* in Part II.C.3, the proposed amendments would limit the types of conditions to which exercise of a put could be subject. Paragraph (a)(6) of Rule 2a-7 as proposed to be amended.

<sup>67</sup> Paragraph (a)(19) of Rule 2a-7 (paragraph (a)(27) of Rule 2a-7 as proposed to be amended). A demand feature that is conditional also may serve as the basis for determining whether a security is an eligible security and categorizing it as a first or second tier security; however, the long-term credit quality of the security subject to a conditional demand feature must also be analyzed. See paragraph (c)(3)(ii) of Rule 2a-7.

<sup>68</sup> Paragraph (a)(16) of Rule 2a-7 (paragraph (a)(23) of Rule 2a-7 as proposed to be amended).

<sup>69</sup> Investment Company Act Rel. No. 14607 (July 1, 1985) [50 FR 27982 (July 9, 1985)] (“Release 14607”) (proposing the 1986 Amendments) at Section B. The 1986 Amendments codified a series of exemptive orders that enabled money market funds to acquire standby commitments for municipal securities from broker-dealers. Among other things, these orders permitted tax exempt funds to value these standby commitments at zero for purposes of computing share price.

<sup>70</sup> Paragraphs (d)(3) and (d)(5) of Rule 2a-7 as proposed to be amended. Paragraph (a)(9)(iii)(A) of Rule 2a-7 as proposed to be amended clarifies that where a standby commitment is used only for liquidity purposes, it may be considered an eligible security upon a finding that its issuer presents a minimal risk of default.

<sup>71</sup> The money market is generally considered to be the market for “short-term debt instruments—negotiable certificates of deposit, Eurodollar certificates of deposit, commercial paper . . . among others.” Barron’s Dictionary of Finance and Investment Terms (1987).

that are not expected to fluctuate significantly in value because of interest rate or credit quality changes (the primary justification for allowing money market funds to use the amortized cost and penny rounding methods). The widespread use of puts, demand features and standby commitments results in tax exempt fund portfolios composed primarily of long-term securities with characteristics similar to those of short-term debt securities. If a demand feature cannot be exercised, the fund will be holding a long-term and possibly illiquid lower rated security, the value of which (to the fund) may have declined significantly.<sup>72</sup>

The Commission is proposing several amendments to decrease the risks associated with the use of puts and demand features and to simplify the operation of Rule 2a-7. These amendments also address new types of securities that use puts and demand features that have developed since the 1986 Amendments. The proposed amendments would apply to both taxable and tax exempt (including single state) funds.

The amendments would not modify the basic framework established by the 1986 Amendments, and comment is requested on whether this framework continues to reflect market practices or whether any other types of puts have developed that should be reflected in the rule. Given the effect that the loss of a put could have on a fund's portfolio, comment is requested on whether any additional requirements with respect to the use of puts, particularly conditional puts, should be adopted.

## 2. Diversification and Quality Standards for Put Providers

Rule 2a-7 imposes a general diversification requirement with respect to puts to ensure that the liquidity of a fund will not be impaired by heavy reliance upon one institution, or a handful of institutions, to support securities in the fund's portfolio.<sup>73</sup> The 1986 Amendments tracked the diversification requirements of Section 5(b)(1) of the Act, and provided that a fund could not, with respect to seventy-five percent of its assets, have more than the specified percentage of its assets (five percent for conditional puts; ten percent for unconditional puts<sup>74</sup>) invested in securities subject to puts from, or directly issued by, the same institution.<sup>75</sup> The 1991 Amendments require that taxable funds meet these standards with respect to 100 percent of fund assets.<sup>76</sup> The Commission is proposing to make the limitations on conditional and unconditional puts uniform and to eliminate the twenty-five percent basket for tax exempt funds.

### a. Diversification Requirements: Conditional Puts

Although Rule 2a-7 permits funds to invest in unconditional puts from a single institution guaranteeing up to ten percent of the fund's assets, the limit for conditional puts is five percent of the fund's assets.<sup>77</sup> There appears to be no reason to require a higher level of diversification for conditional puts than unconditional puts. A fund would, in fact, have greater exposure to a provider of an unconditional put that has substituted its credit for that of the issuer of the underlying security.

Under the proposed amendments, the ten percent limit would be applicable to all puts, whether conditional or unconditional. Thus, conditional and unconditional puts from a single issuer, as well as securities directly issued by the issuer of the put, would be aggregated for purposes of determining whether the ten percent limit has been

<sup>72</sup> The value of the security will decline either because it will be of lower credit quality or its interest rate will be lower than long-term rates, or a combination of these two factors. The security may also decline in value if it becomes illiquid.

<sup>73</sup> Release 14983, *supra* note 64, at Section A.2.

<sup>74</sup> See Rule 5b-2 under the 1940 Act [17 CFR 270.5b-2]. Rule 5b-2 provides that a guarantee is not deemed to be a security of the guarantor provided that the value of all securities held by an investment company guaranteed or issued by the guarantor does not exceed ten percent of its total assets.

<sup>75</sup> A fund may not, however, invest more than five percent of its assets in securities (other than puts) directly issued by that institution. Paragraph (c)(4)(i)(A) of Rule 2a-7.

<sup>76</sup> Paragraph (c)(4)(ii) of Rule 2a-7. Tax exempt funds can invest, within the twenty-five percent basket, more than ten percent of assets in instruments backed by unconditional puts from one institution and more than five percent of assets in instruments supported by conditional puts from a single institution.

<sup>77</sup> Paragraphs (c)(4)(ii) and (iii) of Rule 2a-7.

reached.<sup>78</sup> Comment is requested on whether the percent of assets that may be subject to a put (whether conditional or unconditional) should be more or less than ten percent.

b. Put Diversification Requirements: Twenty-Five Percent Basket

The proposed amendments would eliminate the twenty-five percent basket for puts currently available to tax exempt funds. Permitting a fund to rely on one put provider to provide credit support or liquidity with respect to as much as twenty-five percent of its assets could present considerable risks to a fund seeking to maintain a stable net asset value under Rule 2a-7, and may be inconsistent with the safety expectations of investors. Tax exempt funds could invest no more than ten percent of fund assets in securities subject to puts from, or directly issued by, a single issuer. Elimination of the twenty-five percent undiversified put basket would be particularly important for single state funds, which are not and would not be required to be diversified with respect to underlying issuers.

Requiring put diversification as to 100 percent of fund assets could require funds to rely on a larger number of put providers than they do under the current rule.<sup>79</sup> Industry participants have suggested that because relatively few banks provide credit enhancement for most of the municipal market, increased diversification could cause funds to invest in securities subject to puts from weaker financial institutions. A review of fund portfolios suggests that while a small number of banks provide credit enhancement for one-third or more of the market, the remainder of the credit enhanced issues are supported by a wide assortment of put providers.<sup>80</sup> Comment is requested on whether the proposed requirement will cause tax exempt funds to rely on lower quality banks in order to satisfy this limitation, or whether it may cause funds to spread their put exposure more evenly among banks and/or encourage additional highly-rated banks to enter the market.

c. Diversification Requirements: Multiple and Layered Puts and Guarantees

To reduce the cost of credit enhancement, some issuers arrange for two or more institutions to provide joint puts or guarantees covering all or a portion of the value of the securities guaranteed. In addition, funds have invested in securities subject to double layers of puts and guarantees that apply to the entirety of the principal amount. VRDN issuers may obtain bond insurance covering the payment of the principal and interest when due, and then purchase a bank LOC or conditional put at a less expensive rate than would otherwise apply. When the rating of a bank providing an LOC with respect to a VRDN declines, some funds have insisted that the first LOC be wrapped, i.e., that a second bank LOC be obtained that supports the first one. Multiple puts and guarantees are purchased because the underlying credit of the issuer, or first put provider or guarantor, is considered weak.

For purposes of Rule 2a-7's put diversification provisions, the Commission is proposing to require that each such put provider or guarantor be deemed to have guaranteed the entire principal amount of the security, notwithstanding that the

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<sup>78</sup> Paragraph (c)(4)(iii) of Rule 2a-7 as proposed to be amended. Without aggregation, a fund's exposure to a single put provider could be as high as twenty percent. Rule 2a-7 does not currently require aggregation of securities subject to conditional and unconditional puts from the same institution. *See* T. Rowe Price Associates (pub. avail. June 2, 1993).

<sup>79</sup> Under the current rule, if 100 percent of a fund's portfolio is subject to unconditional puts, a minimum of nine institutions would have to provide the puts (eight institutions at the ten percent level and one institution at the twenty percent level); in the case of conditional puts, the minimum is sixteen (fifteen institutions at the five percent level and one at the twenty-five percent level). Under the proposed amendments, a minimum of ten institutions would be required in either case. *See* paragraph (c)(4)(iii) of Rule 2a-7 as proposed to be amended.

<sup>80</sup> Five banks (Industrial Bank of Japan Ltd., Sumitomo Bank Ltd., Credit Suisse, Sanwa Bank Ltd., and Dai Ichi Kangyo Bank Ltd.) wrote forty-three percent of all letters of credit ("LOCs") in the first half of 1993. *See* "Japanese Banks Lead LOC Enhancement Pack," Global Guaranty, July 26, 1993, at 1. Four banks (Canadian Imperial Bank of Commerce, Union Bank of Switzerland, Sumitomo Bank Ltd., and Mitsubishi Bank Ltd.) and the Student Loan Marketing Association wrote thirty-one percent of LOCs in 1992. *See* "Canadian Imperial Bank Led LOC Enhancement Pack in 1992," Global Guaranty, Feb. 1, 1993, at 6.

security is subject to puts from other institutions.<sup>81</sup> Comment is requested on whether other methods of accounting for a fund's exposure to layered guarantees would be more appropriate.<sup>82</sup>

#### d. Quality Limitations on Put Providers

##### (1) Providers of Puts in Excess of Five Percent of Fund Assets

Permitting a money market fund to invest in puts from one institution covering more than five percent of its assets will expose the fund to the credit quality of that institution to a greater extent than Rule 2a-7 otherwise generally allows under the Five Percent Diversification Test. The nature of the fund's exposure to institutions providing puts, however, is different from its exposure to the issuer of the underlying security. When an institution providing a put is downgraded by a NRSRO, in the absence of an adverse development with respect to the issuer of the underlying security, issuers or investors generally can either put the instrument back on short notice or persuade the issuer to obtain a substitute for the downgraded institution.<sup>83</sup> This consideration is reflected in Rule 2a-7's lower level of put diversification.

Nevertheless, the Commission believes that it may be desirable to limit a fund's reliance on any single put provider that is rated below the highest rating category. The proposed amendments would require that 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 be provided by an institution that has received the highest rating with respect to its short-term debt obligations from the requisite NRSROs.<sup>84</sup>

Compliance with the five percent limit on second tier puts would be measured at the time the put was acquired by the fund. Because a security subject to a put may be in a fund portfolio for a relatively long time, the quality of the put could decline after its acquisition and a put that was first tier when acquired could become second tier (or unrated) with the passage of time. Therefore, the Commission is proposing to amend Rule 2a-7 to require that when more than five percent of the fund's assets are subject to a demand feature from a single institution that is no longer first tier, the fund must reduce the amount of securities subject to the demand feature to no more than five percent of the fund's assets by exercising the demand feature at the next succeeding exercise date.<sup>85</sup>

The five percent limit on second tier puts from any single institution should not materially affect current fund investment practices since most institutions providing puts are first tier issuers. The Commission requests comment on the assumptions on which these proposed amendments are based, and how they would affect the management of tax exempt funds.

##### (2) Unrated Put Providers

Rule 2a-7 permits a fund to invest in securities subject to unrated puts so long as the fund's board, or its delegate, determines that the security is of comparable quality to a rated security.<sup>86</sup> In light of the potential exposure of a fund portfolio to an individual put provider under the current rule and the proposed amendments, however, the Commission

<sup>81</sup> Paragraph (c)(4)(iv)(D) of Rule 2a-7 as proposed to be amended. The proposed amendments would clarify that this provision is applicable to all forms of puts and guarantees, including financial guarantee (bond) insurance.

<sup>82</sup> Occasionally, an institution will provide a fractional put or guarantee; that is, the institution will assume the risk of paying only a fraction of the losses on an instrument. In these circumstances, the put provider would be deemed to guarantee only the portion of the value of the instrument actually guaranteed. For example, if two banks issue puts on the same VRDN and each agrees to absorb fifty percent of the losses, each would be deemed to guarantee fifty percent. The Commission is proposing an exception to this approach with respect to "first loss guarantees" on asset backed securities. *See infra* Section II.C.4.e.

<sup>83</sup> Issuers of securities subject to puts are often required to obtain replacement puts if an institution providing a put is downgraded. In other instances, holders have persuaded issuers to obtain replacements to assure that the security remains eligible for money market fund investment under Rule 2a-7.

<sup>84</sup> Paragraph (c)(4)(iii) of Rule 2a-7 as proposed to be amended.

<sup>85</sup> Paragraph (c)(5)(i)(C) of Rule 2a-7 as proposed to be amended. If the demand feature is no longer an eligible security, paragraph (c)(5)(ii) of Rule 2a-7 would require the fund to obtain a new demand feature or dispose of the underlying security (unless the board of directors found that it would be in the best interest of the fund not to dispose of the security). *See also infra* Section II.D.1.b, concerning certain other actions a fund would be required to take in the event of the deterioration of the credit quality of the demand feature.

<sup>86</sup> Paragraphs (c)(3) and (a)(5)(iii) of Rule 2a-7.

believes that a NRSRO rating may provide protection by ensuring input into the quality determination by an outside source. In addition, funds may have limited ability to monitor the credit quality of some put providers, such as foreign banks. A NRSRO rating may facilitate a fund's ability to determine that a security subject to a put represents minimal credit risks.<sup>87</sup> Therefore, 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.<sup>88</sup> Comment is requested on whether this approach will provide an additional degree of protection to fund investors.<sup>89</sup>

### (3) Rating Determinations: Issuer Demand Features

Rule 2a-7 permits a fund to substitute the NRSRO rating of an issuer of an unconditional demand feature for the rating of the underlying security.<sup>90</sup> In some cases, funds invest in a VRDN based upon the rating of the demand feature; in other cases the entire VRDN is rated. In the latter cases, the NRSRO examines not only the financial soundness of the demand feature provider, but also the terms of the VRDN to assure that the demand feature will permit the holder of the underlying security to realize on the demand feature in the event of the bankruptcy of the underlying issuer. Comment is requested on whether Rule 2a-7 should require that all VRDNs have NRSRO ratings. Alternatively, in those instances in which a VRDN is rated, should funds be required to rely on the specific rating of the VRDN rather than the rating of the demand feature provider?<sup>91</sup> Under this approach, an instrument subject to a demand feature (e.g., a VRDN) would be considered to be unrated unless a NRSRO has actually rated the entire instrument.

Demand features are sometimes provided by the issuer of the underlying security. The rule, as originally adopted, provided that only issuer-provided demand features could be used to shorten the maturity of a security. The Commission requests comment on whether issuer-provided demand features should continue to be used in this fashion. While issuer-provided demand features may be "readily exercisable in the event of a default of principal or interest on the underlying securities" as required by the rule, it is unlikely that the issuer will be in a position to honor the demand feature. One approach on which comment is requested would be to require issuer-provided demand features to be secured by a LOC or some other unconditional guarantee provided by a third party.

### (4) Non-Bank Put Providers

The Commission seeks comment on whether it should limit fund reliance on non-bank put providers. Although most VRDNs are backed by bank LOCs, some are backed by insurance companies, pension funds, utilities, or affiliates of the issuer.<sup>92</sup> Commenters have suggested that access to a central bank as a source of liquidity in a crisis assures that banks will be able to honor their put obligations.<sup>93</sup>

<sup>87</sup> A NRSRO rating cannot be the sole basis for making this determination. Paragraph (c)(3) of Rule 2a-7 requires credit risk determinations to be based on factors pertaining to credit quality in addition to the NRSRO rating.

<sup>88</sup> A security that is itself unrated but that is subject to a demand feature that is rated would not be considered to be an unrated security. See paragraph (a)(29)(i)(B) of Rule 2a-7 as proposed to be amended. This reflects the approach of many portfolio managers who generally rely on the credit quality and rating of the bank providing the demand feature to determine whether the VRDN is an eligible security. The proposed amendments remove from the definition of eligible security unrated securities that are subject to demand features. Paragraph (a)(9)(iii)(D) of Rule 2a-7 as proposed to be amended. Thus, in order for a security subject to a demand feature to be eligible, either the security or the demand feature must be rated.

<sup>89</sup> As noted *infra* in Section II.C.4, the Commission is also adopting this approach for fund investment in certain other types of "structured" securities, including asset backed and synthetic securities.

<sup>90</sup> Paragraph (c)(3)(i) of Rule 2a-7.

<sup>91</sup> Under paragraph (c)(3)(i) of Rule 2a-7, a demand instrument that has an unconditional demand feature may be an eligible security or a first tier security based solely on the status of the unconditional demand feature. This determination may be based on the ratings of comparable debt securities of the issuer of the demand feature. See paragraphs (a)(5) and (a)(6) of Rule 2a-7 (paragraphs (a)(9) and (a)(11) of Rule 2a-7 as proposed to be amended).

<sup>92</sup> The use of alternative put providers has increased as LOCs have become more expensive, which is due in part to the revised capital requirements adopted for banks. See "Municipal Bond Insurance—The Economics of the Market," *Municipal Finance Journal*, Vol. 13 No. 2 (Summer 1992).

<sup>93</sup> A liquidity crisis appears to some extent to have been the cause of the MBLI default when a "run" on MBLI occurred after a newspaper article appeared. See "State Outlines Plan to Rescue Mutual Benefit," *Wall Street Journal*, July 17, 1991, at A3; "Seizure of Insurer Roils Bonds," *Wall Street Journal*, July 18, 1991, at A1.

### 3. Conditional Puts

The inability of a fund to exercise a demand feature because of the occurrence of a condition precluding exercise would result in violation of the maturity limitations of Rule 2a-7, the liquidity requirements of the 1940 Act, and a loss of value of the underlying security when, for example, a short-term security paying interest at short-term rates is transformed into a long-term security.<sup>94</sup> Rule 2a-7 does not currently restrict the types of conditions to which a demand feature may be subject. As one commenter pointed out, the occurrence of some conditions attached to demand features cannot be effectively monitored by funds.<sup>95</sup> In addition, some conditions may have “hair triggers”—that is, they could occur suddenly without any advance warning (such as a downgrade of a security’s rating from AAA to AA)—or be based on subjective factors (such as a “material adverse change” in the financial condition or prospects of the issuer), effectively depriving a fund of sufficient warning that the demand feature may no longer be available.<sup>96</sup>

The Commission believes that it may not be appropriate under Rule 2a-7 to use demand features to shorten the maturity or enhance the credit quality or liquidity of a security if a fund cannot effectively determine, from a source other than the issuer of the underlying security, whether a condition precluding exercise has occurred or is likely to occur. A fund must be able to monitor the continued availability of a demand feature and, in certain circumstances, take steps to sell the security or replace the demand feature if it appears that conditions that would limit the ability of the fund to exercise the demand feature are likely to occur.<sup>97</sup> Therefore, the Commission is proposing amendments that would limit the permissible conditions with respect to conditional puts to the following:

1. default in the payment of principal or interest on the underlying security;
2. the bankruptcy, insolvency, or receivership of the issuer or a guarantor of the underlying security;
3. the downgrading of the underlying security or a guarantor by more than two full rating categories; and
4. 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.<sup>98</sup>

Other than the fourth condition (which appears to be customary and can often be addressed through appropriate legal opinions), these conditions relate directly to credit quality and other factors that may be monitored if the fund or other third parties have continuing access to financial data concerning the issuer.<sup>99</sup> Comment is requested on whether any additional conditions should be permitted, whether any of these conditions are inappropriate, and whether different conditions are appropriate depending on whether the put is used for liquidity (standby commitments) or to shorten maturity (demand features).

### 4. Asset Backed and Synthetic Securities

In response to the shortage of short-term tax exempt securities, market participants have created highly structured “synthetic” tax exempt securities and asset backed securities (“ABSs”) designed to meet the requirements of Rule 2a-7. Both types of instruments generally rely on demand features and complex liquidity arrangements to meet the requirements of the rule. The Commission is proposing a number of amendments to Rule 2a-7 to address these securities.

An ABS represents an interest in a pool of financial assets, such as credit card or automobile loan receivables. Typically, an ABS is sponsored by a bank or other financial institution to pool financial assets and convert them into capital market instruments, thereby enabling the sponsor to transform typically illiquid assets into cash and increase balance

<sup>94</sup> The fund could lose liquidity at the time when it is most necessary. A money market fund is limited to investing no more than ten percent of its assets in illiquid securities. *See supra* note 65.

<sup>95</sup> *See* ICI Letter, *supra* note 56.

<sup>96</sup> *Id.*

<sup>97</sup> *See* Nuveen Advisory Corp. (pub. avail. Sept. 4, 1990).

<sup>98</sup> Paragraph (a)(6) of Rule 2a-7 as proposed to be amended.

<sup>99</sup> *See infra* Section II.D.1.

sheet liquidity.<sup>100</sup> Unlike a conventional debt security, an ABS is structured to assure that the issuer of the ABS will not be affected by the bankruptcy of the sponsor. This structure enables a NRSRO to provide the ABS with a rating that is often higher than that of the sponsor. In addition, the structure of the ABS affects the nature and amount of the credit enhancement. While these structural issues affect the risks associated with many types of securities, they are particularly important in evaluating ABSs.<sup>101</sup>

Synthetic securities are another form of ABSs that have been developed to address the shortage in the supply of short-term tax exempt securities.<sup>102</sup> While a variety of synthetic structures exist, all involve trusts or partnerships that in effect convert long-term fixed-rate bonds into variable or floating rate demand instruments. Typically, one or more long-term, high quality fixed rate bonds of a single state or municipal issuer (the “core securities”) are deposited in a trust by a sponsor. Interests in the trust may be distributed through a public offering or private placement. Holders of interests in the trust receive interest at the current short-term market rate and the sponsor receives the difference (after administrative expenses) between the current market interest rate and the long-term rate paid by the core securities. An affiliate of the sponsor or a third party (usually a bank) issues a conditional demand feature permitting holders to recover principal at par within a specified period. Thus, the instruments satisfy Rule 2a-7’s maturity limitations. The puts are conditional to address tax-related concerns.<sup>103</sup>

Synthetic structures offer their sponsors the capacity to transform relatively standard, well-understood securities (e.g., long-term municipal bonds) into conventional VRDNs as well as more complex instruments, such as interest-only and principal-only strips and inverse floaters, all of which have very different risk characteristics from those of the underlying security.<sup>104</sup> The structures by which the core securities are deposited, held, and divided into various interests, and the credit enhancement and liquidity features built into these structures are extremely complex.<sup>105</sup> The proposed amendments would establish certain criteria for fund investment in synthetic securities and other ABSs and address issues concerning their treatment for diversification and maturity purposes.

#### a. Definitional Matters

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<sup>100</sup> For a detailed discussion of ABSs, see U.S. Securities and Exchange Commission Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation, May 1992, at 1-103 and Investment Company Act Rel. No. 18736 (May 29, 1992) [57 FR 23980 (June 5, 1992)] and Investment Company Act Rel. No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)] (“Release 19105”) respectively proposing and adopting Rule 3a-7 under the 1940 Act [17 CFR 270.3a-7], the rule excluding the issuers of certain ABSs from the definition of investment company.

<sup>101</sup> While the structure of ABSs vary, the ABSs that have been marketed to money market funds generally involve: (i) the trust, which issues the ABSs; (ii) the sponsor, which contributes the assets to the trust; (iii) the servicer, which is responsible for administering the assets in the pool; (iv) the trustee, which monitors the activities of the servicer; and (v) the bank, which provides some form of liquidity and/or credit enhancement to assure that the trust will have sufficient funds to meet interest and amortization payments in the event that cash flow from the underlying assets is insufficient to meet the payment schedule of the ABS.

<sup>102</sup> See “Taxable Money Funds Still Shifting into FRNs,” Donoghue’s Money Fund Report, Aug. 27, 1993 (“derivatives and structured financing products are the investments of choice these days as money managers struggle with paltry yields and thinner supply in traditional products”). To date, synthetic securities have generally been offered to money market funds through private placements.

<sup>103</sup> For distributions from the trust to be tax exempt, the owner of trust interests must be deemed the owner of the core securities for tax purposes. The conditions attached to the puts are designed to assure that investors in the trust bear some of the credit risks of the core securities, thus establishing some indicia of ownership. If the proposed amendments are adopted, any put conditions would have to meet the proposed limitations on conditional puts discussed *supra* in Part II.C.3. When analyzing the structure of a trust, the fund must ensure that it bears a substantial portion of the “benefits and burdens” associated with the long-term bonds and that it will have control (access) to the securities at some point. See “Risks Associated With Derivatives Held by Tax-Exempt Money Funds,” Moody’s Public Finance, June 15, 1993.

<sup>104</sup> See *infra* Section II.D.2.d for a discussion of the interest related risks presented by certain types of instruments that have been developed using these structures.

<sup>105</sup> The tax-free derivative market is changing and expanding constantly to meet demand for municipal issuance. For example, new derivative securities are being created that resemble existing structures but that also have multi-class features similar to those used in the mortgage-backed securities market. See “Firms Line Up to Create New Derivatives in Secondary Market as SEC Rules Change,” Bond Buyer, Apr. 26, 1993. Industry participants have sought to address the tax and other uncertainties presented by these structures through legislative proposals that would permit creation of “tax-exempt municipal investment conduits,” or “TEMICs.” See “Bond Industry Officials Send TEMIC Proposal To Treasury, Congress,” Bond Buyer, Sept. 14, 1993.

The proposed revisions would define an ABS as a fixed income security issued by a “special purpose entity,” substantially all of the assets of which consist of “qualifying assets”—generally, financial assets that by their terms convert into cash in a fixed period of time.<sup>106</sup> The proposed definition would exclude issuers that are not typically considered to be direct issuers of ABSs, such as finance companies.<sup>107</sup> Comment is requested on whether the proposed definition could be refined to assure that securities other than ABSs will not be included in the rule.

#### b. Quality Determinations and NRSRO Ratings

The credit quality of a typical ABS depends both upon the structure of the security and the quality of the underlying assets. Determining that an ABS presents minimal credit risks requires an examination of the criteria used to select the underlying assets, the credit quality of the put providers,<sup>108</sup> and the conditions of the contractual relationships among the parties to the arrangement. When an ABS consists of a large pool of financial assets, such as credit card receivables or mortgages, it may not be susceptible to conventional means of credit risk analysis because credit quality is based not on a single issuer but on an actuarial analysis of a pool of financial assets.<sup>109</sup> The complexity of these arrangements has caused investors typically to rely on the ratings given an ABS by a NRSRO.

NRSROs have played a significant role in the development of ABSs by analyzing the structural integrity of ABSs and assuring that the underlying assets are properly valued and provide adequate asset coverage for the cash flows required to fund the ABS.<sup>110</sup> In rating ABSs, NRSROs consider the structure of the instruments and the quality of the underlying assets.<sup>111</sup>

The Commission is concerned that fund credit analysts may be unable to perform the thorough legal, structural and credit analyses required to determine whether a particular ABS involves inappropriate risks for money market funds. Therefore, the Commission is proposing that money market funds invest only in ABSs that have a short-term and, when the final maturity of the ABS exceeds 397 days, a long-term debt rating, from a NRSRO. In view of the role that NRSROs have played in the structured finance markets, the proposed rating requirements should not be burdensome.

Except for the requirement that it be rated by a NRSRO, an ABS would be treated as is any other debt security for purposes of the rule’s credit quality conditions. As under the current rule, a fund would be required to make its own assessment that the security posed the minimal credit risks appropriate for a fund seeking to maintain a stable share price and a high level of liquidity.<sup>112</sup> Comment is requested on the proposed NRSRO rating requirement. Specifically, would

<sup>106</sup> Paragraph (a)(2) of Rule 2a-7 as proposed to be amended. Qualifying assets would consist of “financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.” This definition is similar to the definition of “eligible assets” in Rule 3a-7.

<sup>107</sup> Paragraph (a)(2) of Rule 2a-7 as proposed to be amended would define a “special purpose entity” as a trust, corporation, partnership or other entity organized for the sole purpose of issuing fixed income securities, which securities entitle their holders to receive payments that depend primarily on the cash flow from qualifying assets. Typically, finance companies and similar enterprises are not organized for the sole purpose of owning qualifying assets and issuing ABSs and have some other purpose, such as providing financing for the sale of an affiliate’s products. Registered investment companies would be explicitly excluded from the definition.

<sup>108</sup> Each put must qualify as an eligible security, and, if the put is conditional, the security must have received a first or second tier long-term rating from the requisite NRSROs or, if it is unrated, be of comparable quality. *See* paragraph (c)(3)(ii) of Rule 2a-7. In the case of a synthetic security, the core security generally will have the requisite rating.

<sup>109</sup> The complexity of credit risk analyses currently may be less of a concern for synthetic securities, the underlying assets of which generally consist of the securities of a single issuer. This concern may increase as synthetic securities funded by a significant number of securities continue to develop.

<sup>110</sup> Release 19105, *supra* note 100.

<sup>111</sup> “Asset-Backed CP’s New Look,” Fitch Research Structured Finance Special Report, May 10, 1993. In addition, both Moody’s and S&P rate synthetic instruments. For a description of the process by which one NRSRO analyzes synthetics, *see* “Moody’s Rating Criteria for Custodial Receipts,” Moody’s Perspective on Structured Finance, Apr. 15, 1991; “Understanding Custodial Receipts: Tender Option Bonds,” Moody’s Perspective on Structured Finance, Nov. 2, 1992.

<sup>112</sup> *See* Release 13380, *supra* note 8. In the case of synthetic securities, this assessment should include an analysis of current and historical interest rate trends (to determine whether short-term market rates will likely exceed the interest rate of the core security, which normally results in the dissolution of the trust and in the fund holding the long-term core securities) and whether the circumstances that could result in the termination of the put would occur prior to the time the put is next exercisable. *See* Nuveen Advisory Corp., *supra* note 97. If an analysis of these factors suggests that the synthetic security no longer presents minimal credit risks, the put must generally be exercised. *See* paragraph (c)(5)(ii) of Rule 2a-7.



a NRSRO rating assist funds in assuring that these securities are appropriate investments? Can NRSRO ratings measure the risks of the conditions usually attached to the puts? Would the requirement of an NRSRO rating inhibit or assist the development of a market for these instruments? Are there preferable alternatives to this approach? For example, should fund investment in ABSs be limited to a specified percentage (such as ten or fifteen percent) of fund assets?

#### c. Maturity Determinations

Certain types of ABSs raise questions concerning Rule 2a-7's maturity limitations. Some ABSs are structured as conventional debt securities, such as commercial paper or other fixed income obligations with fixed maturities. These securities are often characterized as "pay throughs" because the ABS has maturities and payment schedules different from those of the underlying assets. Others are characterized as "pass throughs" because the cash generated by the assets passes through directly to the ABS holders, who receive pro rata shares of the cash flows, net of fees. The ultimate maturity of these instruments depends upon the rate of repayment of the underlying assets.<sup>113</sup>

Pass-through ABSs held by money market funds generally are not scheduled to return a holder's principal for three to five years. They typically provide for periodic interest rate resets and for principal to be returned after some period (not exceeding thirteen months) after a demand for repayment is made.<sup>114</sup> The Commission is proposing to revise Rule 2a-7 to clarify that the final maturity of these instruments is the date on which principal is scheduled to be returned to the holder (regardless of whether demand has been made),<sup>115</sup> and to provide that the maturity of an ABS subject to this type of demand provision be measured by reference to the date on which principal is scheduled to be repaid once demand is made.<sup>116</sup> As a result, before the election to begin principal payments is made, a pass-through ABS with a five year final maturity and a feature permitting a fund to obtain principal within thirteen months would be considered a thirteen month instrument at all times (i.e., on a rolling basis).

Comment is requested on this approach and on whether any other maturity-based conditions should be adopted to further reduce the risks of investment in ABSs. For example, since pass throughs do not have scheduled maturities, should fund investment be limited to first tier securities to assure that funds would only invest in instruments with respect to which the likelihood that principal would amortize as scheduled is extremely high? Should the definition of qualifying assets be limited to short-term debt obligations to reflect the short-term liquidity needs of funds and to assure that the market value and pay-out schedule of the ABS would not be subject to fluctuations that characterize long-term assets, such as fixed rate mortgages?

#### d. Diversification: General

For purposes of the diversification provisions of Rule 2a-7, the issuer of the ABS would be deemed to be the issuer of the qualifying assets unless the qualifying assets consist of the securities of more than ten issuers. When the ten issuer limit is exceeded, the sponsor of the ABS would be considered its issuer.<sup>117</sup> In the case of the typical tax exempt synthetic security, the acquisition of a synthetic security would be deemed to be an acquisition of the core security. This approach would assure that no more than five percent of taxable and national fund assets are exposed to the issuer of the core security. Funds would be required to maintain information regarding the nature of the qualifying assets of the ABS, and if the number of issuers of securities that constitute the qualifying assets of the ABS is ten or less, a record setting forth

<sup>113</sup> Some ABSs (generally backed by credit card receivables) sold to money market funds appear to combine the characteristics of pay throughs and pass throughs: they are structured to allow the holder to make an election to receive principal payments earlier than scheduled, but the repayment obligation is conditioned on sufficient funds being generated by the underlying assets or being provided by liquidity and credit enhancers.

<sup>114</sup> These types of repayment elections currently do not qualify as demand features because the definition of demand feature requires repayment no more than 30 days after demand. Paragraph (a)(4) of Rule 2a-7 (paragraph (a)(8) of Rule 2a-7 as proposed to be amended).

<sup>115</sup> This proposal would supersede the interpretive position taken in Merrill Lynch, Pierce, Fenner & Smith (pub. avail. Mar. 6, 1987).

<sup>116</sup> Paragraph (a)(8) of Rule 2a-7 as proposed to be amended.

<sup>117</sup> Paragraph (c)(4)(iv)(E) of Rule 2a-7 as proposed to be amended. Treating the sponsor as the issuer of the security for diversification purposes is consistent with Section 2(4) of the 1933 Act [*15 U.S.C. 77b(4)*], which provides that the person "performing the acts and assuming the duties of depositor or manager" under provisions of the relevant trust instruments is the issuer of interests in an unincorporated investment trust not having a board of directors.

the identities of the issuers, the percentage of the qualifying assets constituted by the securities of each and the overall exposure of the fund's portfolio to those issuers.<sup>118</sup>

In the case of a typical ABS whose qualifying assets may consist of receivables from thousands of obligors, the financial institution that sponsored the ABS would be deemed to be the issuer. Thus, if five percent of a taxable fund's assets were invested in an ABS sponsored by a particular bank, the fund could not invest any more of its assets in the securities of that bank.<sup>119</sup> This limitation is designed to assure that no more than five percent of a fund's assets would be exposed to the loan portfolio of a specific financial institution. This proposed approach assumes that the credit quality of the ABS reflects the asset origination practices of the sponsor and that, in many cases, the sponsor provides some form of credit enhancement to the trust.<sup>120</sup>

Comment is requested on the proposed approach. How should this limitation be applied to ABSs that have multiple sponsors? Should each sponsor be treated as an issuer based on its proportionate contribution to the trust? Should the trust be treated as the issuer if it is diversified as to depositors (i.e., no single depositor contributed more than five or ten percent of the trust's assets)?

#### e. Diversification: First Loss Guarantees

Some ABSs are issued with guarantees as to first losses, in which, for example, one guarantor guarantees all losses up to ten percent of the assets of the pool. Because the loss coverage is usually a multiple of the likely losses to be experienced, the possibility of the losses exceeding the coverage is generally considered to be remote. As a result, a first loss guarantee exposes the guarantor to essentially the same risk as a guarantor of the entire value of the security.

The proposed amendments would treat a first loss guarantor as the guarantor of the entire security for purposes of the diversification requirements of Rule 2a-7.<sup>121</sup> For example, the guarantor of the first \$1,000,000 of losses on a \$10,000,000 principal amount ABS would be deemed to have guaranteed \$10,000,000 for purposes of Rule 2a-7's put diversification provisions. Comment is requested on the proposed approach to limiting a fund's exposure to first loss guarantors. Comment is also requested on whether and, if so, how limits on second and third loss guarantors should be measured.

#### 5. Puts and Fund Liquidity

Comment is requested on the use of conditional demand features and standby commitments as a source of liquidity for fund portfolios. Have these liquidity arrangements been successfully used during times of stress in the financial markets? Commenters on the 1986 Amendments suggested that standby commitments would only be used as a last resort because their use would result in losses to the broker-dealer providing the commitment. Were these commenters correct and, if so, does this suggest that standby commitments merely create the appearance of liquidity in order to comply with the Commission's policy that money market funds limit investment in illiquid securities to ten percent of fund assets?<sup>122</sup>

Comment is also requested concerning the liquidity of the tax exempt security market, and the mechanisms that can be used to dispose of portfolio securities subject to demand features. Do demand features provide the only mechanism for disposing of securities or are there secondary market mechanisms? What mechanisms exist for disposing of securities with demand features that cannot be exercised in intervals of seven days or less? In the release adopting the 1986 Amendments, the Commission stated that it expected boards of directors, in determining the liquidity of demand instruments, to establish procedures to evaluate the existence and depth of the secondary market for the instruments, and to consider the period remaining until the principal amount can be recovered through demand.<sup>123</sup> Are markets sufficiently developed for a fund to determine that a security with a demand feature that cannot be exercised every seven days is liquid?

<sup>118</sup> Paragraph (c)(8)(v) of Rule 2a-7 as proposed to be amended.

<sup>119</sup> The fund could invest up to an additional five percent of its assets in securities subject to puts from that bank.

<sup>120</sup> The put diversification requirements would continue to apply to the puts and demand features applicable to a synthetic security.

<sup>121</sup> Paragraph (c)(4)(iv)(F) of Rule 2a-7 as proposed to be amended.

<sup>122</sup> See *supra* note 65.

<sup>123</sup> Release 14983, *supra* note 64, at Section A.4.

## D. Other Proposed Amendments

### 1. Review, Information, and Notice Requirements

#### a. Continuing Disclosure and Review Requirement

When maturity is determined by reference to a demand feature, a portfolio security is, in essence, a long-term instrument.<sup>124</sup> The short-term securities typically held in taxable fund portfolios must be periodically “rolled over,” triggering the obligation to perform a new credit risk evaluation.<sup>125</sup> In contrast, if the demand feature to which a long-term instrument is subject is not exercised, the security may remain in the fund’s portfolio for a considerable length of time after the fund makes its initial determination that the demand feature and the underlying security present minimal credit risks.

Funds have a continuing duty under Rule 2a-7 to ensure that all securities in their portfolios continue to present minimal credit risks.<sup>126</sup> Periodic reviews of instruments subject to demand features may be particularly important due to the length of time the instruments are in the fund’s portfolio. During reviews subsequent to the initial purchase of a security, it may be necessary to review both the risks presented by the demand feature and, when the demand feature is conditional, those presented by the underlying issuer of the security.

The Commission is proposing to require 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.<sup>127</sup> This review should be based on all pertinent financial and other credit related information about the issuer of the security (or where the security is subject to an unconditional demand feature, the issuer of the demand feature) that is publicly available or provided under the terms of the security’s governing documents. The review should also include an examination of pertinent information about the provider of any demand feature or other credit or liquidity enhancement. Under paragraph (e) of Rule 2a-7, the credit review could be delegated to the fund’s investment adviser, subject to the conditions for delegation.

#### b. Analysis of Underlying Securities

A fund may determine whether a security subject to an unconditional demand feature is an eligible or first tier security based solely on the unconditional demand feature.<sup>128</sup> It may be appropriate in certain circumstances for the fund to review or have available not only information concerning the credit risks of the demand feature but the underlying security as well. These circumstances may include a significant adverse change in the credit quality of the provider of the demand feature or the impending expiration of the demand feature.<sup>129</sup> The proposed amendments would require that, in these circumstances, funds obtain sufficient information about the issuers of securities subject to unconditional demand features to permit them to value the security without the demand feature.<sup>130</sup> The information that 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

<sup>124</sup> See *supra* Section II.C.1.

<sup>125</sup> Paragraph (c)(3) of Rule 2a-7.

<sup>126</sup> Rule 2a-7 originally required a fund board to review on a quarterly basis the credit quality of instruments subject to demand features. The 1986 Amendments deleted this requirement because most of these instruments had high quality ratings from at least one NRSRO and because of concern about the appropriateness of having fund boards of directors perform these reviews. The provision of Rule 2a-7 that limits fund investments to securities that present minimal credit risk requires that funds monitor their existing investments to assure that they continue to present minimal credit risks. See paragraphs (c)(3), (c)(5)(ii), (c)(6)(i), and (c)(7) of Rule 2a-7.

<sup>127</sup> Paragraphs (c)(6)(ii)(D) and (c)(7)(ii)(A) of Rule 2a-7 as proposed to be amended.

<sup>128</sup> Paragraph (c)(3)(i) of Rule 2a-7. See *supra* text accompanying notes 66-67.

<sup>129</sup> For example, if the financial condition of the issuer of an LOC-backed demand feature has deteriorated significantly, security holders may desire to obtain a substitute or supplemental LOC to assure that the security continues to be first tier. It may be impracticable to obtain a new LOC in the absence of financial information about the underlying issuer. Similarly, if the LOC is approaching its expiration, a fund should be in a position to know whether substitute LOCs will be available. In either case, the fund should be in a position to know if the financial condition of the underlying issuer has deteriorated, so that the fund can demand payment prior to the expiration of the LOC.

<sup>130</sup> Paragraph (c)(6)(ii)(E) and (c)(7)(ii)(B) of Rule 2a-7 as proposed to be amended.

of default.<sup>131</sup> Comment is requested on whether the circumstances specified are appropriate and whether additional circumstances that warrant a credit review of the underlying issuer are appropriate. Comment is also requested on whether the rule should specify what events or standards should be used to determine that a “significant adverse change” in the credit quality of the demand feature has occurred.

Tax exempt funds may experience particular problems obtaining information concerning issuers of securities subject to demand features because tax exempt issuers generally do not file periodic reports with the Commission.<sup>132</sup> The lack of reports may make it difficult for funds to obtain current information about the financial condition of these issuers. The consequences of the lack of publicly available information regarding municipal issuers were illustrated when money market funds holding approximately \$110 million of MBLI-backed VRDNs experienced difficulty in obtaining current financial information about the issuers of the underlying securities. This lack of information impeded obtaining a replacement for MBLI and contributed to problems in valuing these securities.<sup>133</sup> In at least one case, a fund did not reflect the effects of the MBLI seizure in ascertaining the market price of its holding for five weeks.<sup>134</sup> Under the proposed revisions, if a fund could not obtain this information in the specified circumstances, the fund would be required to dispose of the security as soon as practicable by sale or by exercise of the demand feature.<sup>135</sup>

Comment is requested on whether the Commission should prohibit funds from investing in securities subject to demand features unless the issuer of the security is subject to the periodic reporting requirements of the Securities Exchange Act of 1934 or submits information to the Commission under Rule 12g3-2(b) [17 CFR 240.12g3-2(b)] thereunder, or the holder of the instrument has the right to obtain from the issuer pertinent credit information sufficient to permit the fund to conduct periodic credit risk reviews. Do other standards for secondary market information provide more appropriate guidelines for the information that should be available to money market funds?<sup>136</sup> Should such an information requirement be applied only to securities that have final maturities longer than thirteen months and for which the demand feature also serves to shorten their maturity? Should securities currently outstanding be subject to such an information requirement or should funds be able to continue to hold (or purchase) currently outstanding securities if the required credit information is not available? As an alternative, should a security subject to an unconditional demand feature be held to a requirement of high quality independent of the demand feature?

### c. Notice of Substitution of Put Provider

The Commission is aware of several instances in which a money market fund has invested in a security backed by a LOC or other credit or liquidity enhancement (such as a remarketing arrangement with a broker-dealer) that was replaced during the life of the underlying security without notice to the fund. It is important for purposes of assuring compliance

<sup>131</sup> The last two items are among the information the American Bankers Association Corporate Trust Committee has recommended that issuers direct the trustees of their bond issues to provide to security holders on a voluntary basis. *See* American Bankers Association Corporate Trust Committee, Disclosure Guidelines for Corporate Trustees (Oct. 1991) (“ABACT Guidelines”).

<sup>132</sup> *See* Sections 3(a)(12)(A) (including municipal securities in the definition of an “exempted security”) and 12(a) (excluding “exempted securities” from registration requirements) of the 1934 Act [15 U.S.C. 78c(a)(12)(A) and 781(a)]. *See also* “Staff Report on the Municipal Securities Market,” *supra* note 49, at 39 (quality of municipal securities market disclosure could be addressed through a variety of means, including rescission of statutory exemptions).

<sup>133</sup> *See* “Caution Flags for Muni Investors,” Wall Street Journal, July 22, 1991 (“even as investors scramble to determine what their [MBLI backed] bonds are worth, they are finding the task extremely difficult due to the lack of financial disclosure in the \$800 billion municipal bond market”).

<sup>134</sup> *See* In the Matter of Bank of California, Investment Company Act Rel. No. 19545, 54 SEC Dkt. 1300 (June 28, 1993).

<sup>135</sup> Paragraph (c)(5)(ii)(E) of Rule 2a-7 as proposed to be amended. Disposal would not be required if the fund board concluded that disposing of the security would not be in the best interests of the fund.

<sup>136</sup> *See, e.g.*, Government Finance Officers Association, Disclosure Guidelines for State and Local Government Securities (1991) (“GFOA Guidelines”). The GFOA Guidelines, published by an association of state and local finance officers, identify information that over the years has been important for primary and secondary market disclosure. Adherence to the GFOA Guidelines is voluntary. The American Bankers Association Corporate Trust Committee, representing bank trustees, published guidelines designed to guide bond indenture trustees in assisting issuers of municipal securities with respect to secondary market information disclosure. ABACT Guidelines, *supra* note 131. *See* “Staff Report on the Municipal Securities Market,” *supra* note 49, at 29-31 for a discussion of other efforts by the Commission, the Municipal Securities Rulemaking Board, and market participants to improve secondary market disclosure.

with Rule 2a-7 that a fund know the identity of the put provider.<sup>137</sup> Comment is requested on whether Rule 2a-7 should be amended to restrict funds to investing only in those credit or liquidity enhanced securities that obligate the issuer or the trustee under any applicable indenture to inform investors of the substitution of a credit enhancer or, alternatively, securities whose issuer has agreed to provide written notice to funds in the event that the credit or liquidity enhancer is replaced.

## 2. Variable and Floating Rate Securities

Rule 2a-7 defines a “variable rate security” as an instrument the terms of which provide for the adjustment of the interest rate on specified dates and that, upon adjustment, can reasonably be expected to have a market value that approximates par value.<sup>138</sup> A “floating rate” security is defined as an instrument the terms of which provide for the adjustment of its interest rate whenever a specified benchmark changes and that, at any time, can reasonably be expected to have a market value that approximates par value.<sup>139</sup> Rule 2a-7 allows variable and floating rate securities (“adjustable rate instruments”) to be treated as having maturities shorter than their final maturities; however, the manner in which adjustable rate instruments are treated depends upon whether they have demand features, the final maturity of the instrument and whether the instrument is a Government security.

### a. Maturity Determinations: Floating Rate Securities

The maturity of a floating rate security subject to a demand feature is the period remaining until principal can be recovered through demand.<sup>140</sup> The same test is generally applicable in determining the maturity of a variable rate security subject to a demand feature, the principal amount of which is scheduled on the instrument’s face to be paid in more than 397 days.<sup>141</sup> In contrast, a variable rate security (without a demand feature) scheduled to be paid in 397 days or less may be treated as having a maturity equal to the period remaining until the next readjustment of the interest rate.<sup>142</sup> There is no parallel provision for floating rate securities with final maturities of 397 days or less.

Because variable and floating rate securities expose funds to similar types of interest rate risk, the Commission is proposing to amend 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.<sup>143</sup> The interest rate of a floating rate security moves in tandem with changes in the interest rate to which it is linked, and the proposed amendment will permit funds to treat these instruments as having one-day maturities.

### b. Maturity Determinations: Variable Rate Securities

When the period remaining until the final maturity of a variable rate demand instrument (i.e., its maturity without reference to the demand feature) is less than 397 days, its maturity under Rule 2a-7 is the longer of the period remaining until the next interest rate readjustment or the date on which principal can be recovered on demand.<sup>144</sup> A variable rate security with the same final maturity that does not have a demand feature is treated as having a remaining maturity equal

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<sup>137</sup> A fund must know the identity of the put provider for purposes of determining compliance with the rule’s put diversification test. Paragraph (c)(4)(iii) of Rule 2a-7 as proposed to be amended. In addition, substitution of a put provider may require the fund to take certain actions if the substitute put has a lower NRSRO rating than the original put or, if as a result of the substitution, the security ceases to be an eligible security or no longer presents minimal credit risks. Paragraph (c)(5) of Rule 2a-7. Finally, if proposed amendments to Regulation S-X are adopted, funds will have to know the identity of the put provider for purposes of preparing the portfolio schedule that accompanies fund financial statements. *See infra* Section III.C.

<sup>138</sup> Paragraph (a)(21) of Rule 2a-7 (paragraph (a)(30) of Rule 2a-7 as proposed to be amended). These instruments must be expected to return the value of the instrument to par so that the market-based value of the instrument does not deviate significantly from its amortized cost value. *See* Release 14983, *supra* note 64, at nn. 10-11 and accompanying text.

<sup>139</sup> Paragraph (a)(7) of Rule 2a-7 (paragraph (a)(12) of Rule 2a-7 as proposed to be amended).

<sup>140</sup> Paragraph (d)(4) of Rule 2a-7.

<sup>141</sup> Paragraph (d)(3) of Rule 2a-7.

<sup>142</sup> Paragraph (d)(2) of Rule 2a-7.

<sup>143</sup> Paragraph (d)(4) of Rule 2a-7 as proposed to be amended.

<sup>144</sup> Paragraph (d)(3) of Rule 2a-7.

to the period remaining until the next readjustment in the interest rate.<sup>145</sup> The effect of these provisions is that a variable rate security with a final maturity of less than 397 days will have a longer maturity when a demand feature is added to it. To correct this anomaly, the amendments would provide that only a variable rate demand security with a final maturity in excess of 397 days would have its maturity measured by the longer of the period remaining until its next interest rate adjustment or the date on which principal can be recovered on demand;<sup>146</sup> the maturities of 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 or the date on which principal can be recovered on demand.<sup>147</sup>

Comment is requested on whether Rule 2a-7 could be simplified by allowing the maturity of a variable rate demand instrument to be determined by reference to the date on which principal can be recovered on demand as opposed to the longer of the period remaining until the next interest rate readjustment or the date on which principal can be recovered on demand.<sup>148</sup> Comment is also requested on whether funds should be permitted to use the interest rate reset date to determine the fund's weighted average portfolio maturity.<sup>149</sup> The put date would be used to determine whether the fund could purchase the instrument.<sup>150</sup>

### c. Adjustable Rate Government Securities

Rule 2a-7 provides that “an instrument that is issued or guaranteed by the United States government or any agency thereof which has a variable rate of interest adjusted no less frequently than every 762 days”<sup>151</sup> is deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.<sup>152</sup> The Commission is proposing amendments to clarify the scope of this provision.

First, the rule would be amended to make clear that 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.<sup>153</sup> This change would make explicit that Government securities are treated the same way as other adjustable rate securities under the rule.<sup>154</sup>

Second, the reference to Government securities in paragraph (d)(1) of Rule 2a-7 would be conformed to other provisions of the rule relating to Government securities. As proposed to be amended, the provision would apply to all Government

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<sup>145</sup> Paragraph (d)(2) of Rule 2a-7.

<sup>146</sup> Paragraph (d)(3) of Rule 2a-7 as proposed to be amended.

<sup>147</sup> Paragraph (d)(2) of Rule 2a-7 as proposed to be amended.

<sup>148</sup> It is the Commission's understanding that while interest reset dates may occur more frequently than dates on which demand features can be exercised, demand feature exercise dates almost always correspond to interest rate readjustment dates.

<sup>149</sup> Industry representatives have suggested that the interest rate sensitivity of a variable rate security depends upon the frequency of its interest rate reset dates and that weighted average maturity is often treated as an indication of the fund's sensitivity to interest rate changes. The current manner in which weighted average maturity is calculated may overstate a fund's interest rate sensitivity.

<sup>150</sup> For example, a variable rate instrument with quarterly reset dates and subject to annual demand would be treated as having a one year maturity for purposes of determining whether the fund could buy it under paragraph (c)(2)(i) of the rule but as having a ninety day maturity for purposes of calculating the fund's average portfolio maturity under paragraph (c)(2)(iii) of the rule.

<sup>151</sup> Paragraph (d)(1) of Rule 2a-7. Generally, the readjustment must occur every 397 days to reflect the rule's maturity requirements. For certain funds that mark-to-market, however, readjustment may occur every 762 days. *See* paragraph (c)(2)(ii) of Rule 2a-7.

<sup>152</sup> Paragraph (d)(1) of Rule 2a-7.

<sup>153</sup> This would codify the position taken by the Division of Investment Management in no-action letters. *See* Investment Company Institute (pub. avail. June 16, 1993) (“ICI Capped Floater Letter”); Morgan Keegan & Company, Inc. (pub. avail. July 24, 1992) at n.7.

<sup>154</sup> The proposed amendments would also make clear that this provision applies to floating rate Government securities. *See* paragraph (d) (1) of Rule 2a-7 as proposed to be amended. As proposed, funds may treat floating rate Government securities as having a maturity of one day.

securities, including securities issued by persons controlled or supervised by and acting as instrumentalities of the U.S. Government.<sup>155</sup>

#### d. Other Issues Concerning Adjustable Rate Instruments

Rule 2a-7 allows the maturity of adjustable rate instruments to be determined by reference to interest rate adjustment dates if the instrument “can reasonably be expected to have a market value that approximates its par value” upon adjustment of the interest rate.<sup>156</sup> When Rule 2a-7 was adopted, the Commission acknowledged limited experience with adjustable rate instruments, emphasized that the funds’ boards, as part of a general duty to supervise to ensure share price stability, should make volatility determinations for long-term notes, and stated that rule amendments would be considered if “market experience indicates that it is inappropriate to the rule’s overall purposes.”<sup>157</sup>

The Commission is proposing to clarify that the board of directors or its delegate must have a reasonable expectation that, upon adjustment of its interest rate at any time until the final maturity of the instrument or until the principal amount can be recovered through demand, the instrument will return to or maintain its par value.<sup>158</sup> The Commission also is proposing to require that funds maintain written records of the determination, with respect to a security the maturity of which is determined by reference to the date on which the next interest rate readjustment is to occur, that the instrument will either maintain a value of par (for a floating rate instrument) or return to par (for a variable rate instrument).<sup>159</sup>

New types of adjustable rate instruments have recently been developed and purchased by money market funds whose advisers have asserted that they meet the definitions of variable or floating rate instruments because they believe they are likely to return to par upon the next interest rate adjustment date. These instruments include “inverse floaters,”<sup>160</sup>

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<sup>155</sup> The amendment would reflect a no-action position taken by the Division of Investment Management with respect to securities issued by instrumentalities of the U.S. government. *See* Student Loan Marketing Association (pub. avail. Jan, 18, 1989). Paragraph (c)(3) of Rule 2a-7 limits money market fund investments to instruments that present minimal credit risks and requires a fund’s board to determine instruments’ creditworthiness, including securities issued by the U.S. government and its agencies. A practical application of this requirement to Government securities requires different levels of analyses depending upon the government entity issuing the security and the terms of the security. The depth of the analysis required—and the adequacy of a fund’s records of the analysis—will depend on: (i) whether the securities are backed by the full faith and credit of the U.S. Government; and (ii) whether the instrument has any special features or a guarantee structure that might increase the riskiness of the instrument or the fund’s potential failure to comply with some aspect of Rule 2a-7. Comment is requested on the level of credit analysis and related documentation that would be appropriate for various types of Government securities.

<sup>156</sup> Paragraphs (a)(7) and (a)(21) of Rule 2a-7. Adjustable rate securities may be priced at a premium to par value when the instrument pays interest above market rates. A fund may treat the instrument as an adjustable rate instrument for purposes of Rule 2a-7’s maturity provisions if the fund reasonably expects that upon readjustment of the interest rate, the market value of the instrument will approximate its amortized cost. The premium generally would be amortized over the life of the instrument. It is critical that the fund carefully consider all factors involved in the valuation of the instrument, particularly the likelihood of prepayment before the premium is fully amortized. An accelerated return of principal will require the fund to write off the premium before it is amortized, and could result in a significant deviation between the amortized cost and market value of the instrument.

<sup>157</sup> Release 13380, *supra* note 8, at note 16.

<sup>158</sup> Paragraphs (a)(12) and (a)(30) of Rule 2a-7 as proposed to be amended.

<sup>159</sup> Paragraphs (c)(6)(ii)(F), (c)(7)(ii)(C) and (c)(8)(iv) of Rule 2a-7 as proposed to be amended.

<sup>160</sup> An inverse floater has an interest rate that fluctuates inversely with market rates. Thus, if interest rates increase, the interest rate of the inverse floater (and its market value) would decrease. Typically, the interest rate adjustment mechanisms are such that the effect of a market rate change is magnified through use of a multiplier, resulting in a highly volatile security. *See infra* note 163. The Division of Investment Management has stated, and the Commission agrees, that these instruments are not appropriate investments for money market funds. *See* Investment Company Institute (pub. avail. Dec. 6, 1991) (“ICI Inverse Floater Letter”).

“capped floaters,”<sup>161</sup> “CMT floaters,”<sup>162</sup> leveraged floaters<sup>163</sup> and instruments linked to an interest rate that significantly lags prevailing short-term rates.<sup>164</sup> These securities share the common characteristic that, at the time of issuance, changes in interest rates or other conditions that can reasonably be foreseen to occur during their term will result in their market value not returning to par at the time of an interest rate adjustment. To compensate funds for assuming this risk, these instruments typically offer yields greater than short-term instruments of comparable maturity and credit quality. Some fund advisers have justified investment in these instruments by asserting that they would be able to sell them before an interest rate adjustment occurs that would result in the value of the security falling below par. Because many of these securities have been designed for and are held primarily by money market funds, a significant change in interest rates (or even a widely anticipated change) could result in a “fire sale” of these securities by funds. The increased selling pressure could result in the instruments having market values of less than par. Selling funds would realize losses and funds that did not sell might have to take actions to address any resulting significant deviation between market and par value. This type of risk is inappropriate for a money market fund to assume.

The effect of the proposed language would be to prohibit funds from purchasing a long-term adjustable rate Government security unless the adjustment mechanism can reasonably be expected to return the instrument to par upon all interest rate adjustment dates during the life of the instrument. A fund could purchase a short-term adjustable rate security the value of which the fund does not expect to return to par on all interest rate adjustment dates, but would have to treat the security as a fixed rate security and measure its maturity by reference to its final maturity. Adjustable rate securities with demand features generally would not be affected by the proposed changes because if a discount develops or is likely to develop a fund could exercise the demand feature and receive the amortized cost value of the instrument.

Comment is requested on whether alternative amendments are required to reflect the development of the types of instruments described above. For example, should funds relying on the maturity-shortening provisions of the rule be restricted to investing in instruments whose interest rate mechanisms are based solely on a single short-term interest rate benchmark? Comment is requested on whether other tests can be developed to measure interest rate risk. For example, should the rule establish interest rate risk criteria based on “duration” as opposed to maturity? Should adjustable rate instruments be subject to a price sensitivity test (that would preclude fund investment if the estimated market price of the instrument would shift by more than a specified amount in the event of a significant immediate and sustained parallel

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<sup>161</sup> A capped floater limits the amount by which the interest rate may increase. The cap may place a limit on the amount the interest rate can increase over the instrument’s lifetime or for each interest rate readjustment period (e.g., a cap of 25 basis points per quarter). The staff has interpreted Rule 2a-7 as not permitting its maturity shortening provisions to be applicable to these instruments in the absence of a demand feature. Thus, a capped floater with a final maturity of more than thirteen months is generally not eligible for fund investment because the rule’s maturity shortening provisions may not be used. This position has not been applied when the cap is set to conform with state usury laws and the maximum rate is in excess of twenty percent. ICI Capped Floater Letter, *supra* note 153. When the capped floater has a demand feature, the maturity shortening provisions can be used regardless of the reason for the cap and the level at which it is set, subject to certain conditions (e.g., it can be expected to reset at par). *See* Nuveen Advisory Corp., *supra* note 97. When a capped floater has a remaining maturity of less than thirteen months and no demand feature, it may be purchased by the funds but its maturity must be measured by reference to its final maturity date. Investment Company Institute (pub. avail. June 25, 1993).

<sup>162</sup> CMT floaters and similar instruments have interest rates that are tied to fixed rates that are often medium- or long-term, raising the question of whether these instruments will return to par in the event of a change in short-term rates relative to long-term rates (i.e., a change in the shape of the yield curve). Yields on Treasury securities at constant maturity are interpolated by the U.S. Treasury from the yield curve, which is based on the market bid yields on actively traded Treasury securities in the over-the-counter market. The constant maturity yield values are read from the yield curve at fixed points of between one year and thirty years.

<sup>163</sup> The interest rate adjustment mechanism of a leveraged floater employs multipliers so that the effect of an increase or decrease in interest rates on the coupon of the instrument is greatly magnified. For example, for an instrument with a multiplier of 3.0 in its interest rate reset mechanism, a decrease of 50 basis points in short-term market rates would result in a decrease of 150 basis points in the instrument’s coupon. Such “leveraged” coupons could result in an instrument trading far below par should interest rates decline even slightly. ICI Inverse Floater Letter, *supra* note 160, at n.2.

<sup>164</sup> An example of this type of mechanism is one linked to the monthly Cost of Funds Index (“COFI”), representing the cost of funds to thrift institutions in the Eleventh Federal Home Loan Bank District. Changes in the COFI can significantly lag the market. This lag means that an instrument with a rate linked to the COFI always trades at a premium or a discount to par since a change in the COFI will always occur following market rate changes. In a declining interest rate environment, COFI floaters have generally traded at a premium; however, in an environment in which short-term rates steadily rise, the lag will result in COFI floaters trading under par, creating significant risks for funds.



shift in the yield curve)?<sup>165</sup> In addition, the Commission requests information on other interest rate mechanisms that may result in securities not returning to par and on whether these mechanisms are used primarily for Government securities, non-government securities, or both.

### 3. Repurchase Agreements

Rule 2a-7 permits a fund to “look through” a repurchase agreement (“repo”) to the underlying collateral for diversification purposes when the obligation of the counterparty to repurchase the securities from the fund is “collateralized fully.”<sup>166</sup> A repo is collateralized fully if, among other things, the collateral consists entirely of Government securities or securities that, at the time the repurchase agreement is entered into, are rated in the highest rating category by the requisite NRSROs.<sup>167</sup> The proposed amendments would limit the types of collateral that could be used for purposes of the “look through” provisions to assure that a repo can be liquidated if the counterparty enters bankruptcy or, in the case of a federally insured depository institution, a conservator or receiver is appointed.<sup>168</sup>

The Federal Bankruptcy Code [*11 U.S.C. 101 et seq.*] (the “Bankruptcy Code”) provides special treatment in bankruptcy to repos collateralized by securities issued or guaranteed by the U.S. Government or one of its agencies, certificates of deposit and certain bankers’ acceptances.<sup>169</sup> If the counterparty is a bank, the Federal Deposit Insurance Act affords preferential treatment to repos collateralized by certain mortgage-related securities as well.<sup>170</sup> Both statutes provide that repos collateralized by the specified securities can be liquidated immediately and the lender can realize immediately on the collateral.

The proposed amendments would permit repos to be treated as fully collateralized only if, among other things, they are collateralized by securities that would qualify the repo for preferential treatment.<sup>171</sup> Repos otherwise collateralized would be deemed to be securities issued by the counterparty for purposes of the rule’s diversification and quality requirements.<sup>172</sup> As under the current rule, the non-Government securities constituting collateral also would have to be first tier securities.

Comment is requested on whether money market funds should only be permitted to enter into repos when they may “look through” the counterparty. Comment is also requested on the need to retain the current requirement that funds make a minimal credit risk determination with respect to repo counterparties that are collateralized fully. The requirement that a fund analyze the repo counterparty reflected uncertainty concerning the treatment of repurchase

<sup>165</sup> See Federal Financial Institutions Examinations Council Supervisory Policy Statement on Securities Activities, *57 FR 4028* (Feb. 3, 1992).

<sup>166</sup> Paragraph (c)(4)(i) of Rule 2a-7.

<sup>167</sup> Paragraph (a)(3)(iv) of Rule 2a-7.

<sup>168</sup> Depository institutions are not eligible for protection under the Bankruptcy Code. Section 109 of the Bankruptcy Code [*11 U.S.C. 109*]. Instead, the bank regulatory laws provide for the establishment and conduct of conservatorship and receiverships of depository institutions in default. See, e.g., Section 11 of the Federal Deposit Insurance Act [*12 U.S.C. 1821*].

<sup>169</sup> See, e.g., Section 559 of the Bankruptcy Code [*11 U.S.C. 559*].

<sup>170</sup> See *12 U.S.C. 1821(e)(8)(A)* and *(C)* (affording preferential treatment to “qualified financial contracts”), *12 U.S.C. 1821(e)(8)(D)(i)* (defining qualified financial contract to include repurchase agreements) and *12 U.S.C. 1821(e)(8)(D)(v)* (defining repurchase agreement).

<sup>171</sup> Paragraph (a)(4) of Rule 2a-7 as proposed to be amended. Not all collateral that would qualify a repo for preferential treatment under the Federal Deposit Insurance Act would be permitted. Of the mortgage-related securities referred to in *12 U.S.C. 1821(e)(8)(D)(v)*, only “mortgage related securit[ies]” as defined in Section 3(a)(41) of the 1934 Act [*15 U.S.C. 78c(a)(41)*] would be permitted.

<sup>172</sup> If the collateral does not qualify for special treatment under these statutes, a fund could encounter significant liquidity problems if a large percentage of its assets were invested in a repo with a bankrupt counterparty. The “look through” provisions of the rule may be inappropriate in these circumstances because the credit risks assumed by the fund would be directly tied to the counterparty rather than the issuers of the underlying collateral.

agreements in bankruptcy proceedings.<sup>173</sup> Have the Bankruptcy Code amendments sufficiently addressed these concerns or do the mechanics of bankruptcy filings and the manner in which these provisions have been applied suggest that funds should continue to analyze the counterparty's credit quality? For example, the protection from the automatic stay provisions offered by section 559 do not apply to stockbrokers or depository institutions, which constitute the counterparties of many repos entered into by funds. Thus, a liquidation of a stockbroker could result in a repo with that stockbroker being temporarily illiquid.<sup>174</sup> Comment is also requested on whether repos with foreign institutions receive protections similar to those afforded by U.S. insolvency laws such that they should be treated as being fully collateralized for purposes of Rule 2a-7.

The definition of "collateralized fully" in Rule 2a-7 would be amended to include a definition of the term "resale price."<sup>175</sup> The resale price would be equal to the price paid to the seller of the securities plus the accrued resale premium—the "interest rate" specified in the repo agreement or the daily amortization of the difference between the purchase price and the resale price.<sup>176</sup> Currently, the rule requires that the market value of the collateral be at least equal to the resale price provided in the repo agreement. This has been interpreted to require that the full repurchase price (including unaccrued interest) must be collateralized at all times, rather than allowing additional margin to be transferred as interest accrues. By contrast, interest on an open repo can be collateralized as it accrues over the term of the repo. The proposed amendment would permit all repos to be collateralized as interest accrues.

Rule 2a-7 also would be amended to provide that a repo that is "collateralized fully" need not always be deemed to be an acquisition of the underlying securities. When a repo permits the counterparty to substitute collateral to replicate the original collateral, determinations that the collateral meets the rule's diversification requirements may be difficult. In these cases, the proposed amendments would permit a fund to look to the counterparty, rather than to the underlying collateral, in meeting the diversification requirements of the rule.<sup>177</sup>

#### 4. U.S. Dollar-Denominated Instruments

To eliminate their exposure to foreign currency risk, money market funds are limited by Rule 2a-7 to investing only in "United States dollar-denominated instruments."<sup>178</sup> The purpose of this provision was to preclude exposure of the fund to currency fluctuations. The Commission is proposing to define the term "United States dollar-denominated" to clarify that it means: (1) the payment of interest and principal must be made in U.S. dollars in all circumstances;<sup>179</sup> and (2) an

<sup>173</sup> See Release 13380, *supra* note 8, at n.31. Before the passage of the Bankruptcy Amendments and Federal Judgeship Act of 1984 ("BAFJA") [Pub. L. No. 98-353], the treatment of a repo under the Bankruptcy Code depended upon whether it was characterized as a secured loan or a purchase-and-sale transaction. If the repo was characterized as a secured loan, the borrower-counterparty would retain at least an equitable interest in the securities, and the securities would be subject to the automatic stay provisions of the Bankruptcy Code, preventing the lender from taking any action against the borrower's property. If the repo was characterized as a purchase-and-sale transaction, the open portion of the repo (the repurchase obligation) would be viewed as an executory contract, which the bankruptcy trustee could reject or accept. Until rejection or acceptance, the buyer (i.e., the fund) would be exposed to the market risk of the securities. Regardless of the repo's characterization, prior to BAFJA a question existed whether "mark-to-market" payments (the payments required to keep the repo fully collateralized) could be voided by the trustee as preferential transfers. The BAFJA amendments removed qualifying repos from operation of the Bankruptcy Code's stay and avoidance provisions.

<sup>174</sup> In a liquidation of a stockbroker, the Securities Investors Protection Corporation ("SIPC") may request an order from the court barring the closeout of repo transactions with the debtor firm. *15 U.S.C. 78aaa et seq.* However, SIPC has developed a policy to address the unwinding of repos in insolvency proceedings designed to minimize the effects of the proceedings on their liquidity when the repo would be a qualified repo under the Bankruptcy Code. See Letter from Michael E. Don, Deputy General Counsel of SIPC, to Robert A. Portnoy, Deputy Executive Director and General Counsel of the Public Securities Association (Feb. 4, 1986).

<sup>175</sup> Paragraph (a)(4)(v) of Rule 2a-7 as proposed to be amended.

<sup>176</sup> Under the proposed amendment, the collateralization of "open" repos and those with established repurchase prices would be subject to the same collateralization requirements.

<sup>177</sup> Paragraph (c)(4)(iv)(A) of Rule 2a-7 as proposed to be amended.

<sup>178</sup> Paragraph (c)(3) of Rule 2a-7.

<sup>179</sup> For example, an instrument that pays interest in Mexican pesos in the event of the devaluation of the peso is currently ineligible for fund investment under the rule. The proposed definition would clarify this interpretation.

eligible instrument's interest rate may not vary or float with a rate tied to foreign currencies, foreign interest rates, or any index expressed in a currency other than U.S. dollars.<sup>180</sup>

## 5. Investment in Other Money Market Funds

The Commission is proposing amendments to Rule 2a-7 that codify existing staff positions regarding money market fund investment in other money market funds ("acquired funds"). The amendments clarify that shares in other money market funds that comply with Rule 2a-7: (i) are First Tier Securities;<sup>181</sup> and (ii) should be treated as having a rolling maturity equal to the period of time within which the acquired fund is required to make payment upon redemption under applicable law.<sup>182</sup> A shorter maturity may be used if the fund making the investment has a contractual arrangement with the acquired fund for more rapid receipt of redemption proceeds. For diversification purposes, an investment in another money market fund would generally be treated as an investment in any other issuer (and therefore could generally not exceed five percent of the investing fund's assets).<sup>183</sup>

An exception to this treatment would be made for funds that invest substantially all of their assets in shares of another money market fund (the "underlying fund"),<sup>184</sup> in which case the fund would be permitted to "look through" the shares to the assets of the underlying fund.<sup>185</sup> As proposed, such a fund would be deemed to be in compliance with Rule 2a-7 for diversification and other purposes if the board of directors reasonably believes that the underlying money market fund is in compliance with the rule. The proposed amendment would not require the board of directors of the fund to monitor every investment decision made by the underlying fund. Rather, the board could review the underlying fund's procedures and obtain regular reports concerning the underlying fund's compliance with the rule.

## 6. Board Approval of Certain Securities

The 1991 Amendments added a 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.<sup>186</sup> The Commission excepted tax exempt funds from the ratification requirement prior to its becoming effective.<sup>187</sup> Seven commenters urged the Commission also to eliminate the requirement for taxable funds, arguing that directors lack the specialized, technical knowledge necessary for credit

<sup>180</sup> For example, an instrument with an interest rate linked to the London Interbank Offered Rate ("LIBOR") for a currency other than United States dollars (*e.g.*, Swiss franc LIBOR) or the consumer price index of another nation would not be eligible for fund investment under Rule 2a-7.

<sup>181</sup> See paragraph (a)(1)(iv) of Rule 2a-7, as proposed to be amended.

<sup>182</sup> See paragraph (d)(8) of Rule 2a-7 as proposed to be amended. Currently, this period would be seven calendar days. See Section 22(e) of the 1940 Act [15 U.S.C. 80a-22(e)]. Under revisions to Rule 15c6-1 effective June 1, 1995, purchases and sales of shares in a fund distributed by a registered broker-dealer must settle within three business days of the trade date. See Rel. No. 34-33023; Investment Company Act Rel. No. 19768 (Oct. 6, 1993) [58 FR 52891 (Oct. 13, 1993)]. Thus, after June 1, 1995, shares of a fund that are distributed by a broker-dealer may be deemed to have a rolling maturity of three days.

In addition, draft staff guides to Forms N-1A and N-3 being published with this Release state that the two money market funds must not have inconsistent investment objectives and policies. For example, a money market fund whose investments are limited to Government securities could not invest in a money market fund that invests primarily in commercial paper and other corporate obligations. See proposed Guide 34 to Form N-1A and proposed Guide 38 to Form N-3.

<sup>183</sup> Investment by one fund in another is limited by Section 12(d)(1)(A) of the 1940 Act [15 U.S.C. 80a-12(d)(1)(A)]. Section 12(d)(1)(A) provides that a fund may not invest more than ten percent of its assets in securities issued by other investment companies, invest more than five percent of its assets in any single investment company, or acquire more than three percent of the voting securities of another investment company.

<sup>184</sup> The restrictions of Section 12(d)(1)(A) do not apply if the fund making the investment invests all of its assets in the shares of another fund, subject to certain conditions. Section 12(d)(1)(E) [15 U.S.C. 80a-12(d)(1)(E)].

<sup>185</sup> These include feeder funds in "master-feeder" arrangements and certain separate accounts offering variable insurance products. In a "master-feeder" structure, one or more open-end management investment companies with their own service and distribution arrangements invest all of their assets in a single mutual fund or a single series of a mutual fund. In some variable insurance structures, a unit investment trust offers units of interest in variable insurance contracts to investors and invests at least a portion of the proceeds in a mutual fund.

<sup>186</sup> Paragraph (c)(3) of Rule 2a-7.

<sup>187</sup> Investment Company Act Rel. No. 18177 (May 31, 1991) [56 FR 26028 (June 6, 1991)]. Tax exempt funds argued that the high percentage of tax exempt securities that were either unrated or single-rated would make the requirement impracticable and unduly burdensome for these funds.

analysis. They suggested that board involvement in these determinations on a day-to-day basis was inappropriate and that boards should be permitted to delegate this responsibility to portfolio managers. The proposed amendments would eliminate this requirement for taxable funds.

Two commenters recommended eliminating the requirement that the fund board promptly reassess whether a security presents minimal credit risks when the fund's investment adviser becomes aware that an unrated security or second tier security has been given a rating by any NRSRO below the NRSRO's second highest rating category.<sup>188</sup> The Commission requests comment on whether to permit delegation of the reassessment requirement.

## 7. Recordkeeping

During 1991, the Commission staff conducted special inspections of almost all money market funds to examine, among other things, whether they were performing the credit analysis required to determine that portfolio securities present minimal credit risks.<sup>189</sup> Some funds lacked adequate records to document their analysis and, thus, the Commission could not confirm that these funds had complied with the rule. To permit the Commission to determine compliance with Rule 2a-7, the Commission is proposing to amend the rule to specifically require a fund 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.<sup>190</sup> In addition, funds would be required to keep a written record of their diversification analysis of any ABS the qualifying assets of which consist of the securities of ten or fewer issuers.<sup>191</sup>

The Commission's recent examinations of money market funds also indicate that funds frequently fail to maintain sufficient records regarding the particular features of each security to permit ready determination that the security complies with Rule 2a-7. The Commission is proposing an amendment to Rule 31a-1 that would 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.

## 8. Defaulted Securities

Rule 2a-7 requires a fund to dispose of defaulted securities as soon as practicable (subject to certain conditions)<sup>192</sup> and to report to the Commission if it holds defaulted securities that, prior to the default, accounted for more than one half of one percent of the fund's assets.<sup>193</sup> Some funds believed that it was unclear whether the seizure of MBLI by New Jersey regulators and MBLI's subsequent refusal to honor its puts constituted a default within the meaning of these requirements. To clarify the application of these requirements, Rule 2a-7 would be amended to include "events of insolvency" with respect to the issuer of the security or any put to which the security is subject as events that trigger these obligations.<sup>194</sup>

The Commission is proposing an amendment to the rule that would change the circumstances under which a money market fund must notify the Commission that an issuer of securities held by the fund has defaulted. Rule 2a-7 currently requires funds to report to the Commission by telephone (or fax) and on Form N-SAR all defaults related to the financial condition of the issuer. Under the proposed rule, reporting would be required, in the case of a security subject to a credit

<sup>188</sup> Paragraph (c) (5)(i)(A) of Rule 2a-7.

<sup>189</sup> Paragraph (c)(3) of Rule 2a-7 requires funds to limit portfolio investments to securities determined to present minimal credit risks.

<sup>190</sup> These records would include the proposed "minimal risk" analysis with respect to certain adjustable rate instruments. *See supra* note 159 and accompanying text. A fund would be required to retain these records in a readily accessible location for a period of three years after the date the fund acquired the instrument or last reviewed its credit risks, whichever is later. *See* paragraphs (c)(8)(iii) and (iv) of Rule 2a-7 as proposed to be amended.

<sup>191</sup> Paragraph (c)(8)(v) of Rule 2a-7 as proposed to be amended. The Commission is proposing to require that the diversification requirements be met as to issuers of qualifying assets when the qualifying assets consist of the securities of no more than ten issuers. *See supra* Section II.C.4.d.

<sup>192</sup> Paragraph (c)(5)(ii) of Rule 2a-7.

<sup>193</sup> Paragraph (c)(5)(iii) of Rule 2a-7.

<sup>194</sup> "Event of insolvency" would be defined in paragraph (a)(10) of Rule 2a-7 as proposed to be amended.

enhancement or put, only when the provider of the credit enhancement or put fails to fulfill its obligations, whether by continuing to make principal and interest payments on the security without protest or by paying out the security's full value when it is put back by the fund.

### 9. Technical Amendments

Additional technical revision to Rule 2a-7 are being proposed to clarify the terminology and operation of the rule. References to "instruments" would be changed to "securities." In addition, the definition of "unrated security" would be revised to clarify that if an unrated security becomes rated while held by the fund, the fund may continue to treat it as an unrated security, in the same manner as a fund may continue to determine whether a security rated by a single NRSRO is first or second tier if a second NRSRO rates the security after it is acquired by the fund.<sup>195</sup> Comments are requested on other necessary clarifications.

## III. Proposed Revisions to Disclosure Rules

The Commission continues to believe, as reflected in the 1991 Amendments, that investors should be given information that makes it clear that investment in a money market fund is not without risk. The Commission is proposing amendments to the forms and advertising rules used by tax exempt funds and publishing a draft Staff Guide designed to elicit disclosures concerning the specific risks of investing in tax exempt funds.

### A. Single State Funds

To alert investors to the greater risks of investing in single state funds, Form N-1A would be amended to require that a single state fund 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.<sup>196</sup> Comment is requested as to whether single state funds that meet the diversification requirements of Section 5(b)(1) of the 1940 Act should be permitted to provide modified risk disclosure.

### B. Disclosure of Exposure to Put Providers

A substantial portion of many money market fund portfolios is supported by credit and liquidity enhancements from third parties, generally LOCs issued by domestic and foreign banks.<sup>197</sup> As a result, the credit quality of these portfolios is largely dependent on the credit quality of banks. Because investors may believe that the designation "tax exempt" signifies that the credit quality of the portfolio is more closely tied to that of municipal and state issuers, the Commission is publishing for comment an amendment to Staff Guide 21 of Form N-1A that would interpret the form as requiring a fund to disclose in its prospectus the relationship between the credit quality of put providers and that of the fund's portfolio; that letters of credit are not necessarily subject to federal deposit insurance; and that adverse developments in the banking industry may adversely affect the credit quality of the portfolio and the fund's ability to maintain a stable net asset value and share price. These requirements would apply where more than forty percent of a fund's portfolio is subject to puts. Comment is requested on whether funds should be required to make any other disclosures concerning the composition of their portfolios, such as the extent to which the fund invests in unrated securities.

### C. Identification of Put Providers

Investment company financial statements include a "portfolio schedule" of all securities held by the fund.<sup>198</sup> A portfolio schedule lists the name of the issuer and the title of the issue, but is not required to list the name of the party providing

<sup>195</sup> Paragraph (a)(29) of Rule 2a-7 as proposed to be amended.

<sup>196</sup> Item 4(c) of Form N-1A as proposed to be amended.

<sup>197</sup> Recent money market fund inspections suggest that approximately seventy percent of national fund and sixty-one percent of single state fund assets are subject to unconditional credit enhancements.

<sup>198</sup> Financial statements are included in a fund's Statement of Additional Information that is part of the fund's registration statement under the Securities Act of 1933 and must be delivered on request to prospective investors. *See* Items 1 and 23 of Form N-1A [17 CFR 239.15A and 274.11A]. They are also included in fund semi-annual and annual reports to shareholders. *See* Rule 30d-1 under the 1940 Act [17 CFR 270.30d-1].

a put or guarantee with respect to the security.<sup>199</sup> Because the credit quality of a financial institution providing a put is important in assessing an instrument's quality, the Commission is proposing that the portfolio schedules of money market funds include the names of parties providing puts.<sup>200</sup> Identifying these institutions would make the portfolio schedules of money market funds more meaningful to investors. Comment is requested on whether this disclosure should not be required if the put is a standby commitment designed only to provide liquidity. In addition, should the portfolio schedule be required to state the ratings of the securities held by the fund? Finally, should this disclosure be required for all investment companies?

#### D. Risk Disclosure in Certain Advertisements

Funds are required to include in certain advertisements and sales literature a statement that an investment in a money market fund is not insured or guaranteed by the U.S. Government and there can be no assurance that the fund will maintain a stable net asset value.<sup>201</sup> The proposed amendments would extend this requirement to "tombstone" advertisements under Rule 134 under the 1933 Act.

### IV. Proposed Exemptive Rule Governing Purchases of Certain Portfolio Instruments by Affiliated Persons

When money market funds have held a defaulted security, fund advisers or related persons generally have repurchased the security from the fund at the security's principal amount plus accrued interest (or amortized cost value) to avoid any fund shareholder loss.<sup>202</sup> These transactions came within Section 17(a)(2) of the 1940 Act [*15 U.S.C. 80a-17(a)(2)*], which prohibits an affiliated person of a fund from knowingly purchasing a security from the fund in the absence of a Commission exemption.<sup>203</sup> Nevertheless, these transactions appeared to be reasonable, fair, in the best interests of fund shareholders, and consistent with the actions that a fund should take in the event of a default of a portfolio security.<sup>204</sup> Thus, the staff of the Division of Investment Management has advised the parties to these transactions that the staff would not recommend enforcement action to the Commission if these transactions were consummated.

The Commission now is proposing new Rule 17a-9 under the 1940 Act to exempt these types of transactions from Section 17(a). The proposed exemption would apply when (1) the security is no longer an eligible security; (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). Funds using the exemptive rule would continue to be required to notify the Commission in the event of a default with respect to portfolio securities that account for one half of one percent or more of a fund's assets before the occurrence of the default.<sup>205</sup> Comment is requested on the scope of the proposed exemption and these conditions. Should the exemption be available when the fund board has determined that a security no longer presents minimal credit risks?<sup>206</sup>

### V. Conforming Amendment

Rule 12d3-1 under the 1940 Act [*17 CFR 270.12d3-1*] provides exemptive relief to permit investment companies to purchase or otherwise acquire securities issued by persons engaged in securities related activities, subject to certain limitations. Under Rule 12d3-1, an investment company, including any money market fund, may acquire puts issued by persons engaged in securities related activities, provided that the company complies with the diversification requirements

<sup>199</sup> See Section 210.12-12 of Regulation S-X.

<sup>200</sup> *17 CFR 210.12-12* as proposed to be amended. Funds would also be required to maintain a written record of the liquidity and credit enhancements associated with each portfolio security under the proposed amendment to rule 31a-1. See *supra* Section II.D.7.

<sup>201</sup> Paragraph (a)(7) of Rule 482 [*17 CFR 230.482(a)(7)*] and introductory paragraph of Rule 34b-1 [*17 CFR 270.34b-1*].

<sup>202</sup> See *supra* notes 12 and 28 and accompanying text.

<sup>203</sup> The definition of "affiliated person" is contained in Section 2(a)(3) of the 1940 Act [*15 U.S.C. 80a-2(a)(3)*].

<sup>204</sup> Paragraph (c)(5)(ii) of Rule 2a-7 requires funds holding a defaulted security to dispose of the security as soon as practicable consistent with achieving an orderly disposition of the security, unless the fund board concludes that disposal would not be in the best interests of the fund.

<sup>205</sup> Paragraph (c)(5)(iii) of Rule 2a-7.

<sup>206</sup> As in the case of a default and a security no longer being an eligible security, in this instance the rule requires the fund to dispose of the security as soon as practicable. See paragraph (c)(5)(ii) of Rule 2a-7.

in Rule 2a-7.<sup>207</sup> Rule 2a41-1 [17 CFR 270.2a41-1] under the 1940 Act allows investment companies to assign a fair value of zero to standby commitments under certain conditions.<sup>208</sup> The Commission is proposing to amend Rule 12d3-1 to reflect the proposed diversification limitations,<sup>209</sup> and to amend Rule 2a41-1 to revise the reference therein to Rule 2a-7.

## VI. Transition Period

If the proposed rule and form amendments are adopted, the Commission would expect to make the amendments effective ninety days after publication in the Federal Register to provide registrants, issuers, and other participants in the money markets with an appropriate period of time to make any changes required by the rule. Comment is requested on whether ninety days would be sufficient or whether a shorter or longer period would be appropriate.

## VII. General Request for Comments

Any interested persons wishing to (1) submit written comments on the proposed rule and form changes that are the subject of this Release; (2) suggest additional changes (including changes to provisions of Rule 2a-7 that the Commission is not proposing to amend); or (3) submit comments on other matters that might have an effect on these proposals, are requested to do so. Commenters suggesting alternative approaches are encouraged to submit proposed rule text.

## VIII. Cost/Benefit of the Proposal

The Commission believes that the proposals discussed above will not substantially increase costs for money market funds. Whatever increased costs are incurred should be outweighed by the benefits of increased money market fund safety. Most national funds already comply with the Five Percent Diversification test, and those national funds not in compliance should be able to adapt to the proposed limit without great expense. Because most single state fund assets consist of first tier securities, these funds are not likely to incur significant additional costs if the proposal to limit their investments to first tier securities is adopted.

The Commission believes that although most funds meet the proposed quality and diversification requirements for put providers, a significant minority of funds may not. The Commission requests comments on the extent to which finding alternative put providers will increase fund costs. The conditions proposed with respect to ABSs may impose some additional costs on funds, but it is not expected that these costs will be significant and they should be outweighed by the benefits of clarifying the conditions under which funds may invest in these instruments, which may facilitate development of the ABSs markets. The proposed rescission of the requirement that boards of directors of taxable funds approve or ratify unrated and single-rated securities should reduce fund costs to a limited extent. Most funds currently meet the proposed recordkeeping requirements, and these should impose only modest costs on funds. The proposed disclosure requirements would not impose any expense for funds, since it is anticipated that additional disclosure will be permitted to be added when the funds make their annual updates. These costs should be outweighed by the benefits of additional disclosure. The proposed exemptive rule governing purchases of certain portfolio securities from funds by fund affiliates should produce savings in administrative expenses for those funds that hold securities that are no longer eligible for fund investment and whose advisers wish to repurchase the security as permitted by the rule.

The Commission requests specific comment on its assessment of the costs and benefits associated with the proposal, including specific estimates of costs and benefits.

## IX. Summary of Initial Regulatory Flexibility Analysis

An Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603 concerning the proposed amendments. The analysis explains that in February 1991 the Commission adopted amendments to Rule 2a-7 to tighten the risk-limiting conditions of the rule. These amendments were applicable primarily to taxable money market funds. Thereafter, the Commission examined the characteristics of tax exempt funds and the markets in which they trade to

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<sup>207</sup> See Release 14983, *supra* note 64. These diversification requirements were not changed by the 1991 Amendments except to make them applicable to taxable funds with respect to 100 percent of these funds' assets.

<sup>208</sup> *Id.*

<sup>209</sup> See *supra* Section II.C.2.a.

determine whether the same or similar amendments should apply to tax exempt funds. This examination has revealed certain areas of concern that have led the Commission to propose further amendments to Rule 2a-7 applicable primarily to tax exempt funds. The analysis describes the characteristics of tax exempt funds and explains that the safety of these funds would be increased by application of certain risk-limiting conditions tailored specifically to their characteristics.

The analysis summarizes the proposed amendments to Rule 2a-7 and related rules and forms and a new proposed rule. The amendments to Rule 2a-7 would tighten the conditions of the rule relating to the quality and diversity of tax exempt fund investments, including puts. The amendments would require funds to reevaluate at least annually the credit risks of certain long-term portfolio investments, and limit investments in such securities to those whose issuers supply periodic financial and other information. The amendments to related rules and forms would require ongoing credit reviews and certain other procedures with respect to fund investments in securities subject to puts. A new exemptive rule would permit funds to sell securities that are no longer eligible securities to advisers and other affiliated persons without obtaining exemptive relief.

The analysis states that the objectives of the proposals are to (1) tighten the quality standards in the rule; (2) reduce the exposure of tax exempt funds to the credit risks posed by investment in a single issuer; (3) limit risks associated with investing in securities subject to puts, including ABSs; (4) provide for continuing determinations with respect to the credit quality of issuers of certain long-term securities; (5) rationalize the provisions of the rule relating to the determination of maturity of certain instruments; (6) allow fund boards of directors to delegate certain portfolio management responsibilities, subject to oversight; (7) improve fund recordkeeping; and (8) limit the risks associated with investing in repurchase agreements. The objectives of the amendments to related rules and forms are intended to improve money market fund disclosure relating to (1) fund investments in securities subject to puts; and (2) lack of diversification of certain single state funds. The objective of proposing a new exemptive rule under Section 17(a) is to facilitate certain transactions between funds and their affiliates that benefit shareholders.

The analysis states that as of September 29, 1993, 211 money market funds are small entities for purposes of Rule 0-10 of the 1940 Act [17 CFR 270.0-10]. Of these 211 funds, ninety-three were tax exempt funds. The proposed amendments would primarily affect tax exempt funds.

The analysis states that the reporting, recordkeeping and other compliance requirements of the proposed amendments should not be significantly greater than those currently imposed by Rule 2a-7, and that the additional costs, if any, should not be any greater for small money market funds than for other money market funds. The analysis further states that the Commission believes that there are no duplicative, overlapping or conflicting rules.

The analysis discusses the significant alternatives to the proposed amendments that would accomplish their objectives while minimizing any significant economic effect of the proposals on small funds. For example, the analysis states that the Commission considered the establishment of different compliance or reporting requirements or timetables that would take into account the resources available to small money market funds, and the simplification of compliance and reporting requirements under Rule 2a-7 for small money market funds. The use of performance rather than design standards was considered. Lastly, the Commission considered the alternative of exempting small money market funds from one or more of the conditions of the rule. The analysis concludes that these alternatives would not accomplish the objectives of the rule, nor would the alternatives be consistent with the statutory mandate of the Commission under the 1940 Act. A copy of the analysis may be obtained by contacting Martha H. Platt, Office of Disclosure and Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

## **X. Statutory Authority**

The Commission is proposing to amend Rule 2a-7 under the exemptive authority set forth in Sections 6(c) [15 U.S.C. 80a-6(c)], 22(c) [15 U.S.C. 80a-22(c)], 34(b) [15 U.S.C. 80a-33(b)], and 38(a) [15 U.S.C. 80a-37(a)] of the Investment Company Act of 1940. The authority citations for the amendments to the rules and forms precede the text of the amendments.



## XI. Appendices

### APPENDIX A

The following table sets forth the terminology used by the NRSROs to characterize their highest ratings for taxable short-term debt:

Moody's	S&P	Fitch	D&P	IBCA	TBW
P-1	A-1	F-1	Duff-1	A1+	TBW-1
superior	strong	very strong	very high certainty of timely repayment	very highest quality	very strong

### APPENDIX B

The following table sets forth the ratings categories of the principal NRSROs that rate tax-exempt notes and the meaning that the NRSROs ascribe to the rating:

	Moody's	S&P	Fitch
MIG-1	best quality	-	-
SP-1	-	very strong or strong	-
F-1	-	-	very strong
MIG-2	high quality	-	-
SP-2	-	satisfactory	-
F-2	-	-	good
MIG-3	favorable quality	-	-
SP-3	-	speculative	-
F-3	-	-	fair
MIG-4	adequate quality	-	-
F-s	-	-	weak
SG	speculative quality	-	-
D	-	-	actual or imminent default

## XII. Text of Proposed Rule and Form Amendments

List of Subjects in 17 CFR Parts 210, 230, 239, 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Commission is proposing to amend chapter II, title 17 of the Code of Federal Regulations as follows:

### Part 210—Form and Content of and Requirements for Financial Statements, Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Investment Company Act of 1940, and Energy Policy and Conservation Act of 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77aa(25), 77aa(26), 781, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37a, unless otherwise noted.

2. Section 210.12-12 is amended by adding the following as the second sentence in footnote two:

Section 210.12-12 Investment in Securities of Unaffiliated Issuers

2 \*\*\* In the case of a money market fund, also identify any institution providing a put (as defined in Rule 2a-7 under the Investment Company Act of 1940 [§ 270.2a-7 of this chapter]) or guarantee with respect to a portfolio security and give a brief description of the nature of the put (e.g., unconditional demand feature, conditional demand feature, guarantee, letter of credit, or bond insurance). \*\*\*

### **Part 230—General Rules and Regulations, Securities Act of 1933**

3. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77b, 77j, 77s, 77sss, 78c, 78l, 78m, 78n, 78o, 78w, 79ll(d), 79t, 80a-8, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

4. Section 230.134 is amended by adding paragraph (e) to read as follows:

§ 230.134 Communications not deemed a prospectus.

(e) In the case of an investment company registered under the Investment Company Act of 1940 that holds itself out as a “money market fund,” a communication used under this section shall contain the disclosure required by § 230.482(a)(7).

### **Part 270—Rules and Regulations, Investment Company Act of 1940**

5. The authority citation for Part 270 is amended by removing the third paragraph in the sub-authority to read as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-37, 80a-39 unless otherwise noted;

6. Section 270.2a-7 is revised to read as follows:

§ 270.2a-7 Money market funds.

(a) Definitions.

(1) “Amortized Cost Method” of valuation shall mean the method of calculating an investment company’s net asset value whereby portfolio securities are valued at the fund’s acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(2) “Asset Backed Security” shall mean a fixed income security issued by a Special Purpose Entity (as hereinafter defined), substantially all of the assets of which consist of Qualifying Assets (as hereinafter defined). “Special Purpose Entity” shall mean a trust, corporation, partnership or other entity organized for the sole purpose of issuing fixed income securities which entitle their holders to receive payments that depend primarily on the cash flow from Qualifying Assets, but does not include a registered investment company. “Qualifying Assets” shall mean financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(3) “Business day” shall mean any day, other than Saturday, Sunday, or any customary business holiday.

(4) “Collateralized Fully” in the case of a repurchase agreement shall mean that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the money market fund reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price (as defined hereinafter) provided in the agreement; and

(ii) The money market fund or its custodian either has actual physical possession of the collateral or, in the case of an instrument registered on a book entry system, the book entry is maintained in the name of the money market fund or its custodian; and

(iii) The money market fund retains an unqualified right to possess and sell the collateral in the event of a default by the seller; and

(iv) The collateral consists entirely of securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency thereof, and/or certificates of deposit, bankers' acceptances which are eligible for acceptance by a Federal Reserve Bank, and, if the seller is a depository institution as defined in *12 U.S.C. 1813(c)*, mortgage related securities (as such term is defined in Section 3(a)(41) of the Securities Exchange Act of 1934 [*15 U.S.C. 78c(a)(41)*]) that, at the time the repurchase agreement is entered into, are rated in the highest rating category by the Requisite NRSROs; and

(v) "Resale Price" shall mean the purchase price paid to the seller of the securities plus the accrued resale premium on such purchase price. The accrued resale premium shall be the amount specified in the repurchase agreement or the daily amortization of the difference between the purchase price and the resale price specified in the repurchase agreement.

(5) A "Conditional Demand Feature" shall mean a Conditional Put that is also a Demand Feature.

(6) A "Conditional Put" shall mean a Put that is not an Unconditional Put, provided that its exercise is subject only to one or more of the following conditions:

(i) A default in the payment of principal of or interest on the underlying security;

(ii) An Event of Insolvency with respect to the issuer of the underlying security or guarantor of the underlying security;

(iii) The downgrading of the underlying security or a guarantor of the underlying security by more than two full rating categories by an NRSRO; and

(iv) In the case of a security the interest payments on which purport to be exempt from federal income tax, a determination of taxability by the Internal Revenue Service.

(7) "Conduit Security" shall mean a security issued by a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality thereof, which is not:

(i) Payable from the revenues of such governmental unit;

(ii) Unconditionally guaranteed by such governmental unit;

(iii) Related to a project or facility owned and operated by such governmental unit; or

(iv) Related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned by and under the control of such governmental unit.

(8) "Demand Feature" shall mean a Put that may be exercised either:

(i) At any time on no more than 30 days' notice; or

(ii) At specified intervals not exceeding 397 calendar days and upon no more than 30 days' notice; Provided, however, that in the case of an Asset Backed Security, a feature permitting the holder of the Asset Backed Security to receive principal and interest within thirteen months of making demand shall be deemed a Demand Feature.

(9) "Eligible Security" shall mean:

(i) A security with a remaining maturity of 397 days or less that is rated (or that has been issued by an issuer that is rated with respect to a class of Short-term debt obligations, or any debt obligation within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in one of the two highest rating categories for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(ii) A security:

(A) That at the time of issuance was a Long-term debt obligation but that has a remaining maturity of 397 calendar days or less, and

(B) Whose issuer has received from the Requisite NRSROs a rating, with respect to a class of Short-term debt obligations (or any debt obligation within that class) that is now comparable in priority and security with the security, in one of the two highest rating categories for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(iii) An Unrated Security (other than a security subject to a Demand Feature or an Asset Backed Security) that is of comparable quality to a security meeting the requirements of paragraphs (a)(9)(i) or (ii) of this section, as determined by the money market fund's board of directors; Provided, however, that:

(A) The board of directors may base its determination that a Standby Commitment that is not a Demand Feature is an Eligible Security upon a finding that the issuer of the commitment presents a minimal risk of default;

(B) A security that at the time of issuance was a Long-term debt obligation but that has a remaining maturity of 397 calendar days or less and that is an Unrated Security is not an Eligible Security if the security has a Long-term rating from any NRSRO that is not within the NRSRO's two highest categories (within which there may be sub-categories or gradations indicating relative standing);

(C) An Asset Backed Security shall not be an Eligible Security unless:

(1) it has short-term debt rating from an NRSRO and,

(2) in the case of an Asset Backed Security that has a final maturity of greater than 397 days that is subject to a Conditional Demand Feature and the Qualifying Assets of which do not consist of securities that have a long-term debt rating from an NRSRO, a long-term debt rating from an NRSRO; and

(D) A security that is subject to a Demand Feature shall not be an Eligible Security unless the Demand Feature has received a rating from an NRSRO (or the issuer of the Demand Feature has received from an NRSRO a rating with respect to a class of short-term debt obligations or any debt obligation within that class that is comparable in priority and security to the Demand Feature).

(10) "Event of Insolvency" shall mean, with respect to an issuer or guarantor, an admission of insolvency, the application by the issuer or guarantor for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the issuer of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors, or the institution of similar proceedings by another person (other than a governmental agency responsible for regulating the activities of the issuer or guarantor) which is not contested by the issuer or guarantor.

(11) "First Tier Security" shall mean any Eligible Security that:

(i) Is rated (or that has been issued by an issuer that is rated with respect to a class of Short-term debt obligations, or any debt obligation within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in the highest rating category for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(ii) Is a security described in paragraph (a)(9)(ii) of this section whose issuer has received from the Requisite NRSROs a rating, with respect to a class of Short-term debt obligations (or any debt obligation within that class) that now is comparable in priority and security with the security, in the highest rating category for Short-term debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(iii) Is an Unrated Security that is of comparable quality to a security meeting the requirements of paragraphs (a)(11)(i) and (ii) of this section, as determined by the fund's board of directors; or

(iv) Is a security issued by a registered investment company that is a money market fund.

- (12) “Floating Rate Security” shall mean a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate (such as a bank’s designated prime lending rate) changes and which, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its par value.
- (13) “Government Security” shall mean any Government security as defined in Section 2(a)(16) of the Act.
- (14) “Long-term” shall mean having a remaining maturity greater than 366 days.
- (15) “NRSRO” shall mean any nationally recognized statistical rating organization, as that term is used in paragraphs (c) (2)(vi)(E), (F) and (H) of § 240.15c3-1 of this Chapter that is not an affiliated person, as defined in Section 2(a)(3)(c) of the Act [15 U.S.C. 80a-2(a)(3)(c)], of the issuer of, or any insurer, guarantor or provider of credit support for, the security.
- (16) “Penny-Rounding Method” of pricing shall mean the method of computing an investment company’s price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.
- (17) A “Put” shall mean a right to sell a specified underlying security or securities within a specified period of time and at an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise, that may be sold, transferred or assigned only with the underlying security or securities.
- (18) “Refunded Security” shall mean a debt security the principal and interest payments of which are to be paid by Government Securities (“deposited securities”) that have been irrevocably placed in an escrow account pursuant to agreement between the issuer of the debt security and an escrow agent that is not an affiliated person, as defined in Section 2(a)(3)(c) of the Act [15 U.S.C. 80a-2(a)(3)(c)], of the issuer of the debt security, and, in accordance with such escrow agreement, are pledged only to the payment of the debt security and, to the extent that excess proceeds are available after all payments of principal, interest, and applicable premiums on the Refunded Securities, the expenses of the escrow agent; provided that:
- (i) The deposited securities shall not be redeemable prior to their final maturity;
  - (ii) At the time the deposited securities are placed in the escrow account, an independent certified public accountant or an NRSRO shall have certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities; and
  - (iii) The escrow agreement shall prohibit the substitution of the deposited securities unless the substituted securities are Government Securities and, at the time of such substitution, the escrow agent shall have received a certification substantially the same as that required by paragraph (a)(18)(ii) of this section which certification shall give effect to the substitution.
- (19) “Requisite NRSROs” shall mean:
- (i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer, or
  - (ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund purchases or rolls over the security, that NRSRO.
- (20) “Second Tier Security” shall mean any Eligible Security that is not a First Tier Security.
- (21) “Short-term” shall mean having a remaining maturity of 366 days or less.
- (22) “Single State Fund” shall mean a Tax Exempt Fund that holds itself out as primarily distributing income exempt from the income taxes of a specified state or locality.
- (23) “Standby Commitment” shall mean a Put that entitles the holder to achieve same day settlement and to receive an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise.

- (24) “Tax Exempt Fund” shall mean any money market fund that holds itself out as distributing income exempt from regular federal income tax.
- (25) “Total Assets” shall mean, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.
- (26) An “Unconditional Demand Feature” shall mean an Unconditional Put that is also a Demand Feature.
- (27) An “Unconditional Put” shall mean a Put, any guarantee, or letter of credit or similar unconditional credit enhancement that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.
- (28) “United States Dollar-Denominated” shall mean, with reference to a security, that all principal and interest payments on such security are payable to security holders in United States dollars under all circumstances and that the interest rate of, the principal amount to be repaid, and the timing of payments related to such security do not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars.
- (29) An “Unrated Security” shall mean:
- (i) A security with a remaining maturity of 397 days or less issued by an issuer that did not, at the time it was acquired or rolled over by the fund, have a current short-term rating assigned by any NRSRO:
    - (A) To the security, or
    - (B) To the issuer of the security with respect to a class of Short-term debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security, or a Demand Feature with respect to the security; and
  - (ii) A security:
    - (A) That at the time of issuance was a Long-term debt obligation but that has a remaining maturity of 397 calendar days or less, and
    - (B) Whose issuer had not at the time it was acquired or rolled over by the fund received from any NRSRO a rating with respect to a class of Short-term debt obligations (or any debt obligation within that class) that now is comparable in priority and security with the security; and
  - (iii) A security that is a rated security and is the subject of an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security (or the issuer) was assigned its rating unless the security has a rating from an NRSRO reflecting the existence of the credit support agreement.
  - (iv) A security is not an Unrated Security if any Short-term debt obligation (“reference security”) that is issued by the same issuer and is comparable in priority and security with that security is rated by an NRSRO. The status of such security as an Eligible Security or First Tier Security shall be the same as that of the reference security.
- (30) A “Variable Rate Security” shall mean a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and which, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its par value.
- (b) Holding Out. It shall be an untrue statement of material fact within the meaning of Section 34(b) of the Act [15 U.S.C. 80a-33(b)] for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act [15 U.S.C. 80a-24(b)] to:

(1) Adopt the term “money market” as part of its name or title or the name or title of any redeemable securities of which it is the issuer, or

(2) Hold itself out to investors as, or adopt a name which suggests that it is, a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this Section. For purposes of this paragraph, a name which suggests that a registered investment company is a money market fund or the equivalent thereof shall include one which uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) Share Price Calculations. The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund”), notwithstanding the requirements of Section 2(a)(41) of the Act [15 U.S.C. 80a-2(a)(41)] and of §§ 270.2a-4 and 270.22c-1 thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; Provided, however, That:

(1) Board Findings. The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.

(2) Portfolio Maturity. The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; Provided, however, That the money market fund will not:

(i) Except as provided in paragraph (c)(2)(ii) of this section, purchase any instrument with a remaining maturity of greater than 397 calendar days, or

(ii) In the case of a money market fund not using the Amortized Cost Method, purchase a Government Security with a remaining maturity of greater than 762 calendar days; or

(iii) Maintain a dollar-weighted average portfolio maturity that exceeds ninety days.

(3) Portfolio Quality. The money market fund shall limit its portfolio investments, including Puts and repurchase agreements, to those United States Dollar-Denominated securities that its board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to the rating assigned to such securities by an NRSRO) and which are at the time of acquisition Eligible Securities and, in the case of a Single State Fund, First Tier Securities. For purposes of this section:

(i) A security that is subject to an Unconditional Demand Feature may be determined to be an Eligible Security or a First Tier Security based solely on whether the Unconditional Demand Feature is an Eligible Security or First Tier Security, as the case may be; and

(ii) A security that is subject to a Conditional Demand Feature may be determined to be an Eligible Security or a First Tier Security only if:

(A) the Conditional Demand Feature is an Eligible Security or First Tier Security, as the case may be, and,

(B) the security (or the Long-term debt securities of the issuer of the security subject to the Conditional Demand Feature) has been rated by the Requisite NRSROs in one of the two highest rating categories for Long-term debt obligations (within which there may be sub-categories or gradations indicating relative standing), or, if unrated, are determined to be of comparable quality by the money market fund’s board of directors.

(4)(i) Portfolio Diversification: Taxable Funds.

(A) Immediately after the acquisition of any security (other than a Government Security), a money market fund that is not a Tax Exempt Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer

of the security; Provided, however, That a money market fund may invest more than five percent of its Total Assets in the First Tier Securities of a single issuer for a period of up to three Business days after the purchase thereof; Provided, further, That such investments made by the money market fund in accordance with the foregoing proviso at any time may not exceed twenty-five percent of the money market fund's Total Assets; and

(B) In the event that such security is a Second Tier Security, the money market fund shall not have invested more than:

(1) The greater of one percent of its Total Assets or one million dollars in securities issued by that issuer which when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Securities, and

(2) Five percent of its Total Assets in securities which, when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Securities.

(ii) Portfolio Diversification: National Funds.

(A) Immediately after the acquisition of any security (other than a Government Security), a Tax Exempt Fund that is not a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security, Provided, however, That a fund may invest more than five percent of its Total Assets in the First Tier Securities of a single issuer for a period of up to three Business days after the purchase thereof; Provided, further, That such investments made by the money market fund in accordance with the foregoing proviso at any time may not exceed twenty-five percent of the fund's Total Assets;

(B) In the event that such security is a Second Tier Security that is a Conduit Security, the money market fund shall not have invested more than:

(1) The greater of one percent of its Total Assets or one million dollars in securities issued by that issuer which, when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Securities, and

(2) Five percent of its Total Assets in securities which, when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Securities that are Conduit Securities.

(iii) Portfolio Diversification: Puts. Immediately after the acquisition of any Put or security subject to a Put, no more than ten percent of the money market fund's Total Assets may be invested in securities issued by or subject to Puts from the institution that issued such Put. In addition, if at the time of its acquisition, such Put (or the security, after giving effect to the Put) was a Second Tier Security, the fund shall not, after giving effect to the acquisition of such Put, have invested more than five percent of its Total Assets in securities issued by or subject to Puts from the institution that issued such Put.

(iv) Portfolio Diversification: Certain Calculations. For purposes of making calculations under this paragraph (c)(4):

(A) The acquisition of a repurchase agreement which provides for the repurchase of underlying securities at a date certain not later than one year after the purchase of the underlying securities may be deemed to be an acquisition of the underlying securities, provided that the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully;

(B) The acquisition of a Refunded Security shall be deemed to be an acquisition of a Government Security, provided that the fund has not invested more than twenty-five percent of its assets in the Refunded Securities of a single issuer;

(C) A Conduit Security shall be deemed to be issued by the person ultimately responsible for payments of interest and principal on the security;

(D) If a security is subject to Puts from more than one institution, the diversification requirements of paragraph (c)(4)(iii) of this section shall be satisfied as to each institution and each institution shall be deemed to have guaranteed the entire principal amount of the security unless the obligation of the institution is otherwise limited (except as provided in paragraph (c)(4)(iv)(F) of this section);



(E) The acquisition of an Asset Backed Security shall be deemed to be an acquisition of the securities comprising the Qualifying Assets unless the Qualifying Assets consist of securities issued by more than ten issuers, in which case it shall be deemed to be an acquisition of a security issued by the institution that deposited the assets in the Special Purpose Entity that issued the Asset Backed Security; and

(F) Each institution providing a credit enhancement with respect to an Asset Backed Security (whether the enhancement consists of a Put, a line of credit or an obligation to maintain specified levels of collateral) shall be deemed to be the issuer of a Put with respect to the entire principal amount of the Asset Backed Security.

(v) A money market fund substantially all of the assets of which consist of shares of another money market fund acquired in reliance on Section 12(d)(1)(E) of the Act [15 U.S.C. 80a-12(d)(1)(E)] shall be deemed to be in compliance with this section if the board of directors reasonably believes that the money market fund in which it has invested is in compliance therewith.

(vi) A money market fund that satisfies the applicable diversification requirements of paragraph (c)(4) of this section shall be deemed to have satisfied the diversification requirements of Section 5(b)(1) of the Act [15 U.S.C. 80a-5(b)(1)] and the rules promulgated thereunder.

(5) (i) Downgrades.

(A) In the event that:

(1) a portfolio security of a money market fund (other than a Single State Fund) ceases to be a First Tier Security (either because it no longer has the highest rating from the Requisite NRSROs or, in the case of an Unrated Security, the board of directors of the money market fund determines that it is no longer of comparable quality to a First Tier Security), or

(2) the money market fund's investment adviser (or any person to whom the money market fund's board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated Security or Second Tier Security held by the money market fund has, since the security was acquired by the fund, been given a rating by any NRSRO below the NRSRO's second highest rating category, the board of directors of the money market fund shall reassess promptly whether such security presents minimal credit risks and shall cause the money market fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders.

(B) The reassessments required by paragraph (c)(5)(i)(A) of this section shall not be required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five Business days of the specified event and, in the case of events specified in paragraph (c)(5)(i)(A)(2) of this section, the board is subsequently notified of the adviser's actions.

(C) In the event that after giving effect to a rating downgrade, more than five percent of the fund's Total Assets are invested in securities issued by or subject to Demand Features from a single institution that are Second Tier Securities, the board of directors shall cause the fund to reduce its investment in securities issued by or subject to Demand Features from that institution to five percent of its Total Assets by exercising the Demand Features at the next succeeding exercise date(s).

(ii) Defaults and Other Events. In the event:

(A) Of a default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(B) A portfolio security of a money market fund ceases to be an Eligible Security or, in the case of a Single State Fund, a First Tier Security;

(C) It has been determined that a portfolio security no longer presents minimal credit risks;

(D) Of an Event of Insolvency with respect to the issuer of or the provider of any Put with respect to a portfolio security; or

(E) The fund is unable to obtain the information specified by paragraphs (c)(6)(ii)(E) or (c)(7)(ii)(B) of this section concerning the issuer of a security subject to an Unconditional Demand Feature prior to the last time that the Unconditional Demand Feature can be exercised or upon the occurrence of a significant adverse change in the credit quality of the issuer of the Unconditional Demand Feature; absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security), the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise.

(iii) Notice to the Commission. In the event of a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Put to which it is subject, where immediately before default the securities (or the securities subject to the Put) accounted for  $\frac{1}{2}$  of 1 percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically or by means of a facsimile transmission, followed by letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management.

(iv) Defaults for Purposes of Paragraphs (c)(5)(ii) and (iii). For purposes of paragraphs (c)(5)(ii) and (iii) of this section, an instrument subject to a Demand Feature or unconditional credit enhancement shall not be deemed to be in default (and an Event of Insolvency with respect to the security shall not be deemed to have occurred) if:

(A) in the case of an instrument subject to a Demand Feature, the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest, or

(B) the provider of the credit enhancement is continuing to make payments as due on the instrument without protest.

(6) Required Procedures: Amortized Cost Method. In the case of a money market fund using the Amortized Cost Method:

(i) In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) Included within the procedures adopted by the board of directors shall be the following:

(A) Written procedures providing that the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute which reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions; periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and maintenance of records of the determination of deviation and the board's review thereof; and

(B) In the event such deviation from the money market fund's amortized cost price per share exceeds  $\frac{1}{2}$  of 1 percent, a requirement that the board of directors shall promptly consider what action, if any, should be initiated by the board of directors; and

(C) Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results; and

(D) In the case of a security for which maturity is determined by reference to a Demand Feature, written procedures requiring ongoing review of the security's continued minimal credit risks, which review must be based on, among other things, financial data for the most recent fiscal year of the issuers of the Demand Feature and, in the case of a security subject to a Conditional Demand Feature, the security, whether publicly available or provided under the terms of the security's governing documentation; and

(E) In the case of a security subject to an Unconditional Demand Feature, written procedures designed to assure that the fund has access to sufficient financial and other information concerning the issuer of the security subject to the Demand Feature to permit the fund to perform a credit analysis of the issuer:

(1) in the event of a significant adverse change in the credit quality of the issuer of the Unconditional Demand Feature; and

(2) prior to the last time that the Demand Feature can be exercised or the expiration of any letter of credit or other credit enhancement securing the Demand Feature, unless the credit enhancement will be timely substituted for or renewed in a manner that preserves the security's eligibility for purposes of this section; and

(F) In the case of a Variable Rate or Floating Rate Security that does not have a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1) or (d)(2) of this section, written procedures requiring periodic review of whether the security, upon readjustment of its interest rate, can reasonably be expected to have a market value that approximates its par value.

(7) Required Procedures: Penny-Rounding Method. (i) In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.

(ii) The board of directors shall also

(A) In the case of a security for which maturity is determined by reference to a Demand Feature, adopt written procedures requiring ongoing review of the security's continued minimal credit risks, which review must be based on, among other things, financial data for the most recent fiscal year of the issuers of the Demand Feature and, in the case of a security subject to a Conditional Demand Feature, the security, whether publicly available or provided under the terms of the security's governing documentation;

(B) In the case of a security subject to an Unconditional Demand Feature, adopt written procedures designed to assure that the fund has access to sufficient financial and other information concerning the issuer of the security subject to the Demand Feature to permit the fund to perform a credit analysis of the issuer:

(1) in the event of a significant adverse change in the credit quality of the issuer of the Unconditional Demand Feature; and

(2) prior to the last time that the Demand Feature can be exercised or the expiration of any letter of credit or other credit enhancement securing the Demand Feature, unless the credit enhancement will be timely substituted for or renewed in a manner that preserves the security's eligibility for purposes of this section; and

(C) In the case of a Variable Rate or Floating Rate Security that does not have a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1) or (d)(2) of this section, adopt written procedures requiring periodic review of whether the security, upon readjustment of its interest rate, can reasonably be expected to have a market value that approximates its par value.

(8) Record Keeping and Reporting. The money market fund will record, maintain, and preserve:

- (i) For a period of not less than six years following the replacement of such procedures with new procedures (the first two years in an easily accessible place), a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(5), (c)(6), (c)(7) and (e) of this section;
- (ii) For a period of not less than six years (the first two years in an easily accessible place) a written record of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth above, to be included in the minutes of the board of directors' meetings;
- (iii) For a period of not less than three years from the date of the acquisition of a portfolio security (or the date that the credit risks of a portfolio security were most recently reviewed in accordance with paragraph (c)(6)(ii)(D) or (c)(7)(ii)(A) of this section), in an easily accessible place, a written record of the determination that a portfolio security presents minimal credit risks and the NRSRO ratings (if any) used to determine the status of the security as an Eligible Security, First Tier Security or Second Tier Security;
- (iv) For a period of not less than three years from the date of the acquisition of a portfolio security, in an easily accessible place, a written record of the determination required by paragraphs (c)(6)(ii)(F) or (c)(7)(ii)(C) of this section that a Variable Rate or Floating Rate Security that does not have a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1) or (d)(2) of this section can reasonably be expected, upon readjustment of its interest rate at all times during the life of the instrument, to have a market value that approximates its par value;
- (v) For a period of not less than three years from the date of the acquisition of an Asset Backed Security the Qualifying Assets of which are comprised of the securities of ten or fewer issuers, in an easily accessible place, a written record of the identities of the issuers of the Qualifying Assets and the percentage of the Qualifying Assets constituted by the securities of each such issuer and the percentage of the fund's Total Assets that are invested in securities of each issuer of Qualifying Assets.

The documents preserved pursuant to this paragraph (c)(8) shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act [15 U.S.C. 80a-30(b)] as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act [15 U.S.C. 80a-30(a)]. If any action was taken under paragraphs (c)(5)(ii) (with respect to defaulted securities) or (c)(6)(ii)(B) of this section, the money market fund will attach an exhibit to the Form N-SAR [17 CFR 274.101] filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

(d) Maturity of Portfolio Securities. For the purposes of this section, the maturity of a portfolio security shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, except that:

- (1) A Government Security which is a Variable Rate Security where the variable rate of interest is readjusted no less frequently than every 762 days shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate. A Government Security which is a Floating Rate Security shall be deemed to have a remaining maturity of one day.
- (2) A Variable Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity equal to the earlier of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.
- (3) A Variable Rate Security, the principal amount of which is scheduled to be paid in more than 397 days, that is subject to a Demand Feature shall be deemed to have a maturity equal to longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) A Floating Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity of one day.

(5) A Floating Rate Security, the principal amount of which is scheduled to be paid in more than 397 days, that is subject to a Demand Feature shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(6) A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where no date is specified, but the agreement is subject to a demand, the notice period applicable to a demand for the repurchase of the securities.

(7) A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where no date is specified, but the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(8) An investment in a money market fund shall be treated as having a maturity equal to the period of time within which the acquired money market fund is required to make payment upon redemption, unless the acquired money market fund has agreed in writing to provide redemption proceeds to the investing money market fund within a shorter time period, in which case the maturity of such investment shall be deemed to be the shorter period.

(e) Delegation. The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (c)(1), (c)(5)(i)(A)(2), (c)(5)(ii), (c)(6)(i), (c)(6)(ii)(A), (B), and (C), and (c)(7)(i) of this section) provided that the board:

(1) Establishes and periodically reviews written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this section) and procedures under which the delegate makes such determinations; and

(2) Exercises adequate oversight (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security that requires notification of the Commission under paragraph (c)(5)(iii) of this section) to assure that the guidelines and procedures are being followed.

7. Section 270.2a41-1 is amended by revising paragraph (a) to read as follows:

§ 270.2a41-1 Valuation of standby commitments by registered investment companies.

(a) A standby commitment as defined in § 270.2a-7(a)(23) may be assigned a fair value of zero, Provided, That:

8. Section 270.12d3-1 is amended by revising paragraph (d)(7)(v) to read as follows:

§ 270.12d3-1 Exemption of acquisitions of securities issued by persons engaged in securities related businesses.

(d) \* \* \*

(7) \* \* \*

(v) Acquisition of Puts, as defined in § 270.2a-7(a)(17), provided that, immediately after the acquisition of any Put:

(A) in the case of a company (other than a money market fund), the company will not, with respect to 75 percent of the total value of its assets, have invested more than ten percent of the total value of its assets in securities underlying Puts from the same institution and;

(B) in the case of a money market fund, no more than ten percent of the total value of its assets may be invested in securities issued by or subject to Puts from the same institution.

For the purposes of this section, a Put will be considered to be from the party to whom the company will look for payment of the exercise price.

9. Section 270.17a-9 is added to read as follows:

§ 270.17a-9 Purchase of certain securities from a money market fund by an affiliate, or an affiliate of an affiliate.

The purchase of a security that is no longer an Eligible Security (as defined in paragraph (a)(9) of § 270.2a-7) from an open-end investment company holding itself out as a “money market” fund by an affiliated person of the company, or any affiliated person of such a person, shall be exempt from Section 17(a) of the Act [*15 U.S.C. 80a-17(a)*], provided that:

(a) the purchase price is paid in cash; and

(b) 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).

10. Section 270.31a-1 is amended by adding a sentence to the end of paragraph (b)(1) to read as follows:

§ 270.31a-1 Records to be maintained by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.

(b) \* \* \*

(1) \* \* \* In the case of a money market fund, also identify the provider of any put (as defined in § 270.2a-7(a)(17)) or guarantee with respect to a portfolio security and give a brief description of the nature of the put (e.g., unconditional demand feature, conditional demand feature, guarantee, letter of credit, or bond insurance) and, in a subsidiary portfolio investment record, provide the complete legal name and accounting and other information (including sufficient information to calculate coupons, accruals, maturities, puts, and calls) necessary to identify, value, and account for each investment.

## **Part 239—Forms Prescribed Under the Securities Act of 1933**

### **Part 274—Forms Prescribed Under the Investment Company Act of 1940**

11. The authority citation for part 239 continues to read, in part, as follows:

Authority: *15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-29, 80a-30 and 80a-37*, unless otherwise noted.

12. The authority citation for Part 274 continues to read as follows:

Authority: *15 U.S.C. 80a-1, et seq.*, unless otherwise noted.

NOTE: The following Forms and Guides do not and the amendments will not appear in the Code of Federal Regulations.

13. Form N-1A (§ 239.15A and § 274.11A) is amended by adding a sentence and an Instruction to the end of paragraph (c) of Part A, Item 4 to read as follows:

## **FORM N-1A**

### **PART A INFORMATION REQUIRED IN A PROSPECTUS**

Item 4. General Description of Registrant

(c) \* \* \* In the case of a Registrant that holds itself out as a money market fund primarily distributing income exempt from the income taxes of a specified state or locality (“single state fund”), a prominent statement that (1) the registrant is concentrated in securities issued by the state or entities within the state and (2) the registrant may invest a significant percentage of its assets in a single issuer, and that therefore investment in the Registrant may be riskier than an investment in other types of money market funds.

Instruction: The disclosure required for money market funds by Item 4(c) may be modified if the registrant limits investment in a single issuer to five percent of fund assets as to 100 percent of assets.

14. Form N-3 [17 CFR 239.17a and 274.11b] is amended by adding Instruction 11.e. to Part A, paragraph (a) of Item 4 to read as follows:

## FORM N-3

### PART A INFORMATION REQUIRED IN A PROSPECTUS

#### Item 4. Condensed Financial Information

(a) \* \* \*

#### Instructions

11. The portfolio turnover rate to be shown at caption 10 shall be calculated as follows:

e. A registrant that holds itself out as a money market fund is not required to provide a portfolio turnover rate in response to this Item.

15. Form N-SAR [17 CFR 274.101] is amended by revising the definition of “Money Market Fund” in General Instruction G to read as follows:

## FORM N-SAR

### GENERAL INSTRUCTIONS

#### G. Definitions

Money Market Fund: The term “money market fund” means any open-end investment company that maintains a stable price per share and holds itself out as a “money market fund.”

16. Form N-SAR [17 CFR 274.101] is amended by revising the last sentence of the Instruction to Item 63 to read as follows:

## FORM N-SAR

#### Instructions to Specific Items

ITEM 63: Dollar weighted average maturity

\* \* \* A money market fund shall make this calculation in the same manner as it would in monitoring compliance with the average portfolio maturity provisions of Rule 2a-7 under the Act.

17. Form N-SAR [17 CFR 274.101] is amended by adding a sentence at the end of the first paragraph of the Instruction to Item 71 to read as follows:

## FORM N-SAR

#### Instructions to Specific Items

## ITEM 71: Portfolio turnover rate

\* \* \* A money market fund should enter a portfolio turnover rate of “0” even if it owns securities that have maturities in excess of one year.

18. Guide 21 (Disclosure of Risk Factors) to Form N-1A [§§ 239.15A and 274.11A] is amended by adding a paragraph to the end of the Guide to read as follows:

## Guide 21. Disclosure of Risk Factors

In many cases, a substantial portion of the portfolio securities held by tax exempt money market funds is supported by credit and liquidity enhancements from third parties, generally letters of credit from foreign or domestic banks. These securities include variable rate demand notes, tender or “put” bonds and similar securities. Where more than forty percent of a money market fund registrant’s portfolio consists, or is likely to consist, of securities subject to these features, the registrant should, in response to Item 4, state that the credit quality of the securities in its portfolio is largely based on letters of credit and other arrangements with foreign and domestic banks and other financial institutions, that these arrangements are not necessarily subject to federal deposit insurance, and that adverse developments in the banking industry could have a significant negative effect on the credit quality of the registrant’s portfolio securities and the registrant’s ability to maintain a stable net asset value and share price.

19. Guide 34 is added to Form N-1A [*17 CFR 239.15A and 274.11A*] to read as follows:

## Guide 34. Money Market Fund Investments in Other Money Market Funds.

Money market funds are permitted to invest in the securities of other money market funds in accordance with the provisions of Rule 2a-7 and Section 12(d)(1) of the 1940 Act. Except when a fund has invested substantially all of its assets in the other money market fund, the investing fund does not need to “look through” the shares of the fund(s) in which it is investing in order to determine compliance with the diversification or Second Tier Security limitations of Rule 2a-7.<sup>1</sup> However, the investment objectives and policies of the money market fund making the investment and the money market fund(s) in which it is investing should not be inconsistent. Paragraph (c)(4)(v) of Rule 2a-7 describes the obligations of a fund that invests substantially all of its asset in another money market fund.

20. Guide 38 is added to Form N-3 to read as follows:

## Guide 38. Money Market Fund Investments in Other Money Market Funds

Money market funds are permitted to invest in the securities of other money market funds in accordance with the provisions of Rule 2a-7 and Section 12(d)(1) of the 1940 Act. Except when a fund has invested substantially all of its assets in the other money market fund, the investing fund does not need to “look through” the shares of the fund(s) in which it is investing in order to determine compliance with the diversification or Second Tier Security limitations of Rule 2a-7.<sup>2</sup> However, the investment objectives and policies of the money market fund making the investment and the money market fund(s) in which it is investing should not be inconsistent. Paragraph (c)(4)(v) of Rule 2a-7 describes the obligations of a fund that invests substantially all of its assets in another money market fund.

By the Commission.

Jonathan G. Katz

Secretary

December 17, 1993

<sup>1</sup> See Letter to Investment Company Registrants from the Division of Investment Management (Feb. 22, 1993).

<sup>2</sup> See Letter to Investment Company Registrants from the Division of Investment Management (Feb. 22, 1993).



## ADOPTION OF REVISIONS TO RULES REGULATING MONEY MARKET FUNDS

Release Nos. 33-7275; IC-21837

March 21, 1996

AGENCY: Securities and Exchange Commission

ACTION: Final Rules

**SUMMARY:** The Commission is adopting amendments to rules and forms under the Securities Act of 1933 and the Investment Company Act of 1940 that govern money market funds. The amendments tighten the risk-limiting conditions imposed on tax exempt money market funds by Rule 2a-7 under the Investment Company Act of 1940; impose additional disclosure requirements on tax exempt funds; and make certain other changes applicable to all money market funds. The amendments are designed to reduce the likelihood that a tax exempt fund will not be able to maintain a stable net asset value.

**EFFECTIVE DATE:** June 3, 1996. Several different compliance dates apply to the amendments. For specific compliance dates for particular amendments, see Section V. of this Release.

**FOR FURTHER INFORMATION CONTACT:** Martha H. Platt, Senior Attorney, (202) 942-0725, or Kenneth J. Berman, Assistant Director, Office of Regulatory Policy, (202) 942-0690, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Requests for formal interpretive advice should be directed to the Office of Chief Counsel (202) 942-0659, Division of Investment Management, 450 Fifth Street, N.W., Washington, D.C. 20549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (“Commission”) is adopting amendments to Rule 2a-7 [17 CFR 270.2a-7] (“Rule 2a-7” or the “rule”) under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] (“1940 Act”), the rule governing the operations of money market funds (“money funds” or “funds”).<sup>3</sup> The Commission is also adopting a new rule, Rule 17a-9 under the 1940 Act [17 CFR 270. 17a-9], and amendments to the following rules and forms: Rule 134 under the Securities Act of 1933 [17 CFR 230.134]; Rules 2a41-1, 12d-3 and 31a-1 under the 1940 Act [17 CFR 270.2a-41-1, 270.12d3-1, and 270.31a-1]; Form N-1A [17 CFR 239.15A and 274.11A]; Form N-3 [17 CFR 239.17a and 274.11b]; and Form N-SAR [17 CFR 274.101]. The Commission is also publishing three new or revised staff guides to Forms N-1A and N-3 that do not appear in the Code of Federal Regulations.

### Executive Summary

The Commission is adopting amendments to Rule 2a-7 under the 1940 Act, the rule that governs the operations of money funds. The primary purpose of the amendments is to tighten the risk-limiting conditions of the rule applicable to tax exempt money funds and thereby reduce the likelihood that a tax exempt fund will not be able to maintain a stable net asset value. The amendments also affect taxable money funds in certain respects.

In addition, the Commission is adopting revisions to the prospectus disclosure requirements for tax exempt money funds and a new rule exempting certain transactions from the 1940 Act’s limitations on affiliated transactions. In considering these amendments, the Commission has made changes from the proposal designed to simplify compliance with the rule while retaining the degree of flexibility necessary for money funds to operate in accordance with their investment objectives. A brief summary of the rule amendments is provided below.

### Issuer Diversification and Quality Standards

The amendments extend the rule’s diversification requirements to tax exempt funds. A “national” tax exempt fund is limited to investing no more than five percent of its assets in securities of a single issuer (other than Government securities) (the “Five Percent Diversification Test”). A “single state” tax exempt fund is subject to the same limitation but only with respect to seventy-five percent of its assets; the remaining twenty-five percent of a single state fund’s

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<sup>3</sup> Unless otherwise noted, all references to Rule 2a-7, as amended, or any paragraph of the rule, will be to 17 CFR 270.2a-7 as amended by this Release.

assets (“twenty-five percent basket”) may be invested in securities of one or more issuers, provided that they are “first tier securities,” as the term is defined in the rule. A tax exempt fund is limited to investing five percent of its assets in “second tier securities” that are “conduit securities,” as these terms are defined in the rule, with investment in the conduit securities of any one issuer limited to one percent of fund assets. To provide an additional element of flexibility, a security subject to an “unconditional demand feature issued by a non-controlled person,” as defined in the rule, will be subject only to the rule’s put diversification requirements.

### **Diversification and Quality Standards Applicable to Providers of Puts and Demand Features**

The amendments provide that a fund cannot, with respect to seventy-five percent of its assets, invest more than ten percent of its assets in securities subject to puts from, or directly issued by, the same institution. The remaining twenty-five percent of a fund’s assets (“twenty-five percent put basket”) may be subject to puts from, or directly issued by, one or more institutions, provided that the puts are first tier securities. A fund may not invest more than five percent of its assets in securities subject to puts that are second tier securities.

As proposed, a demand feature is an “eligible security” (as defined in the rule) only if the demand feature (or its issuer) has received a short-term rating from a nationally recognized statistical rating organization (“NRSRO”). A conditional demand feature is an eligible security if the limitations on its exercise can be readily monitored by the fund’s board of directors (or its delegate). The amendments as adopted, however, do not specify the conditions that may be included in a conditional demand feature.

### **Asset Backed Securities and “Synthetic” Securities**

The amendments clarify the credit quality, diversification and maturity determination standards applicable to synthetic and asset backed securities (“ABSs”). Among other things, an ABS must have a rating from a NRSRO to be eligible for fund investment.

### **Interest Rate Risk Analysis**

The amendments also clarify that floating rate and variable rate securities (“adjustable rate securities”) must reasonably be expected to have market values that approximate their amortized cost values on each interest rate adjustment date through their final maturity dates. The amendments require funds to review periodically whether such securities can reasonably be expected to have market values that approximate their amortized cost values upon readjustment of their interest rates.

### **Exemptive Rule**

The Commission is adopting Rule 17a-9 under the 1940 Act to permit (but not require) an affiliate of a fund to purchase from the fund securities that are no longer eligible securities at the higher of their amortized cost values (including accrued interest) or market values, without having to obtain a Commission order.

## **I. Background**

Money funds are open-end management investment companies registered under the 1940 Act that have as their investment objective generation of income and preservation of capital and liquidity through investment in short-term, high quality securities. More than \$775 billion in assets is currently invested in approximately 25 million money fund shareholder accounts.<sup>4</sup> Approximately sixteen percent of money fund assets (\$127 billion) are held by funds that have as their principal objective distribution of income exempt from federal income taxes (“tax exempt funds”).<sup>5</sup> Approximately one third of the assets held by tax exempt funds (\$43 billion) are held by funds that seek to distribute income that is also exempt from the income taxes of a specific state or locality (“single state funds”).<sup>6</sup> The balance is held by funds that do not limit their investments to securities exempt from the income taxes of a specific state (“national funds”).

<sup>4</sup> IBC’s Money Fund Report at 2, Dec. 29, 1995 (“Money Fund Report”); Investment Company Institute Mutual Fund Fact Book at 58-59 (35th ed.1995). For a summary of the development of money funds, which were first introduced in the early 1970s, *See* Investment Company Act Rel. No. 17589 (July 17, 1990) [55 FR 30239 (July 25, 1990)] (“Release 17589”) at nn.3-7 and 15-18 and accompanying text.

<sup>5</sup> Money Fund Report, *supra* note 2, at 2.

<sup>6</sup> Single state funds are currently available for sixteen states: Alabama, Arizona, California, Connecticut, Florida, Massachusetts, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Texas and Virginia. *Id.*

Unlike other investment companies, money funds seek to maintain a stable share price, typically \$1.00 per share. This stable share price of \$1.00 has encouraged investors to view investments in money funds as an alternative to either bank deposits or checking accounts, even though money funds lack federal deposit insurance, and there is no guarantee that money funds will maintain a stable share price.<sup>7</sup>

To maintain a stable share price, most money funds use the amortized cost method of valuation (“amortized cost method”)<sup>8</sup> or the penny-rounding method of pricing (“penny-rounding method”)<sup>9</sup> permitted by Rule 2a-7. The 1940 Act and applicable rules generally require investment companies to calculate current net asset value per share by valuing portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by, or under the direction of, the board of directors.<sup>10</sup> Rule 2a-7 exempts money funds from these provisions, but contains conditions designed to minimize the deviation between a fund’s stabilized share price and the market value of its portfolio.<sup>11</sup> If the deviation does become significant, the fund may be required to take certain steps to address the deviation, including selling and redeeming its shares at less than \$1.00 (“breaking a dollar”).<sup>12</sup>

In February 1991, the Commission amended Rule 2a-7 (the “1991 Amendments”)<sup>13</sup> to respond to developments in the commercial paper market since the rule was adopted in 1983.<sup>14</sup> Among other things, the 1991 Amendments permit funds to invest only in “eligible securities,” defined generally as securities that are rated in one of the highest two short-term

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<sup>7</sup> A money fund is required to disclose prominently on the cover page of its prospectus that: (1) the shares of the fund are neither insured nor guaranteed by the U.S. Government; and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of \$1.00 per share. *See, e.g.*, Item 1(vi) of Form N-1A. The prescribed legend must appear in money fund sales literature and advertisements as well. *See* paragraph (a) of Rule 34b-1 under the 1940 Act, and paragraph (a)(7) of Rule 482 under the Securities Act of 1933 (“1933 Act”).

<sup>8</sup> Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. Paragraph (a)(1) of Rule 2a-7, as amended.

<sup>9</sup> Share price is determined under the penny-rounding method by valuing securities at market value, fair value or amortized cost and rounding the per share net asset value to the nearest cent on a share value of a dollar, as opposed to the nearest one tenth of one cent. Paragraph (a)(15) of Rule 2a-7, as amended. *See also* Investment Company Act Rel. No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] (“Release 13380”) (adopting Rule 2a-7) at n.6, and Investment Company Act Rel. No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] (“Release 12206”) (proposing Rule 2a-7) at n.5

<sup>10</sup> *See* Section 2(a)(41) of the 1940 Act [15 U.S.C. 80a-2(a)(41)], together with Rules 2a-4 and 22c-1 [17 CFR 270.2a-4 and 270-22c-1]. *See also* Accounting Series Release No. 118 (Dec. 23, 1970 [35 FR 19986 (Dec. 31, 1970)]) (board may appoint persons to assist in determination of securities’ values).

<sup>11</sup> If shares are sold or redeemed based on a net asset value which has been either understated or overstated in comparison to the amount at which portfolio instruments could have been sold, the interests of either existing shareholders or new investors will be diluted. *See* Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Commerce, 76th Cong., 3d Sess. 136-138, 288 (1940), Report of the Staff of the Division of Investment Management of the Securities and Exchange Commission on the Regulation of Money Market Funds Before the Subcommittee on Financial Institutions of the Senate Committee on Banking, Housing, and Urban Affairs at 9 (Jan. 24, 1980), and Release 17589, *supra* note 2, at n.7.

<sup>12</sup> Paragraphs (c)(6) and (c)(7) of Rule 2a-7, as amended.

<sup>13</sup> Investment Company Act Rel. No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)] (“Release 18005”). The 1991 Amendments were proposed in Release 17589, *supra* note 2, and became effective on June 1, 1991.

<sup>14</sup> Before the 1991 Amendments, Rule 2a-7 permitted funds to invest in “high quality” securities, that is, securities that had received at least the second highest rating from one NRSRO. *See* Release 13380, *supra* note 7, at n.34. In the summer of 1989 and the spring of 1990, several taxable funds held approximately \$125 million in defaulted commercial paper issued by Mortgage and Realty Trust or Integrated Resources Inc.; in the fall of 1990 several funds held commercial paper issued by MNC Financial Corp. that was downgraded to below high quality, resulting in a significant decline in its market price. In all three cases, the commercial paper had the second highest rating from one NRSRO when purchased by the funds and thus was eligible for fund investment under Rule 2a-7 as then in effect. Shareholders of funds that held these commercial paper issues were not adversely affected, however, because each fund’s investment adviser purchased the paper from the funds at amortized cost or principal amount or otherwise agreed to indemnify the fund. *See* Release 17589, *supra* note 2, at n.18 and accompanying text.

rating categories by the “requisite NRSROs,”<sup>15</sup> or comparable unrated securities. Taxable funds must further limit their investments in the securities of any one issuer (other than Government securities<sup>16</sup>) to five percent of fund assets (“Five Percent Diversification Test”),<sup>17</sup> and limit fund investment in second tier securities<sup>18</sup> to no more than five percent of fund assets, with investment in the second tier securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars (“Second Tier Securities Tests”).<sup>19</sup>

The 1991 Amendments did not apply the Five Percent Diversification Test and the Second Tier Securities Tests to tax exempt funds.<sup>20</sup> At that time, the Commission concluded that most tax exempt funds could not satisfy these tests without substantially restructuring their portfolios and, perhaps, losing some of their tax advantages.<sup>21</sup> Single state funds were thought to present particular problems because they concentrate their investments in debt securities issued by a single state (or issuers located within that state), making diversification more difficult to achieve. After the adoption of the 1991 Amendments, the Commission closely examined the characteristics of short-term tax exempt securities, the markets in which they trade, and tax exempt fund portfolios to determine what, if any, revisions to Rule 2a-7 should be proposed to provide tax exempt fund investors with protections similar to those afforded taxable fund investors by the 1991 Amendments.

The results of the Commission’s examination of the tax exempt markets were reflected in amendments to Rule 2a-7 that were proposed for comment on December 17, 1993 (“Proposing Release”).<sup>22</sup> A primary objective of the proposed amendments was to tighten the diversification and portfolio quality standards applicable to tax exempt funds to make them more similar to the standards applicable to taxable funds. The proposed diversification and quality standards for tax exempt funds took into account the different investment objectives and portfolio compositions of national funds and single state funds, and would have established different requirements for each type of tax exempt fund.

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<sup>15</sup> “Requisite NRSROs” are defined as: (1) any two NRSROs that have issued a rating with respect to an instrument or class of debt obligations of an issuer, or (2) if only one NRSRO has issued a rating with respect to such instrument or issuer at the time the fund purchases or rolls over the security, that NRSRO. Paragraph (a)(19) of Rule 2a-7, as amended. The term “NRSRO” is defined in paragraph (a)(14) of Rule 2a-7 to have the same meaning as in the Commission’s uniform net capital rule [17 CFR 240.15c3-1(c)(2)(vi)(E), (F) and (H)]. The Commission’s Division of Market Regulation responds to requests for NRSRO designation through no-action letters. Currently, the Division of Market Regulation has designated six NRSROs: Duff and Phelps, Inc., Fitch Investors Services, Inc., Moody’s Investors Service Inc., Standard & Poor’s Corp., and two specialized NRSRO’s: IBCA Limited and its subsidiary, IBCA Inc., which is recognized as a NRSRO only with respect to its ratings of debt issued by banks, bank holding companies, United Kingdom building societies, broker-dealers and broker-dealers’ parent companies, and bank-supported debt, and Thomson BankWatch, Inc., which is recognized as a NRSRO only with respect to ratings for debt issued by banks, bank holding companies, non-bank banks, thrifts, broker-dealers, and broker-dealers’ parent companies. In recognition of the expanded use of credit ratings in Commission rules, the Commission solicited comment on the process employed to designate rating agencies as NRSROs and the nature of the Commission’s oversight role with respect to NRSROs in a concept release issued in 1994. Exchange Act Rel. No. 34616 (Aug. 31, 1994) [59 FR 46314 (Sept. 7, 1994)].

<sup>16</sup> Under paragraph (a)(13) of Rule 2a-7, as amended, the term “Government Security” means those securities issued or guaranteed by the United States or its instrumentalities—the definition of that term given in Section 2(a)(16) of the 1940 Act [15 U.S.C. 80a-2(a)(16)]. It does not include securities issued or guaranteed by the state governments or instrumentalities. For a discussion of securities issued by government-sponsored enterprises (“GSEs”), see Joint Report on the Government Securities Market (Jan. 1992) at p. D-1.

<sup>17</sup> Paragraph (c)(4)(i) of Rule 2a-7, as amended. A limited exception is provided for certain securities held for not more than three business days. See *infra* Section II.D.4. of this Release.

<sup>18</sup> A “second tier security” is an eligible security that is not a “first tier security.” Paragraph (a)(20) of Rule 2a-7, as amended. A first tier security is generally a security that is rated by the requisite NRSROs in the highest rating category for short-term debt obligations, and comparable unrated securities. Paragraph (a)(11) of Rule 2a-7, as amended.

<sup>19</sup> Paragraph (c)(4)(iv)(A) of Rule 2a-7, as amended. The 1991 Amendments also shortened the maximum dollar-weighted portfolio maturity that a fund may maintain from 120 to ninety days, and codified the actions that a fund must take when certain events occur, including defaults and rating downgrades. See paragraphs (c)(2) and (c)(5) of Rule 2a-7, as amended. The 1991 Amendments also require that the cover page of fund prospectuses and certain fund advertisements and sales literature state prominently that investment in a fund is not guaranteed or insured by the U.S. Government and that there can be no assurance that a fund can maintain a stable net asset value per share. See Form N-1A, item 1(a)(vi); Form N-3, item 1(a)(ix); Rule 482(a)(7) under the 1933 Act [17 CFR 230.482(a)(7)]; and Rule 34b-1 under the 1940 Act [17 CFR 270.34b-1].

<sup>20</sup> Tax exempt funds continue to be subject to a diversification test with respect to puts, as they had been prior to the adoption of the 1991 Amendments. Paragraphs (c)(4)(v) and (c)(4)(vi)(B) of Rule 2a-7, as amended.

<sup>21</sup> Release 17589, *supra* note 2, at Section II.6.

<sup>22</sup> Investment Company Act Rel. No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] at Section I.A.

The Commission received comments on the proposed amendments from seventy-one commenters, including twelve municipal issuers, twenty-two mutual fund complexes, and nine professional and trade associations.<sup>23</sup> The comment letters reflect a wide variety of views on almost every topic discussed in the Proposing Release. A number of commenters, expressing a general concern over the complexity of the rule, urged that the rule's diversification and quality standards for taxable and tax exempt funds be as consistent with each other as practicable so that the rule would not become too complicated.

As part of its evaluation of the proposal, the Commission considered recent events in the markets for municipal securities that had a significant effect on money funds. One such event was the bankruptcy of Orange County, California, a large municipal issuer of short-term taxable and tax exempt notes.<sup>24</sup> At the time of Orange County's bankruptcy, a number of taxable and tax exempt funds held notes issued by either Orange County or municipalities that invested in investment pools managed by the Orange County treasurer ("Orange County notes"). While no fund holding Orange County notes has broken a dollar to date (in large part because of actions taken by their advisers to support the funds' share prices) the Orange County bankruptcy reinforced the need to amend rule 2a-7 to address issues unique to tax exempt funds.<sup>25</sup>

## II. Amendments to Rule 2a-7

### A. Preliminary Matters

The Commission is today adopting the second of two sets of amendments to Rule 2a-7 under the 1940 Act designed to tighten the risk-limiting conditions of the rule. These amendments primarily deal with tax exempt funds; they are intended to provide investors in tax exempt money market funds with protections similar to those provided to investors in taxable funds by the 1991 Amendments. The Commission believes that these amendments are necessary to provide greater assurance that tax exempt money market funds meet investors' expectations for safety and convenience by reducing the likelihood that these funds will not be able to maintain a stable net asset value using pricing procedures permitted by Rule 2a-7.

The amendments to Rule 2a-7 adopted in 1991, while not insulating funds from all events that could threaten their net asset values, appear to have reduced the riskiness of money market funds at a modest cost to money fund investors in terms of reduced yield.<sup>26</sup> The Commission acknowledges that none of its rules can eliminate completely the risk that a money market fund will break a dollar as a result of a decrease in value of one or more of its portfolio securities. Thus, in adopting these amendments, the Commission is prescribing minimum standards designed not to ensure that a fund will not break a dollar, but rather to require the management of funds in a manner consistent with the investment objective of maintaining a stable net asset value.

A money fund's board of directors has oversight responsibility for the sound management of the fund.<sup>27</sup> The fund's adviser is typically delegated responsibility for selecting appropriate investments for the fund. Rule 2a-7 requires that fund investments should be made in accordance with procedures "reasonably designed" to maintain a stable net asset

<sup>23</sup> The comment period for the Proposing Release was extended from April 6, 1994 to May 6, 1994. See Investment Company Act Rel. No. 20184 (Mar. 31, 1994) [59 FR 16576 (Apr. 7, 1994)]. The comment letters and a summary of the comments prepared by the Commission staff are included in File No. S7-34-93.

<sup>24</sup> On December 6, 1994, Orange County and investment pools managed by the Orange County treasurer ("Orange County Pools") filed for protection under chapter 9 of the Federal Bankruptcy Code [*11 U.S.C. 901 et seq.*]. The U.S. Bankruptcy Court for the Central District of California subsequently determined that the Orange County Investment Pools were not eligible to seek protection under chapter 9. See "Orange County, Mired in Investment Mess, Files for Bankruptcy," Wall St. J., Dec. 7, 1994 at A1, A6; Michael Utley, "Judge Rules Pool's Bankruptcy Filing Invalid, But Impact is Mostly Academic," Bond Buyer, May 26, 1995 at 1, 36.

<sup>25</sup> The Division of Investment Management addressed analogous issues raised by the Orange County bankruptcy in July 1991, when New Jersey regulators seized Mutual Benefit Life Insurance Company ("MBLI"). A number of securities held by tax exempt funds were subject to demand features provided by MBLI. After its seizure by the New Jersey insurance regulators, MBLI could not longer honor its obligations under the terms of the demand features it provided. Advisers to funds holding MBLI-backed securities took various actions to prevent shareholder losses that would have occurred had the funds been required to break a dollar. The advisers either repurchased the MBLI-backed instruments from the funds at their amortized cost or obtained a replacement guarantor.

<sup>26</sup> See "Has the SEC Reduced the Riskiness of Money Market Funds? An Assessment of the Recent Changes to Rule 2a-7," S. Collins and P. Mack (Nov. 1993)(study by economists for the Board of Governors of the Federal Reserve System of money fund data indicated decrease in risk and 20 basis point reduction in yields due to 1991 Amendments).

<sup>27</sup> See Investment Company Act Rel. No. 13380, *supra* note 7, at nn. 40-42 and accompanying text.

value or share price.<sup>28</sup> In addition, investments made in accordance with such procedures should be consistent with maintaining a stable net asset value or share price. Rule 2a-7 provides an analytical framework for fund advisers to follow when making such investment decisions, including decisions regarding new types of securities not specifically addressed by the rule, Commission releases, or staff interpretive letters. As the Commission stated in 1991, that a particular security is technically eligible for fund investment under Rule 2a-7 is not itself an adequate basis for an investment in the security.<sup>29</sup> For example, a number of money funds recently invested in certain structured notes that were Government securities on the asserted belief that the provisions of Rule 2a-7 dealing with adjustable rate Government securities would permit such an investment. When short-term interest rates increased in early 1994, the values of these securities decreased and many became illiquid.<sup>30</sup> These and other types of losses are more likely to be avoided if a fund has in place, and operates in accordance with, procedures designed to determine whether investment in the security is consistent not only with the technical requirements of Rule 2a-7, but with the rule's analytical framework and with the fund's investment objective of maintaining a stable net asset value.

In preparing these rules for adoption, the Commission has weighed carefully the need to provide a similar level of safety for investors in tax exempt and taxable money funds and the need, frequently expressed by fund commenters, to allow tax exempt funds sufficient flexibility to cope with a limited supply of high quality municipal securities. For example, while the amendments adopted today limit all funds to investing not more than five percent of assets in the securities of any one issuer, the amendments limit the application of this standard to only seventy-five percent of single state fund assets and exclude from the diversification requirements for all funds securities subject to certain types of demand features, refunding agreements, and issuer-provided puts.<sup>31</sup>

In response to comment letters, the Commission has simplified the operation of the rule in several respects. Where possible, the same provisions are applied to all types of funds, separate diversification tests for issuers of conditional and unconditional puts have been eliminated, and fund board involvement is no longer required regarding matters with which directors can be expected to have little expertise. Wherever possible, headings and cross-references have been added to the rule to assist a reader in understanding how its provisions interrelate.

## B. Portfolio Quality and Diversification

### 1. Five Percent Diversification Test

#### a. Application to Tax Exempt Funds

As discussed above, taxable funds are subject to the Five Percent Diversification Test, that is, no more than five percent of the total assets of a taxable money fund may be invested in securities of a single issuer. In proposing to extend diversification standards to tax exempt funds, the Commission took into account the differences between national and single state funds. Most national funds elect to meet the diversification requirements of Section 5(b)(1) of the 1940 Act,<sup>32</sup> and choose not to use the "twenty-five percent basket" (the portion of a diversified fund's assets that is not required to be diversified) to invest more than five percent of their assets in a single issuer. Most commenters, including most

<sup>28</sup> Paragraphs (c)(6)(i) and (c)(7) of Rule 2a-7, as amended.

<sup>29</sup> Release 18005, *supra* note 11, at Section II.A.

<sup>30</sup> See *infra* Section II.F.4.a. of this Release.

<sup>31</sup> See *infra* Sections II.B.1.b., II.C.1.c. and II.D.2. of this Release, and paragraphs (c)(4)(i) and (ii), (c)(4)(vi)(A)(2) and (c)(4)(vi)(B)(1) of Rule 2a-7, as amended.

<sup>32</sup> Section 5(b)(1) provides that a diversified investment company may not, with respect to seventy-five percent of its assets, invest more than five percent of its assets in instruments of any one issuer, other than cash, cash items, Government securities (as defined in Section 2(a)(16) of the 1940 Act [*15 U.S.C. 80a-2(a)(16)*]) and securities of other investment companies. The remaining twenty-five percent of its assets (the "twenty-five percent basket") may be invested in any manner. If an investment company invests more than five percent of its assets in a single issuer, the entire investment is placed in the twenty-five percent basket, and then aggregated with other investments that are greater than five percent to determine whether the fund is in compliance with Section 5(b)(1). The investment company may not invest more than twenty-five percent of its assets in a single issuer by splitting its investment into two lots between the twenty-five percent basket and the diversified portion of its portfolio. See Lybrand, Ross Bros. & Montgomery (Oct. 24, 1941) (pub. avail. Nov. 22, 1991). Section 5(b)(1) also prohibits a diversified fund, with respect to seventy-five percent of its assets, from investing in securities that comprise more than ten percent of the outstanding voting securities of an issuer.

mutual fund commenters, supported the extension of the Five Percent Diversification Test to national funds, which the Commission is adopting as proposed.<sup>33</sup>

Unlike national funds, many single state funds are not diversified under Section 5(b)(1), and could not satisfy the Five Percent Diversification Test because their investment objectives provide them with a much narrower range of high quality investment alternatives.<sup>34</sup> Although the Commission expressed concern about the risks involved in a non-diversified portfolio of a money fund, it was unclear to the Commission that it would be possible for single state funds to satisfy the Five Percent Diversification Test. Accordingly, the proposed amendments would not have required single state funds to comply with any issuer diversification test under the rule. To reduce the risks associated with a non-diversified portfolio, the Commission proposed to limit single state funds to investing in first tier securities, and proposed additional disclosure requirements to inform investors of the risks of an undiversified single state fund.<sup>35</sup> The Commission also asked commenters to consider whether single state funds should be required to satisfy a diversification standard under the rule.<sup>36</sup>

Most commenters supported the exception from the Five Percent Diversification Test for single state funds. Many of these commenters, however, opposed the proposed first tier securities restriction, and asserted that this requirement would exacerbate the supply problem without making funds more safe by forcing single state funds to be less diversified. Other commenters maintained that the rule should mandate some diversification with respect to single state funds, which they asserted present greater risks than other types of money funds. One commenter suggested that single state funds offering securities from “large” states should be subject to the same diversification standards as national funds. Another commenter went even further, stating that the rule should impose the diversification standards applicable to national funds to all single state funds. The views of these commenters, as well as the Commission’s experience in administering Rule 2a-7 since the amendments were proposed, have led the Commission to reconsider its proposal to exempt single state funds entirely from a diversification test.

In proposing the 1991 Amendments, the Commission noted that a fund’s ability to maintain a stable net asset value under the rule may be impaired to the extent it invests heavily in one or more issuers that subsequently experience credit problems or default on their securities.<sup>37</sup> The validity of that observation has been proven by many of the incidents of the past two years in which advisers to funds have taken steps to prevent the fund from breaking a dollar as a result of holding a distressed security.<sup>38</sup> In each case, the smaller the position, the less of an effect the distressed security had on the fund.

In the case of the bankruptcy of Orange County, most of the funds holding the notes held a fairly small portion of their assets in Orange County notes.<sup>39</sup> As a result, in some cases, the fund could maintain its share price without any assistance from the fund’s adviser; in other cases, the adviser was in a position to take steps to prevent the fund from breaking a dollar only because the fund’s Orange County Note position was relatively small. While, as the Commission has stated

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<sup>33</sup> Paragraph (c)(4)(i) of Rule 2a-7, as amended.

<sup>34</sup> Proposing Release, *supra* note 20, at Sections II.A. and II.A.2.

<sup>35</sup> Proposed amendments to Form N-1A would have required a single state fund to disclose in its prospectus risks related to lack of diversification. Proposing Release, *supra* note 20, at Section III.A.

<sup>36</sup> Proposing Release, *supra* note 20, at Section II.A.2.

<sup>37</sup> Release 17589, *supra* note 2, at Section II.1.

<sup>38</sup> Transactions of this type occurred within the last two years because funds held either long-term adjustable rate securities whose market values declined when short-term interest rates were increased, or notes issued by Orange County. Twenty-five advisers or related persons purchased adjustable rate securities from their funds at the securities’ amortized cost values to avoid any fund shareholder losses. Thirty-eight advisers or related persons either purchased Orange County notes from, or entered into credit support arrangements with their affiliated funds in order to maintain the funds’ stable share price of \$1.00. These transactions are prohibited by Section 17 of the 1940 Act [15 U.S.C. 80a-17] in the absence of a Commission exemption. *See infra* Section IV. of this Release.

<sup>39</sup> The thirty-eight funds that sought and were granted “no-action” relief from the Division of Investment Management either to sell the Orange County notes to affiliated persons, or to arrange for affiliated persons to provide some type of credit support for the benefit of the funds, are illustrative. Most of these funds had no more than five percent of their assets invested in notes issued by Orange County, or one of the participants in the Orange County Investment Pools. Within this group, the fund (a single state fund) that had the greatest concentration of its assets in securities issued by a single issuer had 8.7 percent of its assets invested in that issuer.

several times, no adviser is required to guarantee its fund against the possibility of breaking a dollar,<sup>40</sup> experience has demonstrated that diversification may not only limit investment risk, but also may place the fund in a better position to address (or avoid) significant deviation between a fund's market-based and amortized cost values.

The Commission recognizes that single state funds face a limited choice of very high quality issuers in which to invest, and that the number of first tier issuers in several states is especially limited. Application of the Five Percent Diversification Test to one hundred percent of the assets of these funds could force some funds to invest in lower quality issuers than those in which they would otherwise invest. While greater diversification provides an additional measure of safety for investors where there are many issuers to choose from, the Commission is concerned that too stringent a diversification standard could result in a net reduction in safety for certain single state funds. As a result, the Commission has decided to require single state funds to be diversified at the five percent level only as to seventy-five percent of their assets; the remaining twenty-five percent basket may be invested only in the first tier securities of one or more issuers. The availability of the twenty-five percent basket will provide single state funds with the flexibility to retain several positions of over five percent in very high quality investments.<sup>41</sup>

The Commission has decided to exclude from the application of the diversification requirement securities that are subject to an unconditional demand feature from a non-controlled person, as defined in the rule.<sup>42</sup> This approach will be applicable to all money funds, not only single state funds. The Commission believes that this approach, described in more detail below, will provide the advantages of diversification while permitting funds sufficient flexibility to respond to the available supply of eligible securities.

#### b. Scope of the Diversification Standards

A large percentage (sixty to seventy percent) of the securities currently held in tax exempt fund portfolios consist of long-term adjustable rate securities that are subject to unconditional demand features.<sup>43</sup> The provider of an unconditional demand feature assumes the credit risks presented by a particular issuer by agreeing to provide principal and interest payments in the event the issuer of the underlying security is unable to do so. Funds generally rely on the credit quality of the issuer of an unconditional demand feature to satisfy the rule's quality standards.<sup>44</sup> In light of this reliance, two commenters questioned the necessity of requiring a fund to satisfy the rule's issuer diversification and quality standards with respect to the issuer of the underlying security.<sup>45</sup>

If a security subject to an unconditional demand feature was in default or otherwise became distressed, a money fund normally would be expected to exercise the demand feature and receive the entire principal amount of the security and any interest payments due or accrued.<sup>46</sup> Thus, lack of diversification in the underlying security may be less important to a money fund's ability to maintain a stable net asset value than the ability to exercise the demand feature. Demand features

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<sup>40</sup> See, e.g., Release 18005, *supra* note 11, at Section II.H.; Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Issues Affecting the Mutual Fund Industry Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 23-25 (Sept. 27, 1994); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Municipal Bond and Government Securities Markets Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 10-11 (Jan. 5, 1995).

<sup>41</sup> Application of the non-diversified basket will track the comparable provision of Section 5(b)(1) of the 1940 Act [*15 U.S.C. 80a-5(b)(1)*]. See *supra* note 30.

<sup>42</sup> Paragraphs (c)(4)(i) and (ii) of Rule 2a-7, as amended.

<sup>43</sup> Proposing Release, *supra* note 20, at Section I.B.

<sup>44</sup> Paragraph (c)(3)(ii) of Rule 2a-7, as amended, permits a fund to rely on the credit quality of the unconditional demand feature in determining whether the underlying security is an eligible security or a first tier security.

<sup>45</sup> The commenters discussed this issue within the context of the rule's put diversification standards. See *infra* Section II.C.2. of this Release.

<sup>46</sup> Paragraph (c)(5)(ii) of Rule 2a-7, as amended, requires a money fund to dispose of a defaulted or distressed security (e.g., one that no longer presents minimal credit risks) "as soon as practicable," absent a finding by the board of directors that disposal would not be in the best interests of the fund.



are subject to a separate diversification requirement under the rule and, thus, excessive reliance on the credit of a single issuer is already addressed by the rule.<sup>47</sup>

Based on these considerations, and in light of the greater flexibility that would be afforded to single state funds, the Commission has decided to amend the rule so that the issuer diversification requirement—for all money funds—excludes securities subject to an “unconditional demand feature issued by a non-controlled person,” as defined in the rule.<sup>48</sup>

The Commission is limiting this exclusion to securities whose unconditional demand features are issued by non-controlled persons to reduce a fund’s exposure to the credit risks presented by a single economic enterprise.<sup>49</sup> Securities subject to other types of puts, including conditional demand features, would continue to be subject to the rule’s issuer diversification standard.

## 2. Quality Limitations on Portfolio Securities

Rule 2a-7 limits both taxable and tax exempt funds to investing only in eligible securities—securities receiving at least the second highest rating from the requisite NRSROs (as defined in the rule) or comparable unrated securities.<sup>50</sup> Taxable funds must comply with the Second Tier Securities Tests—investment in second tier securities is limited to five percent of fund assets, and investment in the second tier securities of any one issuer is limited to the greater of one percent of fund assets or one million dollars. The proposed amendments to the rule would have established different quality standards for national and single state funds.

### a. Proposed Limitations for Single State Funds

The proposed amendments would have limited single state fund investment to first tier securities. The Commission stated in the Proposing Release that the first tier securities restriction was designed to reduce the additional risks that may accompany lower levels of diversification as a result of the Commission’s proposal not to extend the Five Percent Diversification Test to single state funds. As noted above, most fund commenters objected to this limitation. In light of the requirement that single state funds be diversified as to seventy-five percent of their assets,<sup>51</sup> the Commission has decided not to adopt the proposed first tier securities restriction.

### b. Application of the Second Tier Securities Tests to Conduit Securities

The proposed amendments to the rule would have extended the Second Tier Securities Tests only to national fund investment in “conduit securities.” The Proposing Release explained that, in contrast to traditional state and municipal securities, conduit securities are issued to finance non-governmental private projects, such as retirement homes, private hospitals, local housing projects, and industrial development projects, with respect to which the ultimate obligor is not a governmental entity. Conduit securities are not backed by a revenue source from any essential public facility or by the taxing authority of any state or municipality. As a result, the risk of default for conduit securities is significantly higher than it is for traditional state or municipal securities.<sup>52</sup> Therefore, the Commission proposed to treat a national fund’s

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<sup>47</sup> Demand features and other types of puts that enhance underlying securities continue to be subject to the rule’s put diversification requirements. *See infra* Section II.C.1. of this Release.

<sup>48</sup> An “unconditional demand feature issued by a non-controlled person” is defined in the rule to mean an “unconditional put” that is also a “demand feature issued by a non-controlled person.” Paragraph (a)(26) of Rule 2a-7, as amended. A “demand feature issued by a non-controlled person” is defined to mean “a demand feature issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature. Control shall mean ‘control’ as defined in Section 2(a)(9) of the Act.” Paragraph (a)(8) of Rule 2a-7, as amended.

<sup>49</sup> Similarly, the twenty-five percent put basket will not be available for puts that do not meet the definition of a put issued by a non-controlled person. *See infra* Section II.C.1.b. of this Release.

<sup>50</sup> *See supra* nn. 12 and 13 and accompanying text and paragraph (a)(19) of Rule 2a-7, as amended.

<sup>51</sup> *See supra* Section II.B.1.a. of this Release and paragraph (c)(4)(iii) of Rule 2a-7, as amended.

<sup>52</sup> *See* Municipal Bond Defaults - The 1980’s: A Decade in Review (J.J. Kenny & Co., Inc. 1993). Bankruptcies and defaults by major municipal issuers, such as Orange County, California, are rare events. Of the approximately 120 municipal bankruptcies since 1979, most have involved small, local governments or special tax districts. *See* “Banging a Tin Cup With a Silver Spoon,” N.Y. Times, June 4, 1995 at F1.

investment in conduit securities no differently than a taxable fund's investment in securities typically issued by a private concern.

Most commenters supported the application of the Second Tier Securities Tests to national fund investment in conduit securities. These commenters generally agreed that this limited application of the Second Tier Securities Tests would allow national funds maximum flexibility to invest in the type of tax exempt securities that present the least risk of default. A smaller group of commenters, however, asserted that the proposed limitation would further limit the supply of eligible securities.<sup>53</sup> Many conduit securities in which money funds invest are subject to unconditional demand features. Because the Second Tier Securities Tests will not be applied to conduit securities with unconditional demand features issued by non-controlled persons, the application of the Second Tier Securities Tests to these securities should have a limited effect on the supply of tax exempt securities.<sup>54</sup>

The Commission has decided to extend the Second Tier Securities Tests to national and single state fund investment in conduit securities. Under amendments to the rule being adopted, the non-governmental entity ultimately responsible for the payment of principal and interest is treated as the issuer of the conduit security for purposes of the rule's issuer diversification requirements.<sup>55</sup> Credit quality determinations for a conduit security must be made by reference to the underlying corporate or project issuer, unless the conduit security is subject to an unconditional demand feature, in which case the conduit security will not be subject to the Second Tier Securities Tests.<sup>56</sup> Credit quality determinations for conduit securities subject to conditional demand features must be made by reference to the provider of the demand feature and the long-term rating of the underlying corporate or project issuer.<sup>57</sup> In addition, for purposes of calculating compliance with the one percent limit on second tier securities of a single issuer, the issuer of the conduit is the corporation or project.<sup>58</sup>

### c. Definition of the Term "Conduit Security"

The proposed amendments would have defined the term "conduit security" to mean a security issued through a state or territory of the United States, or any political subdivision or instrumentality thereof, which is not: (1) payable from the revenues of such governmental unit ("Revenue Clause"); (2) unconditionally guaranteed by such governmental unit; (3) related to a project or facility owned and operated by such governmental unit; or (4) related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project owned and under the control of such governmental unit. The definition was intended to exclude securities for which the ultimate obligor is a governmental unit.

Several commenters advised the Commission that portfolio managers would be able to identify conduit securities more readily and without obtaining legal and other expert opinions if the rule affirmatively stated what a conduit security is, instead of what it is not. Several commenters also urged that the Revenue Clause be deleted because it might result

<sup>53</sup> See *supra* note 29 and accompanying text.

<sup>54</sup> As adopted, the rule exempts from the Second Tier Securities Tests any conduit security subject to an unconditional demand feature issued by a non-controlled person, whether the demand feature is first or second tier. Paragraph (c)(4)(iv)(B) of Rule 2a-7, as amended.

<sup>55</sup> Paragraph (c)(4)(vi)(A)(3) of Rule 2a-7, as amended.

<sup>56</sup> Paragraph (c)(4)(iv)(B) of Rule 2a-7, as amended.

<sup>57</sup> See *infra* Section II.B.2.b. of this Release and paragraph (c)(3)(iii) of Rule 2a-7, as amended.

<sup>58</sup> See paragraph (c)(4)(vi)(A)(3) of Rule 2a-7, as amended. For example, a municipal security issued to finance a private hospital that meets the definition of a conduit security would be considered—for diversification purposes—to have been issued by the hospital, not the municipality.

in excluding from the Second Tier Securities Tests a security for which the ultimate obligor is a private entity.<sup>59</sup> The Commission has modified the definition of the term “conduit security” to reflect some of these concerns.<sup>60</sup>

The term “conduit security” is defined as a security issued by a municipal issuer involving an arrangement or agreement entered into, directly or indirectly, with an issuer other than a municipal issuer, which arrangement or agreement provides for or secures repayment of the security.<sup>61</sup> The term “conduit security” does not include a security that is: (1) unconditionally guaranteed by a municipal issuer; (2) payable from the general revenues of the municipal issuer (other than revenues derived from an agreement or arrangement with a person who is not a municipal issuer that provides for or secures repayment of the security); (3) related to a project owned and operated by a municipal issuer; or (4) related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a municipal issuer.<sup>62</sup>

### C. Diversification and Quality Standards for Put Providers

A substantial portion of securities held by tax exempt funds are subject to puts and demand features.<sup>63</sup> A “put” is the right to sell a specified underlying security within a specified period of time and at a specified exercise price that may be sold, transferred, or assigned only with the underlying security.<sup>64</sup> A demand feature is a put that may be exercised at specified intervals not exceeding 397 calendar days and upon no more than thirty days’ notice.<sup>65</sup> Demand features can serve three different purposes: (1) to shorten the maturity of a variable or floating rate security;<sup>66</sup> (2) to enhance the security’s credit quality; and (3) to provide liquidity support for the security. If the demand feature can be exercised on seven days’ notice, then the security will be treated as a liquid security under the appropriate guidelines.<sup>67</sup>

Demand features may be conditional or unconditional.<sup>68</sup> Under Rule 2a-7, a demand feature used as a substitute for the credit quality of the underlying security must be an “unconditional put,” defined to include any guarantee, letter of credit (“LOC”) or similar unconditional credit enhancement that by its terms would be readily exercisable in the event of a

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<sup>59</sup> For example, a governmental unit could issue bonds on behalf of a private firm for the purpose of raising funds to construct facilities for a company, such as a plant or a residential real estate project. The payment of principal or interest on the bonds would be secured through a lease arrangement under which the private firm makes periodic payments to the governmental unit. If these payments were characterized as “revenue,” then the bonds issued by the governmental unit would not be treated as conduit securities under the proposed definition.

<sup>60</sup> In the Proposing Release, the Commission asked commenters whether the rule’s definition of a conduit security should reference the provisions of the Internal Revenue Code (“IRC”) governing the treatment of private activity bonds, IRC sections 141-174 [26 U.S.C. 141-147]. Most commenters discussing the definition of a conduit security strongly opposed this approach, generally observing that it would have the effect of treating certain general obligation bonds, and bonds issued to finance property owned by a governmental unit, as conduit securities that are subject to the Second Tier Securities Tests, which would be inconsistent with the Commission’s objective of subjecting only obligations of non-governmental issuers to the Second Tier Securities Tests. The Commission has decided not to reference the IRC’s private activity bond rules in defining the term “conduit security.”

<sup>61</sup> Paragraph (a)(6) of Rule 2a-7, as amended. The rule amendments, as adopted, define the term “municipal issuer” to mean a state or territory of the United States, or any political subdivision or instrumentality thereof. The term “state” is defined in the 1940 Act to mean any state, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States [15 U.S.C. 80a-2(a)(39)].

<sup>62</sup> Paragraph (a)(6) of Rule 2a-7, as amended.

<sup>63</sup> Proposing Release, *supra* note 20, at Section I.B.

<sup>64</sup> Paragraph (a)(16) of Rule 2a-7, as amended.

<sup>65</sup> Paragraph (a)(7) of Rule 2a-7, as amended.

<sup>66</sup> Paragraphs (d)(3) and (d)(5) of Rule 2a-7, as amended. Initially, Rule 2a-7 provided that only demand features that ran to the issuer of the security could be used to shorten maturities. *See* Release 13380, *supra* note 7, at n.9. This was changed by the amendments to Rule 2a-7 adopted in 1986. Investment Company Act Rel. No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (“Release 14983”).

<sup>67</sup> A money fund is limited to investing no more than ten percent of its assets in illiquid securities. *See* Release 13380, *supra* note 7, at nn.37-38 and accompanying text. *See also* Investment Company Institute (pub. avail. Dec. 9, 1992). The Division of Investment Management has provided guidance concerning the implementation of three business days as the standard settlement period for trades effected by brokers and dealers, and a fund’s determination of whether securities it holds should be deemed liquid for purposes of complying with the ten percent restriction. Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (May 26, 1995) (“T+3 Letter”).

<sup>68</sup> Both conditional and unconditional puts may operate as demand features to shorten the maturities of adjustable rate securities. As discussed in Section II.C.3. of this Release, *infra*, amendments to Rule 2a-7 limit the types of conditions to which exercise of a demand feature can be subject. Paragraph (c)(3)(iii)(B) of Rule 2a-7, as amended.

default in payment of principal or interest on the underlying security.<sup>69</sup> A demand feature that is not an “unconditional put” may serve as the basis for determining whether a security is an eligible security and categorizing it as a first or second tier security; however, the long-term credit quality of the security subject to a conditional demand feature must also be analyzed.<sup>70</sup>

The Commission is adopting several amendments to the provisions of the rule relating to puts and demand features.

#### 1. Put Diversification Standards

Under Rule 2a-7, a taxable money fund may not invest more than five percent of its assets in securities subject to conditional puts from, or securities directly issued by, the same institution. The percentage limitation applicable to unconditional puts is ten percent. A tax exempt fund is required to comply with these two requirements with respect to seventy-five percent of its assets; there is no diversification requirement with respect to the remaining twenty-five percent (“twenty-five percent put basket”). The Commission proposed to apply a uniform ten percent limitation on all puts issued by the same institution and to eliminate the twenty-five percent put basket for tax exempt funds.<sup>71</sup>

##### a. Uniform Diversification Standards for Conditional and Unconditional Puts

Under the proposed amendments, a fund could not have invested more than ten percent of its assets in securities subject to conditional and unconditional puts, and securities directly issued by, the same issuer. A fund would have been required to aggregate conditional and unconditional puts issued by the same issuer in applying the ten percent restriction. Most of the commenters who addressed these aspects of the proposal supported the aggregation of conditional and unconditional puts in applying a uniform percentage restriction. Other commenters disagreed, either urging that the ten percent limit be raised or that the rule’s put diversification standards continue to distinguish between puts that provide liquidity support (conditional puts) and puts that provide credit support (unconditional puts). The Commission has decided to adopt the uniform ten percent limitation as proposed, and eliminate the current distinction between conditional and unconditional puts under the rule’s put diversification standards.<sup>72</sup> Although there are differences between the risks incurred by the put provider and the nature of the reliance by the investor in each case, the Commission does not believe that these differences are significant enough to warrant continued disparate treatment under the rule. Moreover, aggregating conditional and unconditional puts and applying a single put diversification standard to the aggregate number should simplify compliance with the rule.

##### b. The Twenty-Five Percent Put Basket

The proposed amendments to the rule would have eliminated the twenty-five percent put basket so that a tax exempt fund would have been required to meet the rule’s put diversification standards with respect to one hundred percent of its assets. The Commission explained that extensive reliance on a single put provider or a few providers could present considerable risks, particularly for a single state fund which, under the amendments as proposed, would not have been required to be diversified with respect to underlying securities.<sup>73</sup> Most commenters urged the Commission to retain the twenty-five percent put basket in some form. Many concluded that eliminating the twenty-five percent put basket would increase reliance by funds on less creditworthy put providers and decrease the flexibility currently afforded funds in enhancing the credit quality and liquidity of securities. The commenters disagreed with the Commission’s assumption that one probable effect of the elimination of the twenty-five percent put basket would be new entrants to the market as put providers.

A number of commenters suggested that, in light of the Commission’s proposal to require that when a fund invests more than five percent of its assets in securities subject to puts from a single put provider, the puts be first tier securities,<sup>74</sup>

<sup>69</sup> Paragraph (a)(27) of Rule 2a-7, as amended.

<sup>70</sup> Paragraph (c)(3)(iii)(B) of Rule 2a-7, as amended.

<sup>71</sup> See Proposing Release, *supra* note 20, at Section II.C.2.

<sup>72</sup> Paragraph (c)(4)(v)(B) of Rule 2a-7, as amended.

<sup>73</sup> Proposing Release, *supra* note 20, at Section II.C.2.b.

<sup>74</sup> See *infra* Section II.C.2.b. of this Release.

it would be appropriate to retain the twenty-five percent put basket. The Commission has decided to incorporate this approach in amendments to the rule's put diversification standards.

The amendments provide that the twenty-five percent put basket is available to all money funds for first tier puts, but only if the put is a “put issued by a non-controlled person”—a put issued by a person that does not directly or indirectly control, and is not controlled by or under common control with the issuer of the security subject to the put.<sup>75</sup> The Commission is restricting fund use of the twenty-five percent put basket to non-controlled persons to minimize a fund's concentration of assets in a single economic enterprise.

#### c. Issuer-Provided Demand Features

The put diversification standards under Rule 2a-7 apply to “securities issued by or subject to Puts from the institution that issued the Put.”<sup>76</sup> In the Proposing Release, the Commission requested comment on the treatment of puts by the issuer of the underlying securities (“issuer-provided demand features”).<sup>77</sup> Some commenters asserted that funds should be permitted to exclude issuer-provided demand features from the put diversification requirements because issuer-provided demand features can be viewed as the functional equivalent of short-term securities that are “rolled over” periodically. The commenters also suggested that including issuer-provided demand features as puts in determining compliance with the rule's put diversification standards amounts to “double counting.” The Commission agrees and has added language to the rule to clarify that a fund is not required to aggregate an issuer-provided put with the security subject to the put for purpose of determining compliance with the put diversification requirement of the rule.<sup>78</sup>

#### d. Multiple Puts and Guarantees

The proposed amendments would have amended Rule 2a-7's put diversification standards to address how put diversification calculations should be made when a security is subject to several puts (“multiple puts”). Under the proposed amendments, different calculation methods would have been applied when: (i) each multiple put provider had contractually agreed to guarantee only a portion of the total principal value of the underlying security (“fractional puts”), and (ii) each multiple put provider had an obligation that was not limited contractually (“layered puts”). The proposed amendments would have clarified that an institution that provides a fractional put would be treated as guaranteeing only that portion of the principal value of the security that it contractually agreed to provide.<sup>79</sup> An institution providing a layered put would have been deemed to cover the entire principal amount of the security, notwithstanding that the security is subject to puts from other institutions.

Most commenters who discussed these issues supported the proposed treatment of fractional puts. These commenters stated that it was appropriate to allocate exposure among put providers for diversification purposes in accordance with the put providers' contractual obligations. The Commission has decided to adopt these amendments to the rule as proposed.<sup>80</sup>

<sup>75</sup> Paragraphs (a)(17) (definition of “put issued by a non-controlled person”) and (c)(4)(v) of Rule 2a-7, as amended. The Commission is adopting amendments that limit fund investment in puts that are second tier securities to five percent of fund assets. *See infra* Section II.C.2.b. of this Release and paragraph (c)(4)(v)(B) of Rule 2a-7, as amended. Further, a fund that has invested more than ten percent of its assets in securities subject to puts and in securities directly issued by a single issuer must count the total amount invested towards the twenty-five percent undiversified put basket. In other words, a fund may not use all or a portion of its twenty-five percent put basket and an additional amount of its diversified assets to invest more than twenty-five percent of its assets in a single issuer. *See supra*, note 30.

<sup>76</sup> Paragraph (c)(4)(v)(A) of Rule 2a-7, as amended.

<sup>77</sup> *See* Proposing Release, *supra* note 20, at Section II.C.2.d.(3). The Commission noted that Rule 2a-7, as originally adopted, provided that only issuer-provided demand features could be used to shorten the maturity of a security. *See* Release 13380, *supra* note 7, at n.10 and accompanying text.

<sup>78</sup> Paragraph (c)(4)(vi)(B)(1) of Rule 2a-7, as amended. Under this paragraph, a put issued by the same institution that issued the underlying security would not be subject to the rule's put diversification requirements, and would be subject only to the rule's issuer diversification requirements. For example, a security representing four percent of a fund's total assets that had an issuer-provided demand feature would be treated as a four percent position in “securities issued by or subject to Puts from the institution that issued the Put,” not eight percent [quoting paragraph (c)(4)(iv)(A) of Rule 2a-7, as amended].

<sup>79</sup> For example, if two banks issued puts on the same VRDN and each agreed to absorb fifty percent of the losses, then each would be deemed to guarantee no more than fifty percent of the VRDN under the rule's put diversification standards.

<sup>80</sup> Paragraph (c)(4)(vi)(B)(2) of Rule 2a-7, as amended.

Most commenters opposed treating each put provider in a layered put structure as the guarantor of the entire amount guaranteed because, they argued, the approach ignored the fact that the fund may be relying only on the guarantee of one of the put providers. The Commission has decided to adopt amendments to the rule that reflect these comments. For a security subject to layered puts, the rule permits a fund that is not relying on a particular put for satisfaction of the rule's credit quality<sup>81</sup> or maturity standards,<sup>82</sup> or for liquidity, to exclude that put when determining its compliance with the rule's put diversification standards.<sup>83</sup> The fund must document this determination in its records.<sup>84</sup>

In the context of describing the proposed amendments regarding treatment of multiple puts under the rule's diversification standards, the Commission indicated that bond insurance was a type of put under Rule 2a-7.<sup>85</sup> A number of commenters disagreed with this analysis of bond insurance, arguing that bond insurance does not provide liquidity and is not viewed by the market as a substitute for the credit of the underlying issuer. Because bond insurance guarantees the timely payment of principal and interest by the insured issuer,<sup>86</sup> it meets the rule's definition of an unconditional put, permitting credit substitution in the eligibility determination. The Commission has amended the rule to clarify this matter.<sup>87</sup>

The Commission recognizes, however, that bond insurance may not be relied upon by a fund when determining a security's eligibility under the rule. One commenter argued that, in the case of a security subject to a guarantee, such as bond insurance, and a demand feature, the fund is very likely to look only to the issuer of the demand feature if it needs to sell the security and thus, as a practical matter, to the issuer of the demand feature for credit support. Therefore, this commenter concluded, the guarantee should not be counted for purposes of Rule 2a-7's diversification requirements. The Commission agrees, and has amended the rule to permit a fund holding a security subject to a put (including bond insurance) and an unconditional demand feature to count only the demand feature for purposes of the put diversification calculation.<sup>88</sup> A fund relying on this provision of the rule is not required to maintain contemporaneous records of its determination that the fund is not relying on the guarantee to determine credit quality.

## 2. Quality Standards

### a. Rating Requirement for Demand Features

The proposed amendments to the rule would have limited funds to investing in demand features (other than standby commitments) that are rated, or provided by institutions that are rated, by NRSROs. Most commenters discussing this issue opposed the proposed rating requirement for demand features and suggested that the rule should permit a fund to purchase a security subject to an unrated demand feature if it can make a comparability determination similar to

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<sup>81</sup> Under the rule, a fund holding a security that is subject to an unconditional demand feature may satisfy the rule's credit quality standards with respect to the underlying security based solely on the short-term rating of the demand feature provider. Paragraph (c)(3)(ii) of Rule 2a-7, as amended.

<sup>82</sup> Rule 2a-7 generally permits a fund to measure the maturity of an adjustable rate security subject to a demand feature by reference to the date on which principal can be recovered through demand. *See infra* Sections II.F.1. and II.F.2. of this Release and paragraphs (d)(3) and (d)(5) of Rule 2a-7, as amended.

<sup>83</sup> Paragraph (c)(4)(vi)(B)(4) of Rule 2a-7, as amended. This paragraph of the rule also permits a fund holding a security subject to a single put that it is not relying on to satisfy the rule's credit quality or maturity standards, or for liquidity, to disregard that put in determining its compliance with the rule's put diversification standards. If a fund is relying on separate puts for each of these purposes (*e.g.*, a conditional demand feature for purposes of liquidity and maturity, and an unconditional put for purposes of credit quality), then each put would have to satisfy the rule's put diversification standards.

<sup>84</sup> Paragraphs (c)(8)(ii) and (c)(9)(vi) of Rule 2a-7, as amended. A fund would document this determination when it acquires the security. The fund may subsequently determine that it is or is not relying on a particular put, but must reflect the change in its written records.

<sup>85</sup> Proposing Release, *supra* note 20, at note 81.

<sup>86</sup> Eli Nathans, Municipal Bond Insurance—The Economics of the Market, 13 *Mun. Fin. J.*, No.2 (Summer 1992) 1, 2.

<sup>87</sup> Paragraph (a)(27) of Rule 2a-7, as amended. A bond insurance policy that permits the holder of the security to receive all principal and interest payments at the time of the default of the insured obligation would also be an unconditional demand feature. By contrast, a policy under which the fund would only receive periodic payments of principal and interest as those payments came due under the terms of the insured obligation would be an unconditional put, but not an unconditional demand feature.

<sup>88</sup> Paragraph (c)(4)(vi)(B)(3) of Rule 2a-7, as amended.

the determination permitted under the rule in connection with the purchase of unrated securities.<sup>89</sup> Other commenters asserted that the fund manager's obligation under the rule to determine that all portfolio securities present minimal credit risk obviated the need for the proposed rating requirement.<sup>90</sup> The Commission explained in the Proposing Release that NRSRO ratings assigned to demand features or the issuer of demand features may provide additional protection by ensuring input into the minimal credit risk determination by an outside source. This extra source of protection may be particularly important in light of the Commission's decision to preserve the twenty-five percent diversification basket for put providers, and to eliminate the applicability of Rule 2a-7's diversification requirements to securities subject to certain unconditional demand features.<sup>91</sup> In addition, funds may have limited ability to monitor the credit quality of some demand feature providers, such as foreign banks.<sup>92</sup> The Commission is adopting the rating requirement for demand features as proposed.<sup>93</sup>

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

The proposed amendments would have prohibited a money fund from investing more than five percent of its assets in securities subject to a put from a single put provider that is not a first tier put. Compliance with this provision would be measured at the time the put was acquired by the fund. All the commenters discussing this aspect of the proposal agreed that it is appropriate to limit fund investment in puts that are not first tier securities ("second tier puts"), and the Commission is adopting the limit as proposed.<sup>94</sup>

If more than five percent of a fund's assets were subject to a demand feature from a single institution that was no longer a first tier put, the proposed amendments also would have required the fund to reduce the amount of the securities subject to the demand feature to not more than five percent of the fund's assets by exercising the demand feature at the next succeeding exercise date. Most commenters were critical of this proposed requirement and suggested that it might be in the best interests of fund shareholders for the fund either to retain the securities subject to the demand features or dispose of the securities in an orderly manner. Because there may be some circumstances during which it may be in the best interest of the fund to continue to hold the securities subject to the put, the Commission is adopting the amendment with the express provision that a fund's board of directors may determine that disposal of the securities is not in the best interest of the fund, and determine to permit the fund to continue to hold the securities.<sup>95</sup>

#### c. Certain Unrated Securities

Rule 2a-7 currently provides that an unrated security that, when issued, was a long-term security but when purchased by the fund has a remaining maturity of less than 397 calendar days may be considered to be an eligible security based on whether the security is comparable in quality to a rated security, unless the security has received a long-term rating from any NRSRO that is not within the two highest categories of long-term ratings. Under this provision, a long-term rating from an NRSRO below the top two rating categories results in the security becoming ineligible for investment by a money market fund. One commenter stated that, because many issuers with long-term ratings in the third highest ratings categories have first tier short-term ratings, the rule was unnecessarily restrictive. The Commission agrees, and has

<sup>89</sup> Paragraph (a)(9)(iii) of Rule 2a-7, as amended, permits a fund to treat an unrated security as an eligible security if the fund's board of directors determines that the unrated security is of comparable quality to a rated security.

<sup>90</sup> Paragraph (c)(3) of Rule 2a-7, as amended, limits fund investment to securities that its "board of directors determines present minimal credit risks." This determination must be based on factors pertaining to credit quality "*in addition to any rating assigned to such securities by an NRSRO*" (emphasis added).

<sup>91</sup> See *supra* Section II.B.1.b. of this Release.

<sup>92</sup> Proposing Release, *supra* note 20, at Section II.C.2.d.(2).

<sup>93</sup> Paragraph (a)(9)(iii)(D)(1) of Rule 2a-7, as amended. The amendments remove from the definition of eligible security unrated securities that are subject to demand features. Thus, in order for a security subject to a demand feature to be eligible for fund investment, the demand feature must be rated.

<sup>94</sup> Paragraph (c)(4)(v)(B) of Rule 2a-7, as amended.

<sup>95</sup> Paragraph (c)(5)(i)(C) of Rule 2a-7, as amended. This determination may not be delegated. Paragraph (e) of Rule 2a-7, as amended. If the demand feature is no longer an eligible security, paragraph (c)(5)(ii) of Rule 2a-7 requires the fund to obtain a new demand feature or dispose of the underlying security (unless the board of directors finds that it would be in the best interest of the fund not to dispose of the security). See Release 18005, *supra* note 11 at Section II.E.1. for a discussion of securities held by a money fund that are in default, are no longer eligible securities, or no longer present minimal credit risks.

expanded this provision to accommodate long-term ratings within the top three ratings categories.<sup>96</sup> Funds will continue to be required to determine that such a security is of “comparable quality” to rated eligible securities.<sup>97</sup>

### 3. Conditional Demand Features

Rule 2a-7 does not currently restrict the types of conditions to which a demand feature may be subject. The inability of a fund to exercise a demand feature because of the occurrence of a condition precluding exercise would likely result in violations of the maturity limitations of Rule 2a-7, the liquidity requirements of the 1940 Act,<sup>98</sup> and a loss of value of the underlying security, when, for example, a short-term security paying interest at short-term rates is transformed into a long-term security. Therefore, the proposed amendments would have limited the permissible conditions with respect to conditional puts to the following: (1) default in the payment of principal or interest on the underlying security; (2) the bankruptcy, insolvency, or receivership of the issuer or a guarantor of the underlying security; (3) the downgrading of either the underlying security or a guarantor by more than two full rating categories; and (4) 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.<sup>99</sup> These conditions were designed to permit the fund to monitor the continued availability of a demand feature and to take steps to sell the security or replace the demand feature if it appears that conditions are likely to occur that would limit the ability of the fund to exercise the demand feature.<sup>100</sup>

Many commenters objected to the proposed definition of the term “conditional put.” These commenters stated that the current market has few, if any, variable rate demand notes (“VRDNs”) with conditional puts that would satisfy the proposed definition. Even the commenters who recommended the proposed conditions conceded that although most put providers have conditions similar to those included in the proposed amendments, every provider uses somewhat different, often broader, language.<sup>101</sup> As a result, modifying the scope of one or more of the four conditions would not address this concern.

The Commission has decided to adopt an alternative approach suggested by several commenters by revising the rule to provide general guidance concerning the types of conditions that are appropriate for money fund investment. Rule 2a-7, 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.<sup>102</sup> The fund’s board of directors (or its delegate) also must determine that: (1) 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 (2) 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.<sup>103</sup>

Rule 2a-7 currently provides that a security subject to a conditional demand feature (“underlying security”) is an eligible security only if the demand feature is an eligible security and the underlying security has received a long-term rating from the Requisite NRSROs in one of the two highest long-term ratings categories or, if unrated, is determined to be of comparable quality. The rule thus assumes securities subject to conditional demand features are always long-term

<sup>96</sup> Paragraph (a)(9)(iii)(B) of Rule 2a-7, as amended.

<sup>97</sup> Paragraph (a)(9)(iii) of Rule 2a-7, as amended.

<sup>98</sup> The money fund could lose liquidity at a time when it is most necessary. A money fund is limited to investing no more than ten percent of its assets in illiquid securities. *See supra* note 65 and accompanying text and *infra* Section II.C.4.c. of this Release.

<sup>99</sup> The proposed amendments to the rule incorporated recommendations of Fidelity Management & Research Company (“Fidelity”) and the Investment Company Institute (“ICI”). *See* Letter from Matthew Fink, Senior Vice President and General Counsel, ICI, to Marianne Smythe, Director, Division of Investment Management (Mar. 25, 1991); Letter from Thomas D. Maher, Associate General Counsel, Fidelity, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Sept. 24, 1990), in File No. S7-13-90.

<sup>100</sup> Proposing Release, *supra* note 20, at Section II.C.3.

<sup>101</sup> *See* Letter from Thomas D. Maher, Associate General Counsel, Fidelity, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 5, 1994); Letter from Thomas D. Maher, Associate General Counsel, Fidelity, to Kenneth J. Berman, Deputy Office Chief, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission (June 17, 1994); Letter from Paul Schott Stevens, General Counsel, ICI, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 5, 1994), in File No. S7-34-93

<sup>102</sup> Paragraph (c)(3)(iii)(B) of Rule 2a-7, as amended.

<sup>103</sup> *Id.*



securities. The Commission is amending Rule 2a-7 to provide that, in the case of an underlying security that has a remaining maturity of 397 days or less, the underlying security is an eligible security only if the demand feature is an eligible security and the underlying security has received a short-term rating from the requisite NRSROs in one of the two highest short-term ratings categories or, if unrated, is determined to be of comparable quality.<sup>104</sup>

#### 4. Other Issues Applicable to Put Providers

##### a. Accrued Interest

The Commission proposed amendments to the definition of the term “put” and also requested comment whether additional amendments to the rule were necessary to restrict fund investment to certain types of credit and liquidity enhancements. The proposed amendments would have amended the definition of a “put” to specify that the put must enable the holder to receive not only the amortized cost of the securities, but also accrued interest. The Commission is adopting these amendments as proposed.<sup>105</sup>

##### b. Notice of Substitution of Put Provider

The Commission stated in the Proposing Release that it is aware of several instances in which a money fund had invested in a security backed by a LOC or other credit or liquidity enhancement that was replaced during the life of the underlying security without notice to the fund.<sup>106</sup> A fund must know the identity of the put provider for a number of reasons, which include a determination of whether the fund is in compliance with the rule’s put diversification and credit quality provisions. The Proposing Release asked commenters to consider whether the rule should be amended to limit fund investment in puts that obligate the issuer of the underlying security (or the trustee under any applicable indenture) to inform investors of the substitution of the put provider. All the commenters responding to this question agreed with the Commission that it is essential for the control of credit risk and for compliance with the rule that funds be aware of the identity of their put providers at all times, and that rule amendments would be appropriate.<sup>107</sup>

The Commission is adopting amendments to address these concerns. Under the amendments, a security subject to a demand feature is not eligible for fund investment unless arrangements are 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.<sup>108</sup>

##### c. Liquidity Requirements for Money Funds and the Three Business Day Settlement Cycle

Section 22(e) of the 1940 Act provides, with certain exceptions, that no registered investment company may postpone the date of payment upon redemption of a redeemable security for more than seven days after the security is tendered for redemption. The Commission has stated that all mutual funds should limit their holdings of illiquid securities to ensure that they can satisfy all redemption requests within the seven day period. The Commission considers a security to be illiquid if it cannot be disposed of within seven days in the ordinary course of business at approximately the price at which the fund has valued it.<sup>109</sup> The limit on money fund holdings of illiquid securities is ten percent of fund assets.<sup>110</sup>

<sup>104</sup> Paragraph (c)(3)(iii)(C)(1) of Rule 2a-7, as amended.

<sup>105</sup> Paragraph (a)(16) of Rule 2a-7, as amended.

<sup>106</sup> Proposing Release, *supra* note 20, at Section II.D.1.c.

<sup>107</sup> A number of these commenters discussed the problems a fund may encounter in obtaining notice of the substitution of a put provider when the securities are held by an intermediary, such as a securities depository. The Commission was advised that intermediaries employ methods to transmit notice of this type to their participants.

<sup>108</sup> Paragraph (a)(9)(iii)(D)(2) of Rule 2a-7, as amended. The obligation to provide notice may be the obligation of the issuer of the underlying security, the issuer of the demand feature, or a third party, such as the dealer from which the fund wishes to purchase the security.

<sup>109</sup> Release 14983, *supra* note 64; Securities Act Rel. No. 6862 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)] (adopting Rule 144A under the Securities Act of 1933 (discussing the definition of “liquid” and citing Release 14983).

<sup>110</sup> Release 14983, *supra* note 64 at Section A.4.; Investment Company Institute (pub. avail. Dec. 9, 1992).

Rule 15c6-1 under the Securities Exchange Act of 1934, which recently became effective, established three business days (“T+3”) as the standard settlement period for securities trades effected by a broker or dealer.<sup>111</sup> The Division of Investment Management provided advice regarding the implications of the T+3 standard in determining whether a security held by a fund should be deemed liquid for purposes of the restrictions described above.<sup>112</sup> This issue is significant for money funds, because a large percentage of money fund assets consist of securities with a seven day demand feature.<sup>113</sup>

The Division noted that, because Rule 15c6-1 applies to brokers and dealers and does not apply directly to funds, its implementation does not change the standard for determining liquidity, which is based on the requirements of Section 22(e) of the 1940 Act. As a practical matter, however, many funds (including money funds) will have to meet redemption requests within three days because a broker or dealer will be involved in the redemption process. Many of these funds hold portfolio securities that do not settle within three days. In light of the T+3 standard, the Division recommended that funds should assess the mix of their portfolio holdings to determine whether, under normal circumstances, they will be able to facilitate compliance with the T+3 standard by brokers or dealers. Factors the funds should consider include the percentage of the portfolio that would settle in three days or less, the level of cash reserves, and the availability of lines of credit or interfund lending facilities. The Commission shares the Division’s concerns and urges money funds to monitor carefully their liquidity needs in light of the shorter settlement period.

## 5. Short-Term Ratings

Rule 2a-7 currently distinguishes between short-term and long-term securities based on whether the security has a remaining maturity of 366 days—primarily for the purpose of distinguishing between securities that have short-term and long-term ratings. NRSROs do not always draw such a line when assigning ratings.<sup>114</sup> Therefore, the Commission has revised the rule to replace references to “short-term securities” and “long-term securities” in various sections of the rule with references to securities that have received short-term and long-term ratings from a NRSRO.<sup>115</sup> Whether a security has received a long- or a short-term rating from a NRSRO will depend upon how the NRSRO has characterized its rating.

## D. Other Diversification and Quality Standards

### 1. Repurchase Agreements

Rule 2a-7 allows a fund to “look through” a repurchase agreement (“repo”) to the underlying collateral for diversification purposes when the obligation of the counterparty is “collateralized fully.”<sup>116</sup> Under the current rule, a repo is collateralized fully if, among other things, the collateral consists entirely of Government securities or securities that, at the time the repo is entered into, are rated in the highest rating category by the requisite NRSROs.<sup>117</sup> The Commission is adopting, as proposed, amendments to permit a fund to treat the repo as collateralized fully only if it is collateralized

<sup>111</sup> Rule 15c6-1 [17 CFR 240.15c6-1] generally provides that “a broker or dealer shall not effect or enter into a contract for the purchase or sale of a security (other than an exempted security, government security, municipal security, commercial paper, bankers’ acceptances, or commercial bills) that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction.” Securities Exchange Act Rel. No. 33023 (Oct. 6, 1993) [58 FR 52891 (Oct. 13, 1993)].

<sup>112</sup> See T+3 Letter, *supra* note 65.

<sup>113</sup> *Id.*

<sup>114</sup> See, e.g., Fitch Ratings Book (May 1995) (short-term ratings apply to debt payable on demand or to securities with original maturities of up to three years), and Orrick, Herrington & Sutcliffe (pub. avail. July 20, 1994) (synthetic warrants maturing in twenty-two months given short-term ratings by NRSROs).

<sup>115</sup> Paragraphs (a)(9) (definition of “eligible security”), (a)(11) (definition of “first tier security”), (a)(29) (definition of “unrated security”), and (c)(3)(iii)(C) (requirements for security subject to conditional demand feature) of Rule 2a-7, as amended. In addition, the Commission has eliminated the definitions of “short-term” and “long-term” from the rule.

<sup>116</sup> Paragraph (c)(4)(vi)(A)(1) of Rule 2a-7, as amended. A money fund investing in a repurchase agreement that does not meet the requirements of this paragraph may not “look through” and must instead treat the counterparty to the agreement as the issuer.

<sup>117</sup> See Proposing Release, *supra* note 20, at Section II.D.3.

by securities that would qualify the repo for preferential treatment under the Federal Deposit Insurance Act<sup>118</sup> or the Federal Bankruptcy Code.<sup>119</sup> The Proposing Release noted that if the collateral does not qualify for special treatment under either of these statutes, a fund could encounter significant liquidity problems if a large percentage of its assets were invested in a repo with a bankrupt counterparty.<sup>120</sup> Although some commenters argued that the rule should encompass types of collateral that fall outside the repo specific provisions of the Bankruptcy Code, the Commission believes that the “look through” provisions of the rule would be inappropriate in these circumstances because the credit and liquidity risks assumed by the fund would be tied directly to the counterparty rather than the issuers of the underlying collateral.<sup>121</sup>

## 2. Pre-Refunded Bonds

The Proposing Release noted that a significant portion of tax exempt fund assets consist of pre-refunded bonds—bonds the payment of which are funded by and secured by escrowed Government securities.<sup>122</sup> The proposed amendments to the rule would have allowed funds to “look through” the pre-refunded bonds to the escrowed securities for diversification purposes if 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 bonds would not affect payments on the bonds from the escrow account. The proposed amendments would have limited fund investment in pre-refunded bonds issued by the same issuer to twenty-five percent of its assets. Because these securities would, in effect, be treated as Government securities, they would not be subject to a diversification limitation. Most commenters supported the proposed treatment of pre-refunded bonds. A few of these commenters suggested that the twenty-five percent limitation per issuer was not necessary since the issuer’s credit typically does not secure such bonds.<sup>123</sup> The Commission agrees, and has eliminated this limitation.<sup>124</sup> The Commission has decided to make additional technical modifications to the conditions applicable to the escrow arrangements that were suggested by the commenters.<sup>125</sup> The Commission is also amending the rule to include within the definition of an “unrated security” a rated security that subsequently was made subject to a refunding

<sup>118</sup> See also 12 U.S.C. 1821(e)(8)(A) and (C) (affording preferential treatment to “qualified financial contracts”), 12 U.S.C. 1821(e)(8)(D)(i) (defining qualified financial contract to include repurchase agreements) and 12 U.S.C. 1821(e)(8)(D)(v) (defining repurchase agreement). Not all collateral that would qualify a repo for preferential treatment under the Federal Deposit Insurance Act would be permitted. Of the mortgage-related securities referred to in 12 U.S.C. 1821(e)(8)(D)(c), only “mortgage related securit[ies]” as defined in Section 3(a)(41) of the 1934 Act [15 U.S.C. 78c(a)(41)] would be permitted.

See Sections 101(47) of the Federal Bankruptcy Code (“Bankruptcy Code”) (defining “repurchase agreement”), and 559 (protecting repo participants from the Bankruptcy Code’s automatic stay provisions) [11 U.S.C. 101(47), 559]. The Bankruptcy Code defines a repurchase agreement as follows:

an agreement, including related terms which provides for the transfer of certificates of deposit, eligible bankers’ acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptances, or securities as described above, at a date certain no later than one year after such transfer or on demand, against the transfer of funds.

<sup>119</sup> Paragraph (a)(4) of Rule 2a-7, as amended. Depository institutions are not eligible for protection under the Bankruptcy Code. Section 109 of the Bankruptcy Code [11 U.S.C. 109]. Instead, the bank regulatory laws provide for the establishment of conservatorship and receiverships of depository institutions in default. See, e.g., Section 11 of the Federal Deposit Insurance Act [12 U.S.C. 1821].

<sup>120</sup> Proposing Release, *supra* note 20, at n.172.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> The twenty-five percent limitation was a condition specified in a “no-action” position taken by the Division of Investment Management in T. Rowe Price Tax-Free Funds (pub. avail. June 24, 1993) regarding the treatment of these securities for purposes of Section 5(b)(1) of the 1940 Act. See Proposing Release, *supra* note 20, at n.38 and accompanying text.

<sup>124</sup> The Commission is also eliminating the limitation for funds other than money funds that otherwise rely on the staff no-action position set forth in T. Rowe Price Tax-Free Funds.

<sup>125</sup> Paragraphs (a)(18) and (c)(4)(vi)(A)(2) of Rule 2a-7, as amended. The proposed amendments would have permitted a fund to “look through” the pre-refunded bonds to the escrowed securities for diversification purposes if: (1) the escrowed securities were Government securities; (2) the escrowed securities were pledged only with respect to the payment of principal, interest and premiums on the pre-refunded bonds; and (3) either an independent certified public accountant or a NRSRO certified that the escrowed securities would satisfy all scheduled payments of principal, interest and premiums on the pre-refunded bonds. Commenters urged the Commission to clarify condition (2) by stating that excess proceeds could be remitted to the issuer or a third party. Commenters also noted that NRSROs rarely provide the certification described in condition (3), and requested that the reference to a NRSRO be deleted from the text. The rule reflects these comments; only independent certified public accountants may provide the certification.

agreement.<sup>126</sup> This amendment clarifies that a fund must disregard ratings given to a security before the security became a “refunded security” (as that term is defined in the rule) in determining whether the security is an eligible security (as that term is also defined in the rule).

### 3. Diversification Safe Harbor

A money fund that elects to be diversified must comply with the requirements of Section 5(b)(1) of the 1940 Act and the rules under that section.<sup>127</sup> These requirements are applicable to most taxable and many tax exempt money funds, since most elect to be diversified. Although Rule 2a-7’s diversification requirements are more strict, under certain circumstances a money fund may be in compliance with Rule 2a-7, but not in compliance with Section 5(b)(1).<sup>128</sup> The proposed amendments would have provided that money funds complying with Rule 2a-7’s diversification requirements are deemed to be diversified under Section 5(b)(1) (“diversification safe harbor”). Commenters discussing this aspect of the proposal supported the diversification safe harbor, and the Commission is adopting the amendments as proposed.<sup>129</sup>

### 4. Three-Day Safe Harbor

Rule 2a-7 currently permits a fund to invest more than five percent of its assets in the first tier securities of a single issuer for up to three business days (the “three-day safe harbor”) and does not contain any limitation on the percentage of fund assets that can be invested in accordance with this provision. Since the provision is primarily applicable to taxable funds, which typically are diversified companies within the meaning of Section 5(b)(1), funds could not use this provision to invest more than twenty-five percent of their assets in the securities of a single issuer. The Commission proposed to extend the availability of the three-day safe harbor to national funds. To assure that the three-day safe harbor could not have the effect of allowing funds that are not diversified to invest an inordinate portion of their assets in a single issuer at any time, the proposed amendments would have limited to twenty-five percent the percentage of fund assets that may be invested under the safe harbor at any one time. The Commission is adopting this amendment substantially as proposed.<sup>130</sup>

## E. Asset Backed Securities and Synthetic Securities

### 1. Background

The proposed amendments would have amended Rule 2a-7 to clarify the application of the rule to “synthetic” tax exempt securities and ABSs. Both types of securities rely on demand features and complex liquidity arrangements that are designed to meet the risk-limiting conditions of the rule.

An ABS represents an interest in a pool of financial assets, such as credit card or automobile loan receivables. Typically, an ABS is sponsored by a bank or other financial institution to pool financial assets and convert them into capital market instruments, thereby enabling the sponsor to transform illiquid assets into cash and increase balance sheet liquidity.<sup>131</sup> The ABS is structured to assure that the issuer of the ABS will not be affected by the bankruptcy of the sponsor. In

<sup>126</sup> Paragraph (a)(29)(iii) of Rule 2a-7, as amended. If the security has a NRSRO rating that does reflect the existence of the refunding agreement, then the security would not be considered unrated. *Id.*

<sup>127</sup> See *supra* note 30; Proposing Release, *supra* note 20, at n. 29 and accompanying text.

<sup>128</sup> One difference that may cause this to occur is the timing of the measurement of diversification. Compliance with Section 5(b)(1) of the 1940 Act is measured at the time of a purchase based on the value of the fund’s total assets as of the end of the preceding fiscal quarter. See Rule 5b-1 [17 CFR 270.5b-1]. For purposes of Rule 2a-7, both the fund’s total assets (as defined in the rule) and compliance with the rule’s diversification requirements are measured at the time a purchase is made. See paragraph (c)(4)(i) of Rule 2a-7, as amended.

<sup>129</sup> Paragraph (c)(4)(vii) of Rule 2a-7, as amended

<sup>130</sup> Paragraph (c)(4)(iii) of Rule 2a-7, as amended. Because single state funds are required to be diversified only as to seventy-five percent of their assets, they have available a twenty-five percent basket to accommodate purchases in excess of five percent. Paragraph (c)(4)(i) of Rule 2a-7, as amended. As a result, the three-day safe harbor of paragraph (c)(4)(ii) of the amended rule is not extended to them.

<sup>131</sup> For a detailed discussion of ABSs, see U.S. Securities and Exchange Commission Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation, May 1992, at 1-103 and Investment Company Act Rel. No. 18736 (May 29, 1992) [57 FR 23980 (June 5, 1992)] and Investment Company Act Rel. No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)] respectively proposing and adopting Rule 3a-7 under the 1940 Act [17 CFR 270.3a-7], the rule excluding the issuers of certain ABSs from the definition of investment company.

addition, the structure of the ABS affects the nature and amount of the credit enhancement. While structural issues affect the risks associated with many types of securities, they are particularly important in evaluating ABSs.<sup>132</sup>

Synthetic securities are another form of ABSs that have been developed to address the shortage in the supply of short-term tax exempt securities.<sup>133</sup> While a variety of synthetic structures exist, all involve trusts and partnerships that, in effect, convert long-term fixed-rate bonds into variable or floating rate demand securities. Typically, one or two long-term, high quality, fixed-rate bonds of a single state or municipal issuer (the “core securities”) are deposited in a trust by the sponsor. Interests in the trust may be distributed through an offering of securities to the public registered under the 1933 Act, or through an offering exempt from the Act’s registration requirements, such as a “private placement.” Holders of interests in the trust receive interest at the current short-term market rate and the sponsor receives the difference (after administrative expenses) between the current market interest rate and the long-term rate paid by the core securities.

An affiliate of the sponsor or a third party (usually a bank) issues a conditional demand feature permitting holders to recover principal at par within a specified period. The demand features are conditional to address tax-related concerns. The proposed amendments to the rule would have established specific criteria for fund investment in ABSs, and would have addressed issues concerning the diversification, maturity and quality standards applicable to these types of securities. Most commenters argued that it was not necessary to amend the rule in order to provide for the treatment of ABSs because the diversification, quality, and maturity standards applicable to ABSs could be addressed within the existing framework of the rule. Questions were raised, however, concerning the applicability of the rule to ABSs both prior to and after the publication of the Proposing Release,<sup>134</sup> and commenters presented widely divergent and, sometimes, conflicting views on how ABSs should be treated. The Commission therefore has concluded that amendments are necessary to reduce uncertainty concerning the application of the rule to these securities.

## 2. Definitions

The Commission is adopting, substantially as proposed, certain definitions used in the rule. The term “asset backed security” is defined as a fixed-income security issued by a “special purpose entity,” substantially all the assets of which consist of “qualifying assets.”<sup>135</sup> The term “special purpose entity” is defined as a trust, corporation, partnership or other entity organized for the sole purpose of issuing fixed-income securities, which securities entitle their holders to receive payments that depend primarily on the cash flow from qualifying assets.<sup>136</sup> Finally, the term “qualifying assets” is defined as financial assets, either fixed or revolving, that by their terms convert to cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.<sup>137</sup>

## 3. Diversification Standards

### a. Diversification: General

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<sup>132</sup> While the structure of ABSs vary, the ABSs that have been marketed to money funds have generally involved: (i) the trust, which issues the ABSs; (ii) the sponsor, which contributes the assets to the trust; (iii) the servicer, which is responsible for administering the assets in the pool; (iv) the trustee, which monitors the activities of the servicer, and (v) the bank, which provides some form of liquidity and/or credit enhancement to assure that the trust will have sufficient funds to meet interest and amortization payments in the event that cash flow from the underlying assets is insufficient to meet the payment schedule of the ABSs.

<sup>133</sup> See, e.g., Peter Heap, “Inside Derivatives Price and Demand Are Guide in Building Secondary Market Derivatives,” *Bond Buyer*, Mar. 14, 1995 at 4; “Portfolio Manager Paints Derivatives with a Broad Brush,” *The Guarantor*, Oct. 10, 1994 at 3.

<sup>134</sup> See, e.g., Donaldson, Lufkin & Jenrette Securities Corporation (pub. avail. Sept. 23, 1994); Orrick, Herrington & Sutcliffe (pub. avail. July 27, 1994).

<sup>135</sup> Paragraph (a)(2) of Rule 2a-7, as amended.

<sup>136</sup> This term excludes investment companies. *Id.*

<sup>137</sup> *Id.* The Division of Investment Management has received requests for interpretive guidance under Rules 2a-7 and 3a-7 under the 1940 Act regarding trusts that hold assets that may not be redeemed or mature within a “finite time period.” See, e.g., Donaldson, Lufkin & Jenrette Securities Corp. (pub. avail. Sept. 23, 1994) (auction rate preferred stock issued by closed-end fund that remains outstanding after sale at auction); Brown & Wood (pub. avail. Feb. 24, 1994) (cumulative preferred stock with no determinable liquidation date). The Commission welcomes requests for interpretive guidance or exemptive relief concerning such instruments. Rule 2a-7, as amended, should not be interpreted to permit investments in ABSs that hold assets that are not “qualifying assets” if the rule’s conditions applicable to investment in ABSs (e.g., the rating requirement) are not complied with.

The proposed diversification standards would have distinguished between qualifying assets that consist of the securities of ten or fewer issuers, and qualifying assets that consist of the securities of more than ten issuers. In the case of qualifying assets that consist of securities issued by ten or fewer issuers (e.g., most tax exempt tender option bond structures),<sup>138</sup> the issuer of each core security would have been treated as the issuer for issuer diversification purposes. The sponsor of the ABS would have been treated as the issuer when the ten issuer limit was exceeded.

#### (1) Special Purpose Entity as Issuer

In proposing to treat the sponsor of the special purpose entity as the issuer of the ABS, the Commission assumed that the credit quality of the ABS reflects the asset origination practices of the sponsor.<sup>139</sup> While some commenters agreed with the Commission's analysis, most commenters addressing the subject strongly opposed treating the sponsor of the ABS as the issuer for diversification purposes. They argued that the special purpose entity is protected in the event of the sponsor's bankruptcy so that an investment in an ABS does not reflect the credit risks associated with an investment in the sponsor. The commenters pointed out that the NRSRO ratings assigned to ABSs are premised on the integrity of the structure of the special purpose entity. These commenters urged that the rule treat the special purpose entity as the issuer of the ABS. Commenters also pointed out that the proposed treatment of the sponsor as the issuer of the ABS was inconsistent with the approach of the Commission elsewhere in the securities laws.<sup>140</sup>

The Commission has decided to modify the proposal to conform with its treatment of the special purpose entity as the sponsor of the ABS in other contexts. The diversification standards adopted treat the special purpose entity as the issuer of the ABS, subject to the exception described below.<sup>141</sup>

#### (2) Looking through the Special Purpose Entity

Several commenters agreed that in some circumstances it would be appropriate to "look through" the special purpose entity and treat the obligor of the qualifying assets as the issuer of a portion of the ABS. These commenters asserted that whether to look through the special purpose entity should not turn on the number of qualifying assets, as the Commission proposed, but the extent to which the special purpose entity is concentrated in the assets of a single obligor.

The Commission believes that the approach recommended by the commenters has advantages over that included in the proposal. The proposed approach was designed primarily to require a fund to look through the special purpose entity in the case of a tender option bond or other synthetic security that tends to have few underlying securities. These structures may have more underlying securities, but it would be appropriate to continue to look to the ultimate obligor of the underlying security if the security constitutes a sufficiently large portion of the obligations underlying the ABS. Moreover, it would be appropriate to treat an obligor in a more traditional ABS as the issuer of a proportionate portion of the ABS when the security represents a sufficiently large portion of the ABS.

Based on these considerations, the Commission has revised the rule to provide that the special purpose entity generally is treated as the issuer of the ABS; however, any entity whose obligations constitute ten percent or more of the principal amount of the qualifying assets backing the ABS is deemed to be the issuer of that portion of the ABS equal to the percentage of the qualifying assets represented by all of the obligations of the entity included in the pool.<sup>142</sup> As amended, the rule provides that a special purpose entity whose qualifying assets are themselves ABSs ("secondary ABSs") will be

<sup>138</sup> See Proposing Release, *supra* note 20, at Section II.C.4.d.

<sup>139</sup> *Id.*

<sup>140</sup> One commenter stated that a test different from the one proposed—that is, one based on asset concentration, would be consistent with certain positions taken by the Division of Corporation Finance. An asset concentration in excess of ten percent may elicit staff comments requesting disclosure of financial information regarding the obligor of the assets. See Staff Accounting Bulletins 71 and 71A ("SAB 71/71A").

<sup>141</sup> Paragraph (c)(4)(vi)(A)(4) of Rule 2a-7, as amended.

<sup>142</sup> *Id.* A diversification test of this type is consistent with a no-action position taken by the Division of Investment Management under Section 5(b)(1) of the 1940 Act (Hyperion Capital Management, Inc. (pub. avail. Aug. 1, 1994)) and accounting positions taken by the Division of Corporation Finance (SAB 71/71A, *supra* note 136). See also Securities Exchange Act Release No. 34961 (Nov. 10, 1994) [59 FR 59590 (Nov. 17, 1994)] at n.80 and accompanying text.

treated as the issuer of the secondary ABSs.<sup>143</sup> A fund holding ABSs is required to make the calculations necessary to determine the issuer of the ABSs for diversification purposes on a periodic basis.<sup>144</sup>

#### b. Diversification: First Loss Guarantees

The Proposing Release noted that some ABSs are issued with guarantees as to first losses, in which an institution guarantees all losses up to a specified percentage (e.g., ten percent of the assets of the pool).<sup>145</sup> Because the loss coverage is usually a multiple of the likely losses to be experienced, the possibility of the losses exceeding the coverage generally is considered to be remote. Because a first loss guarantee exposes the guarantor to essentially the same risk as a guarantor of the entire value of the security, the Commission proposed that a first loss guarantor be treated as guarantor of the entire principal amount of the security for purposes of the put diversification standards.

Only one commenter supported this aspect of the Commission's proposal. The remaining commenters opposed the proposed amendment, and generally argued that the proposed treatment of first loss guarantors was inconsistent with the proposed treatment of put providers whose obligations are limited by contract.<sup>146</sup> One commenter objected because the amendment appeared to be addressing the guarantor's exposure to losses, rather than the fund's. Another commenter noted that, because of the contractual limit on the first loss guarantor's obligations, that guarantor is only required to make payment for losses experienced by the pool to the extent of its guarantee, and additional losses would have to be borne by the holder of the ABS.

Rule 2a-7 diversification requirements are designed to limit the exposure of the fund to any single issuer or credit enhancer.<sup>147</sup> Because the exposure of a first loss guarantor to losses the pool may incur is substantially greater than the exposure of a fractional guarantor, the exposure of the fund to the first loss guarantor is also substantially greater.<sup>148</sup> Therefore, the Commission believes that it is appropriate to treat first loss guarantees differently from fractional guarantees. Because first loss guarantees typically are designed to cover likely losses to be experienced, a statement made in the Proposing Release no commenter contradicted, it seems appropriate to treat the first loss guarantor as guaranteeing the entire value of the security. The Commission is adopting this amendment as proposed.<sup>149</sup>

#### 4. Quality Standards

The proposed amendments to Rule 2a-7 would have limited funds to investing only in an ABS that has a short-term rating from a NRSRO and, when the final maturity of the ABS exceeds 397 days, a long-term debt rating from a NRSRO. Many commenters opposed this proposed requirement, arguing that it would be redundant because the rule currently requires fund managers to perform a thorough legal, structural and credit analysis with respect to all securities. The Commission notes that the legal, structural and credit analysis required by Rule 2a-7 is to be conducted

<sup>143</sup> Paragraph (c)(4)(vi)(A)(4) of Rule 2a-7, as amended.

<sup>144</sup> Paragraphs (c)(8)(iv) and (c)(9)(v) of Rule 2a-7, as amended. The calculations are required to be made periodically because of the revolving nature of many ABSs' assets.

<sup>145</sup> Proposing Release, *supra* note 20, at Section II.C.4.e.

<sup>146</sup> Under proposed amendments to the rule's put diversification provisions, the issuer of a fractional put would have been treated as guaranteeing only that portion of the value of the security which it contractually agreed to provide. *See* Proposing Release, *supra* note 20, at Section II.C.2.c. The Commission is adopting these amendments as proposed. *See supra* Section II.C.1.d. of this Release and paragraph (c)(4)(vi)(B)(2) of Rule 2a-7, as amended.

<sup>147</sup> *See* Proposing Release, *supra* note 20, at Section II.A.

<sup>148</sup> For example, if a fractional put provider guarantees ten percent of the losses experienced by a \$1 million pool, and the pool has losses of seven percent, the put provider's exposure is \$7,000. By contrast, if a first loss guarantor guarantees the first ten percent of losses experienced by a \$1 million pool, and the pool has losses of seven percent, the guarantor's exposure is \$70,000—an amount ten times greater than the fractional put provider's exposure.

<sup>149</sup> Paragraph (c)(4)(vi)(B)(2) of Rule 2a-7, as amended. The Commission also notes that the proposed treatment of first loss guarantees under Rule 2a-7 is consistent with a notice of proposed rulemaking issued by the Department of the Treasury, the Federal Reserve System, and the Federal Deposit Insurance Corporation. "Risk-Based Capital Requirements—Recourse and Direct Credit Substitutes; Proposed Rule," 59 FR 27115 (May 25, 1994). As described in that release, the Office of the Comptroller of the Currency, Department of the Treasury, The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision, Department of the Treasury proposed revisions to their risk-based capital standards that would treat certain first loss guarantees as a guarantee of the entire principal amount of the assets enhanced.

independently of any determination of a security's credit quality made by a NRSRO.<sup>150</sup> In addition, the Commission continues to believe that, in view of the role NRSROs have played in the development of the structured finance markets, a rating requirement should not be burdensome.<sup>151</sup> Because both short- and long-term debt ratings from NRSROs reflect the NRSROs' legal, structural, and credit analyses, the rule requires that an ABS be rated in order to be eligible for fund investment, but does not specify whether the rating received must be short- or long-term.<sup>152</sup>

## 5. Maturity Standards

The proposed maturity standards for ABSs would have taken into account the difference between “pay-through” ABSs and “pass-through” ABSs. A pay-through ABS has a maturity and payment schedule different from that of its underlying assets. A pass-through ABS is one in which the cash generated by the underlying assets passes through directly to the ABS holders. Pass-through ABSs held by funds generally are not scheduled to return a holder's principal for three to five years. They typically provide for periodic interest rate resets and for principal to be returned after some period (not exceeding thirteen months) after a demand for payment has been made.

The proposed amendments would have provided that the final maturity of an ABS is the date on which principal is scheduled to be returned to the holder, regardless of whether demand has been made. The proposed amendments also would have permitted a fund to measure the maturity of an ABS with an adjustable rate of interest subject to a demand feature by reference to the time principal is scheduled to be repaid once demand is made, but only if the holder is entitled to receive principal and interest within thirteen months of making demand. Several commenters expressed concern regarding the treatment of a pass-through ABS with a “scheduled” maturity. The commenters noted that the effect of the proposed amendments would be to allow funds to determine the maturity of an ABS by relying on the date on which principal is scheduled, but not necessarily required, to be repaid. These commenters concluded that the proposed amendments' reference to a scheduled principal repayment is troublesome because on that date there is no binding obligation under which the fund would receive payment.

In light of the comments, the Commission has decided to modify the ABS maturity determination by amending 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.<sup>153</sup> 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.<sup>154</sup>

<sup>150</sup> Paragraph (c)(3)(i) of Rule 2a-7, as amended; Release 18005, *supra* note 11, at Section II.A. (adopting amendments to paragraph (c)(2) of Rule 2a-7); Letter to Registrants (pub. avail. May 8, 1990). For a discussion of the limitations of NRSRO ratings for evaluating certain aspects of ABSs, *see* Investment Company Act Rel. No. 20509 at § I.B.1 (Aug. 31, 1994) [59 FR 46304 (Sept. 7, 1994)].

<sup>151</sup> Proposing Release, *supra* note 20, at Section II.C.4.b.

<sup>152</sup> Paragraph (a)(9)(iii)(C) of Rule 2a-7, as amended.

<sup>153</sup> Paragraph (a)(7)(ii) of Rule 2a-7, as amended. For example, prior to the fund's election to receive principal payments, the maturity of an adjustable rate ABS with a five year final maturity and a demand feature permitting the fund to obtain principal and interest within thirteen months would be considered a thirteen month instrument at all times (*i.e.*, on a rolling basis). After the election is made, a fund could treat such an instrument as having a maturity equal to the date when principal will be returned (*i.e.*, each day that the fund holds the instrument after election, the fund could reduce the security's maturity by one day).

This amendment supersedes an interpretive position taken by the Division of Investment Management in Merrill, Lynch, Pierce, Fenner & Smith (pub. avail. Apr. 6, 1987). In Merrill, Lynch, the Division addressed the maturity determination for a type of variable rate coupon note. A holder of the notes was required to satisfy certain conditions in order to receive principal on “the date noted on the face of the instrument” (quoting paragraph (d)(1) of Rule 2a-7, prior to amendment), and, so long as the notes continued to be held, their maturity was automatically extended at the end of each interest rate reset period by one additional such period. The Division concluded that, subject to certain conditions, a money fund could treat such a security as having a maturity equal to the date specified on the face of the instrument, as automatically extended by an additional interest payment period. The Merrill, Lynch position is inconsistent with paragraph (d) of Rule 2a-7, as amended, which provides that an instrument's maturity is the date on which “the principal amount must unconditionally be paid” and with the maturity determination requirements for ABS discussed in the text of this release. Money funds may, however, continue to treat a “mandatory tender” feature as an unconditional right to receive principal, provided that the issuer's obligation to pay is not dependent on the fund taking any action (such as giving notice to the issuer of the intent to redeem), other than physically delivering the notes or bonds for redemption.

<sup>154</sup> Paragraphs (d)(3) and (d)(5) of Rule 2a-7, as amended. The maturity of a floating or variable rate ABS may also be determined by reference to a demand feature meeting the requirements of paragraph (a)(7)(i) of the amended rule.



## F. Variable and Floating Rate Securities

Rule 2a-7 generally prohibits a money fund from acquiring a security with a remaining maturity of more than 397 calendar days. The purpose of this requirement and the other maturity provisions of the rule is to limit a fund's exposure to interest rate risk.<sup>155</sup> The rule generally requires a fund to measure the maturity of a portfolio security by reference to the security's final maturity date. A fund, however, may measure the maturity of a "variable rate security" or a "floating rate security" (collectively, "adjustable rate securities") by reference to a date that is earlier than the final maturity date.

Rule 2a-7 defines a "variable rate security" as an instrument the terms of which provide for the adjustment of the interest rate on specified dates and that, upon adjustment, can reasonably be expected to have a market value that approximates par value. A "floating rate" security is defined as an instrument the terms of which provide for the adjustment of its interest rate whenever a specified benchmark changes and that, at any time, can reasonably be expected to have a market value that approximates par value. Rule 2a-7 allows certain adjustable rate securities to be treated as having maturities shorter than their final maturities; however, the manner in which an adjustable rate instrument is treated depends upon whether it has a demand feature, the final maturity of the instrument and whether the instrument is a Government security.

### 1. Maturity Determinations: Floating Rate Securities

Under the current rule, the maturity of a floating rate security subject to a demand feature is the period remaining until principal can be recovered through demand. The same test is generally applicable in determining the maturity of a variable rate security subject to a demand feature, the principal amount of which is scheduled on the instrument's face to be paid in more than 397 days. In contrast, a variable rate security (without a demand feature) scheduled to be paid in 397 days or less may be treated as having a maturity equal to the period remaining until the next readjustment of the interest rate. There is no parallel provision for floating rate securities with final maturities of 397 days or less.

Because variable and floating rate securities expose funds to similar types of interest rate risk, the Commission proposed to amend 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. Commenters supported the proposed amendment, which the Commission is adopting substantially as proposed.<sup>156</sup> The interest rate of a floating rate security moves in tandem with changes in the interest rate to which it is linked, and the amendments will permit funds to treat these instruments as having one-day maturities.

### 2. Maturity Determinations: Variable Rate Securities

Under the current rule, when the period remaining until the final maturity of a variable rate demand instrument (i.e., its maturity without reference to the demand feature) is less than 397 days, its maturity under Rule 2a-7 is the longer of the period remaining until the next interest rate readjustment or the date on which principal can be recovered on demand. A variable rate security with the same final maturity that does not have a demand feature is treated as having a remaining maturity equal to the period remaining until the next readjustment in the interest rate. The effect of these provisions is that a variable rate security with a final maturity of less than 397 days will have a longer maturity when a demand feature is added to it.

To correct this anomaly, the Commission proposed that only a variable rate demand security with a final maturity in excess of 397 days would have its maturity measured by the longer of the period remaining until its next interest rate adjustment or the date on which principal can be recovered on demand; the maturities of securities with final maturities of 397 days or less would be measured by reference to the earlier of the date on which the interest rate next readjusts or the date on which principal can be recovered on demand. Commenters supported the proposed amendment, which the Commission is adopting as proposed.<sup>157</sup>

<sup>155</sup> See Release 13380, *supra* note 7, at n.14 and accompanying text; State of Wisconsin (pub. avail. Mar. 3, 1983).

<sup>156</sup> Floating rate securities with final maturities of more than 397 days that are subject to demand features are deemed to having maturities equal to the period remaining until principal can be recovered through demand. Paragraph (d)(5) of Rule 2a-7, as amended.

<sup>157</sup> Paragraph (d)(2) of Rule 2a-7, as amended.

### 3. Adjustable Rate Government Securities

Rule 2a-7 provides that “an instrument that is issued or guaranteed by the United States government or any agency thereof which has a variable rate of interest adjusted no less frequently than every 762 days” is deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.<sup>158</sup> The Commission is adopting two amendments to clarify the scope of this provision.

First, the amendments clarify that 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.<sup>159</sup> This change makes explicit that Government securities are treated the same way as other adjustable rate securities under the rule.<sup>160</sup>

Second, the reference to Government securities in paragraph (d)(1) of Rule 2a-7 is being conformed to other provisions of the rule relating to Government securities. As amended, the provision applies to all Government securities, including securities issued by persons controlled or supervised by and acting as instrumentalities of the U.S. Government.<sup>161</sup>

### 4. Other Issues Concerning Adjustable Rate Securities

#### a. Background

Rule 2a-7 allows the maturity of adjustable rate securities to be determined by reference to interest rate adjustment dates if the security “can reasonably be expected to have a market value that approximates its par value” upon adjustment of the interest rate.<sup>162</sup> The Commission proposed to clarify that the board of directors or its delegate must have a reasonable expectation that, upon each adjustment of the interest rate until the final maturity of the security or until the principal amount can be recovered through demand, the security will have a market value approximating its amortized cost.<sup>163</sup>

Several commenters discussed the proposed amendments to the maturity determination provisions of the rule as they relate to adjustable rate Government securities. Commenters opposing this aspect of the proposed amendments emphasized that the amendments should exclude adjustable rate Government securities “based on the lack of credit risk” inherent in these instruments. The maturity determination provisions of the rule, however, are designed to limit a fund’s exposure to interest rate, rather than credit, risk and recent history demonstrates that an investment in a Government

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<sup>158</sup> Paragraph (d)(1) of Rule 2a-7, as amended. Generally, the readjustment must occur every 397 days to reflect the rule’s maturity requirements. For certain funds that mark-to-market, however, readjustment may occur every 762 days. Paragraph (c)(2)(ii) of Rule 2a-7, as amended.

<sup>159</sup> This codifies the interpretation of the current rule. *See* Investment Company Institute (pub. avail. June 16, 1993); Morgan Keegan & Company, Inc. (pub. avail. July 24, 1992) at n.7.

<sup>160</sup> The amendments also make clear that this provision applies to floating rate Government securities. Paragraph (d)(1) of Rule 2a-7, as amended.

<sup>161</sup> The amendment reflects a no-action position taken by the Division of Investment Management with respect to securities issued by instrumentalities of the U.S. government. *See* Student Loan Marketing Association (pub. avail. Jan. 18, 1989).

<sup>162</sup> Paragraphs (a)(7) and (a)(21) of Rule 2a-7 [17 CFR 270.2a-7(a)(7) and (a)(21)], prior to amendment. Adjustable rate securities may be priced at a premium to par value when the security pays interest above market rates. A fund may treat the security as an adjustable rate security for purposes of Rule 2a-7’s maturity provisions if the fund reasonably expects that upon readjustment of the interest rate, the market value of the security will approximate its amortized cost. The premium generally would be amortized over the life of the security. It is critical that the fund carefully consider all factors involved in the valuation of the security, particularly the likelihood of prepayment before the premium is fully amortized. An accelerated return of principal will require the fund to write off the premium before it is amortized, and could result in a significant deviation between the amortized cost and market value of the security.

<sup>163</sup> Paragraphs (a)(12) and (a)(30) of Rule 2a-7, as amended.

security can expose the fund to substantial interest rate risk.<sup>164</sup> The Commission is, therefore, adopting the amendment as proposed.

The effect of the new provision is to prohibit funds from purchasing an adjustable rate Government security with a remaining maturity of more than 397 days unless the interest rate readjustment mechanism can reasonably be expected to return the instrument to par upon all interest rate adjustment dates during the life of the instrument. A fund could purchase an adjustable rate Government security with a remaining maturity of 397 days or less, the value of which the fund does not expect to return to par on all interest rate adjustment dates, but would have to treat the security as a fixed rate security and measure its maturity by reference to its final maturity. Adjustable rate securities with demand features generally would not be affected by the proposed changes because if a discount develops or is likely to develop a fund could exercise the demand feature and receive the amortized cost value of the instrument.

#### b. Recordkeeping Requirement

The Commission proposed to require a money market fund to maintain a written record of its determination that an adjustable rate security, the maturity of which is determined by reference to its interest rate readjustment date, will either maintain a value of par or return to par on each interest rate readjustment date through the life of the security. A number of commenters who opposed this requirement stated that further guidance regarding the definition of the term “approximates par” was necessary or that the rule should specifically state the amount of deviation that would be permissible. The Commission believes that this approach would be rigid and unnecessary, absent an indication that decisions reached in this area by funds are inconsistent with the purposes of the rule.

Other commenters asserted that the paperwork burden this requirement could entail might outweigh benefits to shareholders, and might have the effect of forcing funds to purchase higher proportions of fixed rate securities that may have a higher degree of price volatility than adjustable rate securities. The Commission is not persuaded by this argument. One of these commenters suggested that if the determination regarding the return to par would be common to a group of securities, a single documentation of the analysis should be sufficient. The Commission agrees. The amendments do not require a fund’s board of directors to maintain a written determination for each individual adjustable rate security in the fund’s portfolio—it is sufficient for the fund to maintain the required record for each type of security (e.g., one record could be maintained for several different adjustable rate securities of similar credit quality whose interest rate readjustment mechanisms are tied to LIBOR plus or minus a number of basis points that make the securities similarly sensitive to interest rate changes). The Commission has decided to adopt the amendments as proposed.<sup>165</sup>

### G. Other Amendments to Rule 2a-7

#### 1. U.S. Dollar Denominated Instruments

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<sup>164</sup> In the Proposing Release, the Commission noted that a number of adjustable rate securities developed specifically for money market funds had interest rate readjustment formulas that could not be expected to reflect short-term interest rates under certain conditions. At that time, the Commission expressed the concern that changes in interest rates or other conditions that could reasonably be foreseen to occur during the life of the securities could result in their market values not returning to par at the time of an interest rate readjustment. The Commission identified securities that displayed this characteristic, and concluded that such securities presented risks that were not appropriate for money market funds to assume. *See* Proposing Release, *supra* note 20, at nn.161-164 and accompanying text. In June 1994, the Division of Investment Management provided money market funds and their advisers with additional guidance concerning investments in adjustable rate securities. The Division reminded fund managers of their general obligations under Rule 2a-7 to ensure that money market funds invest only in securities that are consistent with maintaining stable net asset values, and directed money market funds that held these securities to work with their advisers in developing plans for their orderly disposition. *See* Letter from Barry P. Barbash, Director, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (June 30, 1994). Money market funds holding adjustable rate securities of the type described in the Proposing Release experienced problems when short-term interest rates increased last year. To maintain their funds’ stable net asset values, a number of fund advisers took actions which included purchasing certain adjustable rate securities from their money market funds at their amortized cost value (plus accrued interest), or contributing capital to the funds. One fund holding notes of this type, the US Government Money Market Fund, a series of Community Bankers Mutual Fund, Inc., announced in September 1994 that it would liquidate and distribute less than \$1.00 per share to its shareholders. Press reports generally treated this liquidation as the first instance in which a money market fund had “broken a dollar.” *See* Brett D. Fromson, “Losses on Derivatives Lead Money Fund to Liquidate,” *Washington Post*, Sept. 28, 1994 at F1; Leslie Wayne, “For Money Market Fund Investors, New Cautions,” *N.Y. Times*, Sept. 29, 1994 at D1, D8.

<sup>165</sup> Paragraphs (c)(8)(iii) and (c)(9)(iv) of Rule 2a-7, as amended.

To avoid exposure to foreign currency risk, Rule 2a-7 limits fund investment to “United States dollar-denominated securities.”<sup>166</sup> The proposed amendments would have defined the term “United States dollar-denominated” to clarify that it means: (a) the payment of interest and principal must be made in U.S. dollars at all times; and (b) an eligible security’s interest rate may not vary or float with a rate tied to foreign currencies, foreign interest rates, or any index expressed in a currency other than U.S. dollars.

Several commenters were critical of the proposed definition and recommended that the rule permit fund investment in securities on which the amount of interest payable is based on changes in the value of a foreign currency as long as principal and interest are payable in full in U.S. dollars. The Commission believes that amending the rule in this manner would have the effect of exposing the fund to currency fluctuations. The Commission has decided to adopt the definition of “United States dollar-denominated” as proposed.<sup>167</sup>

## 2. Investment in Other Money Funds

The Commission is adopting, as proposed, amendments to Rule 2a-7 to clarify that shares in other money funds that comply with the rule: (a) are first tier securities;<sup>168</sup> and (b) should be treated as having a rolling maturity equal to the period of time within which the acquired fund is required to make payment upon redemption under applicable law.<sup>169</sup> A shorter maturity may be used if the fund making the investment has a contractual arrangement with the other money fund for more rapid receipt of redemption proceeds.<sup>170</sup>

For diversification purposes, an investment in another money fund generally may be treated as an investment in any other issuer (and therefore generally cannot exceed five percent of a fund’s assets).<sup>171</sup> An exception to this treatment is made for funds that invest substantially all of their assets in shares of another money fund (the “underlying fund”) in which case the fund is permitted to “look through” the shares to the assets of the underlying fund.<sup>172</sup> These include funds in “master-feeder” arrangements and certain separate accounts offering variable insurance products. Such a fund will be deemed to be in compliance with Rule 2a-7 for diversification and other purposes if the board of directors reasonably believes that the underlying money fund is in compliance with the rule.<sup>173</sup> The board of directors of the fund is not required to monitor every investment decision made by the underlying fund. Rather, the board could review the underlying fund’s procedures and obtain regular reports concerning the underlying fund’s compliance with the rule.<sup>174</sup>

## 3. Board Approval and Reassessment of Certain Securities

Rule 2a-7 currently requires the board of directors of a taxable fund to approve or ratify purchases of unrated securities and securities that are rated by only one NRSRO. The amendments eliminate this requirement.<sup>175</sup>

Rule 2a-7 also requires funds to limit portfolio investments to securities determined to present minimal credit risks. In compliance with this requirement, the fund’s board of directors must reassess promptly whether a security presents

<sup>166</sup> Paragraph (c)(3)(i) of Rule 2a-7, as amended.

<sup>167</sup> Paragraph (a)(28) of Rule 2a-7, as amended.

<sup>168</sup> Paragraph (a)(11)(iv) of Rule 2a-7, as amended.

<sup>169</sup> Paragraph (d)(8) of Rule 2a-7, as amended. *See also* Proposing Release, *supra* note 20, at n.182 and accompanying text; T+3 Letter, *supra* note 65.

<sup>170</sup> *Id.*

<sup>171</sup> Investment by one fund in another is limited by Section 12(d)(1)(A) of the 1940 Act [15 U.S.C. 80a-12(d)(1)(A)]. Section 12(d)(1)(A) provides that a fund may not invest more than ten percent of its assets in securities issued by other investment companies, invest more than five percent of its assets in any single investment company, or acquire more than three percent of the voting securities of another investment company.

<sup>172</sup> Paragraph (c)(4)(vi)(A)(5) of Rule 2a-7, as amended. The restrictions of Section 12(d)(1)(A) do not apply if the fund making the investment invests all of its assets in shares of another fund, subject to certain conditions. Section 12(d)(1)(E) [15 U.S.C. 80a-12(d)(1)(E)].

<sup>173</sup> Paragraph (c)(4)(vi)(A)(5) of Rule 2a-7, as amended. The responsibility for making this determination may be delegated by the board to the fund’s adviser. Paragraph (e) of Rule 2a-7, as amended.

<sup>174</sup> In addition, the investment objectives and policies of the two funds should not be inconsistent. *See* Guide 34 to Form N-1A and Guide 38 to Form N-3.

<sup>175</sup> Paragraph (c)(3) of Rule 2a-7, as amended.

minimal credit risks when the fund's investment adviser becomes aware that an unrated security or a second tier security has been given a rating by any NRSRO below the NRSRO's second highest rating category. The Proposing Release requested comment on whether to permit delegation of the reassessment requirement.<sup>176</sup> All the commenters who responded to this request suggested that the rule should permit delegation of the reassessment requirement to the fund's investment adviser. These commenters stated that the investment adviser is in a better position to make credit determinations given its staff and analytical and information resources. The Commission agrees, and is amending the rule as suggested.<sup>177</sup>

#### 4. Recordkeeping

Amendments to Rule 2a-7 require a fund to maintain a written record of the determination that a portfolio security presents minimal credit risks and to maintain a record of NRSRO ratings (if any) used to determine the status of a security under the rule.<sup>178</sup> The Commission is also adopting, as proposed, amendments to Rule 31a-1 under the 1940 Act that require money funds to maintain in their portfolio investment records information identifying: (a) each security by its legal name; (b) any liquidity or credit enhancements associated with each security; and (c) any coupons, accruals, maturities, puts, calls or any other information necessary to identify, value and account for each security.

#### 5. Defaulted Securities

Rule 2a-7 imposes certain obligations regarding defaulted securities.<sup>179</sup> The Commission proposed amending the rule to include "events of insolvency" as events that would trigger these obligations, and is adopting those amendments substantially as they were proposed.<sup>180</sup> The Commission is adopting as proposed an amendment to the rule that would require a fund to notify the Commission of the default of a security subject to a credit enhancement or demand feature only in the event that the provider of the enhancement or demand feature failed to fulfill its obligations to the fund.<sup>181</sup>

#### 6. Technical Amendments

The Commission is adopting technical amendments to Rule 2a-7 to clarify its terminology. References to "instruments" are being changed to "securities." In addition, references to the requirement that the market value of an adjustable rate security must reasonably approximate its par value are being changed to clarify that the security's market value must reasonably approximate its amortized cost.<sup>182</sup> The definition of "unrated security" also is being revised to clarify that if an unrated security becomes rated while held by the fund, the fund may continue to treat it as an unrated security, in the same manner as a fund may continue to determine whether a security rated by a single NRSRO is first or second tier if a second NRSRO rates the security after it is acquired by the fund.<sup>183</sup> The definition of "first tier security" is also being amended to include government securities.<sup>184</sup>

### III. Amendments to Disclosure Rules

The Commission is adopting amendments to the forms and advertising rules used by tax exempt funds and is publishing a Staff Guide designed to elicit disclosures concerning the specific risks of investing in tax exempt funds.

<sup>176</sup> Proposing Release, *supra* note 20, at Section II.D.6.

<sup>177</sup> Paragraphs (c)(5)(i)(A) and (e) of Rule 2a-7, as amended.

<sup>178</sup> Paragraph (c)(9)(iii) of Rule 2a-7, as amended.

<sup>179</sup> See Proposing Release, *supra* note 20, at Section II.D.8.

<sup>180</sup> Paragraphs (a)(10) and (c)(5)(ii) of Rule 2a-7, as amended.

<sup>181</sup> Paragraph (c)(5)(iv) of Rule 2a-7, as amended.

<sup>182</sup> Paragraphs (a)(12), (a)(30), and (c)(8)(iii) of Rule 2a-7, as amended. See *supra* Section II.F.4.a. (discussion of determination that par will be approximated).

<sup>183</sup> Paragraph (a)(29) of Rule 2a-7, as amended.

<sup>184</sup> Paragraphs (a)(11)(v) and (a)(13) of Rule 2a-7, as amended. Prior to the adoption of today's amendments, a fund purchasing a government security would have been required to treat the security as an unrated first tier security (paragraph (a)(11)(iii) of Rule 2a-7, as amended), because NRSROs do not rate government securities. As a result, the fund would have been required to perform a comparability analysis. Under the amended definition of "first tier security," a fund may treat a government security as first tier without conducting a comparability analysis, even though the security has not received a rating from an NRSRO.

### A. Single State Funds

To alert investors to the greater risks of investing in single state funds, proposed amendments to Form N-1A would have required a single state fund to disclose in its prospectus that: (1) its investments are concentrated geographically; (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 funds. Several commenters, while generally supporting additional disclosure, expressed concern that the proposed disclosure for single state funds might exaggerate the risk of investing in these funds, leading to investor confusion. These commenters urged the Commission not to require a single state fund to disclose that an investment in it may be riskier than an investment in another type of money fund. The amendments to Rule 2a-7 require single state funds to be diversified at the five percent level as to seventy-five percent of their assets, but these funds are less diversified than other types of money market funds and are still dependent on the financial health of a particular state.<sup>185</sup> Because of the importance of diversification in protecting a fund from exposure to a particular issuer, the Commission has decided to require a single state fund that is not diversified as to 100% of assets to disclose on the cover page of the prospectus that it may invest a significant percentage of its assets in the securities of a single issuer, and that an investment in the fund may therefore be riskier than investment in other types of money funds. The Commission has also decided to adopt the disclosure requirement regarding geographic concentration, which may be placed in the text of the prospectus, substantially as proposed.<sup>186</sup>

### B. Disclosure Concerning Exposure to Put Providers

The Commission is publishing an amendment to Staff Guide 21 to Form N-1A. The amendment interprets the form as requiring a money fund having more than forty percent of its portfolio subject to third party credit enhancements to disclose that the safety of its portfolio (and the ability of the fund to maintain a stable share price) is largely dependent upon guarantees from foreign and domestic banks and that these arrangements are not subject to federal deposit insurance. The wording of the guide has been changed somewhat from the draft published in the Proposing Release<sup>187</sup> to reflect the approach taken by the Commission in proposing to simplify money market fund prospectuses.<sup>188</sup>

Under the proposed amendments, money fund portfolio schedules would have been required to include information regarding put providers.<sup>189</sup> Those amendments are not being adopted at this time. The Commission is currently examining portfolio schedule requirements for investment companies generally and will continue to consider the proposed amendments in connection with that project.

### C. Risk Disclosure in Certain Communications

Money funds are required to include in certain advertisements and sales literature a statement that an investment in a money fund is not insured or guaranteed by the U.S. Government and there can be no assurance that the fund will maintain a stable net asset value.<sup>190</sup> The amendments extend this requirement to “tombstone” advertisements under rule 134 of the 1933 Act.<sup>191</sup>

## IV. Exemptive Rule Governing Purchases of Certain Portfolio Securities by Affiliated Persons

The Proposing Release noted that when money funds have held a security that is no longer eligible for fund investment, fund advisers or related persons frequently have repurchased the security from the fund at the security’s amortized cost value to avoid any fund shareholder loss.<sup>192</sup> These transactions came within Section 17(a)(2) of the 1940 Act [*15 U.S.C. 80a-17(a)(2)*], which prohibits an affiliated person of a fund, or an affiliated person of such a person, from knowingly purchasing a security from the fund in the absence of a Commission exemption. Nevertheless, the transactions appeared

<sup>185</sup> See *supra* Section II.B.1.a. of this Release and paragraph (c)(4)(ii) of Rule 2a-7, as amended.

<sup>186</sup> Item 4(c) of Form N-1A, as amended.

<sup>187</sup> Guide 21 to Form N-1A, as amended.

<sup>188</sup> Investment Company Act Rel. No. 21216 (July 19, 1995) [*60 FR 38454* (July 26, 1995)].

<sup>189</sup> Proposing Release, *supra* note 20, at Section III.C.

<sup>190</sup> See paragraph (a)(7) of Rule 482 [*17 CFR 230.482(a)(7)*] and introductory paragraph of Rule 34b-1 [*17 CFR 270.34b-1*].

<sup>191</sup> Paragraph (e) of Rule 134, as amended [*17 CFR 230.134(e)*].

<sup>192</sup> Proposing Release, *supra* note 20, at nn.12 and 28 and accompanying text.

to be reasonable, fair, in the best interests of fund shareholders, and consistent with the actions that a fund should take in the event of a default of a portfolio security.<sup>193</sup> Thus, the staff of the Division of Investment Management advised parties to these transactions that the staff would not recommend enforcement action to the Commission if these transactions were consummated.

Based upon the Commission's experience with actions taken by funds and their affiliates to dispose of portfolio securities that were no longer eligible under Rule 2a-7,<sup>194</sup> the Commission proposed new Rule 17a-9 to exempt from Section 17(a) of the 1940 Act the purchase of a security that is no longer an eligible security. Several commenters, including the ICI, opposed the adoption of Rule 17a-9, asserting that its mere existence would cause investors to expect a fund's adviser to purchase ineligible securities from the fund, and guarantee that the fund will maintain a stable net asset value.

The Commission believes that existing rules applicable to money funds already address this concern by requiring money fund prospectuses and sales literature to disclose prominently that there is no assurance or guarantee that a fund will be able to maintain a stable net asset value of \$1.00 per share.<sup>195</sup> Moreover, the Commission believes it unlikely that the existence of an exemptive rule alone will create any investor expectations.

The Commission has decided to adopt the rule as proposed. In doing so, the Commission is not suggesting that affiliated persons of funds have any legal obligation to enter into transactions covered by the new rule. The exemption applies to transactions where: (a) the purchase price is paid in cash; and (b) 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).<sup>196</sup> The rule, as adopted, is available for transactions involving securities that are no longer eligible securities because they no longer satisfy either the credit quality or maturity limiting provisions of the rule (e.g., the securities are long-term adjustable rate securities whose market values no longer approximate their par values on the interest rate readjustment dates).

## V. Compliance Dates

### A. General Compliance Date

Money funds may comply with any of the amendments or rules adopted today upon publication of this release in the Federal Register. Beginning October 3, 1996, money funds must comply with all amendments and rules adopted today not specifically addressed below in paragraphs B. and C.<sup>197</sup> The Commission is delegating to the Division Director the authority to address issues regarding compliance dates that are not addressed in this section, unless the Director believes that it is necessary in the public interest or in the interest of investors that the Commission consider the issue.

Rule 2a-7 requires funds to meet the rule's diversification requirements with respect to a particular issuer on the date the fund acquires a security of that issuer.<sup>198</sup> Therefore, phase-in rules for the new diversification requirements for tax exempt funds are unnecessary. A tax exempt fund holding a greater percentage of its total assets in the securities of an issuer than the applicable diversification requirement permits as of October 3, 1996 may not purchase additional securities or "roll over" current holdings until such securities purchased or rolled over will not cause the fund to exceed the applicable

<sup>193</sup> Paragraph (c)(5)(ii) of Rule 2a-7, as amended, requires a fund holding a defaulted security to dispose of the security as soon as practicable consistent with achieving an orderly disposition of the security, unless the fund's board of directors concludes that disposal would not be in the best interests of the fund.

<sup>194</sup> See Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Issues Affecting the Mutual Fund Industry Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 23-25 (Sept. 27, 1994); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Municipal Bond and Government Securities Markets Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 10-11 (Jan. 5, 1995).

<sup>195</sup> See Release 18005, *supra* note 11, at Section II.H. (adopting amendments to Item 1(a)(ix) of Form N-1A).

<sup>196</sup> See Rule 17a-9, as adopted. A fund must notify the Commission in the event of default with respect to portfolio securities that account for one half of one percent or more of a fund's assets immediately before the occurrence of default. See paragraph (c)(5)(iii) of Rule 2a-7, as amended.

<sup>197</sup> To the extent these amendments involve clarification of Commission or staff interpretations of the current provisions of Rule 2a-7, these compliance dates are not intended to suggest that non-compliance prior thereto does not involve a violation of Rule 2a-7.

<sup>198</sup> Paragraphs (c)(4)(i) and (ii) (with respect to diversification generally) and (c)(4)(v) (with respect to diversification of puts) of Rule 2a-7, as amended

diversification requirements immediately after the purchase or rollover. Funds are not required to exercise puts or otherwise dispose of portfolio holdings to meet the new diversification requirements.

## B. Grandfathered Securities

To minimize disruption to funds and markets as a result of adoption of these amendments, the Commission is “grandfathering” certain securities first issued on or before June 3, 1996 that do not meet the following requirements of the amended rule:

- (1) requirement that demand features be rated;<sup>199</sup>
- (2) requirement that, in order for a security subject to a demand feature to be an eligible security, the fund must receive notice from the demand feature’s issuer or another institution if there is a substitution of the provider of the demand feature;<sup>200</sup>
- (3) new requirements for ABSs regarding maturity determinations and ratings;<sup>201</sup>
- (4) revised definition of “put” to include ability to recover principal and any accrued interest;<sup>202</sup> and
- (5) requirement that security subject to conditional demand feature is an eligible security only if the board of directors or its delegate makes certain determinations regarding the demand feature’s exercisability.<sup>203</sup>

A money fund may continue to hold these “grandfathered” securities or acquire such securities provided that they satisfy the other provisions of the rule, as amended, and are issued on or before June 3, 1996.

## C. Disclosure and Reporting

The following amendments pertaining to disclosure and advertising will become effective as follows:

- (1) amendments to Form N-1A will be effective: (1) for investment companies whose registration statements become effective on or after June 3, 1996 upon use of any prospectus on or after June 3, 1996; and (2) for all other investment companies, upon use of any prospectus contained in any post-effective amendment filed on or after June 3, 1996;
- (2) amendments to Form N-SAR will be effective for any report required by Rules 30a-1 and 30b1-1 [*17 CFR 270.30a-1 and 270.30b1-1*] filed on or after July 3, 1996; and
- (3) the amendment to Rule 134 under the Securities Act of 1933 will be effective for “tombstone” advertisements used after June 3, 1996.

## VI. Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis regarding the proposed rule and form amendments was published in the Proposing Release. No comments were received. The Commission has prepared a Final Regulatory Flexibility Analysis in accordance with *5 U.S.C. 604*, a copy of which may be obtained by contacting Martha H. Platt, Senior Attorney, Mail Stop 10-6, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

<sup>199</sup> Paragraph (a)(9)(iii)(D)(1) of Rule 2a-7, as amended.

<sup>200</sup> Paragraph (a)(9)(iii)(D)(2) of Rule 2a-7, as amended.

<sup>201</sup> Paragraphs (a)(7)(ii) (definition of demand feature for ABS) and (a)(9)(iii)(C) (rating requirements) of Rule 2a-7, as amended. Note, however, that funds are required to apply the diversification requirements for ABS in accordance with Section V.A., *supra*, of this Release. See also paragraph (c)(4)(vi)(A)(4) of Rule 2a-7, as amended (diversification calculation for ABSs).

<sup>202</sup> Paragraph (a)(16) of Rule 2a-7, as amended.

<sup>203</sup> Paragraph (c)(3)(iii)(B) of Rule 2a-7, as amended.



## VII. Statutory Authority

The Commission is amending Rule 2a-7 under the exemptive and rulemaking authority set forth in Sections 6(c) [15 U.S.C. 80a-6(c)], 8(b) [15 U.S.C. 80a-8(b)], 22(c) [15 U.S.C. 80a-22(c)], 34(b) [15 U.S.C. 80a-34(b)], and 38(a) [15 U.S.C. 80a-37(a)] of the Investment Company Act of 1940. The Commission is adopting Rule 17a-9 under the exemptive and rulemaking authority set forth in Sections 6(c) [15 U.S.C. 80a-6(c)] and 38(a) [15 U.S.C. 80a-37(a)] of the Investment Company Act of 1940. The authority citations for the amendments to the rules and forms precede the text of the amendments.

## VIII. Text of Rule and Form Amendments

List of Subjects in 17 CFR Parts 230, 239, 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Commission is amending chapter II, title 17 of the Code of Federal Regulations as follows:

### Part 230—General Rules and Regulations, Securities Act of 1933

1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78d, 78l, 78m, 78n, 78o, 78w, 79ll(d), 79t, 80a-8, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

\* \* \*

2. Section 230.134 is amended by adding paragraph (e) to read as follows:

§ 230.134 Communications not deemed a prospectus.

\* \* \*

(e) In the case of an investment company registered under the Investment Company Act of 1940 that holds itself out as a “money market fund,” a communication used under this section shall contain the disclosure required by § 230.482(a)(7).

### Part 270—Rules and Regulations, Investment Company Act of 1940

3. The authority citation for Part 270 is amended by removing the third paragraph in the sub-authority to read as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-37, 80a-39 unless otherwise noted;

\* \* \*

4. Section 270. 2a-7 is revised to read as follows:

§ 270. 2a-7. Money market funds.

(a) Definitions.

(1) Amortized Cost Method of valuation shall mean the method of calculating an investment company’s net asset value whereby portfolio securities are valued at the fund’s acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(2) Asset Backed Security shall mean a fixed income security (other than a Government security) issued by a Special Purpose Entity (as hereinafter defined), substantially all of the assets of which consist of Qualifying Assets (as hereinafter defined). Special Purpose Entity shall mean a trust, corporation, partnership or other entity organized for the sole purpose of issuing fixed income securities which entitle their holders to receive payments that depend primarily on the

cash flow from Qualifying Assets, but does not include a registered investment company. Qualifying Assets shall mean financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(3) Business Day shall mean any day, other than Saturday, Sunday; or any customary business holiday.

(4) Collateralized Fully in the case of a repurchase agreement shall mean that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the money market fund reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price (as defined hereinafter) provided in the agreement; and

(ii) The money market fund or its custodian either has actual physical possession of the collateral or, in the case of a security registered on a book entry system, the book entry is maintained in the name of the money market fund or its custodian; and

(iii) The money market fund retains an unqualified right to possess and sell the collateral in the event of a default by the seller; and

(iv) The collateral consists entirely of securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency thereof, and/or certificates of deposit, bankers' acceptances which are eligible for acceptance by a Federal Reserve Bank, and, if the seller is a depository institution as defined in *12 U.S.C. 1813(c)*, mortgage related securities (as such term is defined in Section 3(a)(41) of the Securities Exchange Act of 1934 [*15 U.S.C. 78c(a)(41)*]) that, at the time the repurchase agreement is entered into, are rated in the highest rating category by the Requisite NRSROs.

(v) Resale Price shall mean the purchase price paid to the seller of the securities plus the accrued resale premium on such purchase price. The accrued resale premium shall be the amount specified in the repurchase agreement or the daily amortization of the difference between the purchase price and the resale price specified in the repurchase agreement.

(5) Conditional Demand Feature shall mean a Demand Feature that is not an Unconditional Demand Feature.

(6) Conduit Security shall mean a security issued by a Municipal Issuer (as hereinafter defined) involving an arrangement or agreement entered into, directly or indirectly, with a person other than a Municipal Issuer, which arrangement or agreement provides for or secures repayment of the security. Municipal Issuer shall mean a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality of a state or territory of the United States. A Conduit Security does not include a security that is:

(i) Fully and unconditionally guaranteed by a Municipal Issuer; or

(ii) Payable from the general revenues of the Municipal Issuer or other Municipal Issuers (other than those revenues derived from an agreement or arrangement with a person who is not a Municipal Issuer that provides for or secures repayment of the security issued by the Municipal Issuer); or

(iii) Related to a project owned and operated by a Municipal Issuer; or

(iv) Related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a Municipal Issuer.

(7) Demand Feature shall mean:

(i) A Put that may be exercised either:

(A) At any time on no more than 30 days' notice; or

(B) At specified intervals not exceeding 397 calendar days and upon no more than 30 days' notice; or

(ii) A feature permitting the holder of an Asset Backed Security unconditionally to receive principal and interest within thirteen months of making demand.

(8) Demand Feature Issued By A Non-Controlled Person shall mean a Demand Feature issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature. Control shall mean “control” as defined in Section 2(a)(9) of the Act [15 U.S.C. 80a-2(a)99].

(9) Eligible Security shall mean:

(i) A security with a remaining maturity of 397 calendar days or less that has received a short-term rating (or that has been issued by an issuer that has received a short-term rating with respect to a class of debt obligations, or any debt obligation within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in one of the two highest short-term rating categories (within which there may be sub-categories or gradations indicating relative standing); or

(ii) A security:

(A) That at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less; and

(B) Whose issuer has received from the Requisite NRSROs a rating with respect to a class of debt obligations (or any debt obligation within that class) that is now comparable in priority and security with the security, in one of the two highest short-term rating categories (within which there may be sub-categories or gradations indicating relative standing); or

(iii) An Unrated Security that is of comparable quality to a security meeting the requirements of paragraphs (a)(9)(i) or (ii) of this section, as determined by the money market fund’s board of directors; Provided however, that:

(A) The board of directors may base its determination that a Standby Commitment that is not a Demand Feature is an Eligible Security upon a finding that the issuer of the commitment presents a minimal risk of default;

(B) A security that at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 or less and that is an Unrated Security is not an Eligible Security if the security has received a long-term rating from any NRSRO that is not within the NRSRO’s three highest long-term ratings categories (within which there may be sub-categories or gradations indicating relative standing);

(C) An Asset Backed Security shall not be an Eligible Security unless it has a debt rating from an NRSRO; and

(D) A security that is subject to a Demand Feature shall not be an Eligible Security unless:

(1) The Demand Feature has received a short-term rating from an NRSRO (or the issuer of the Demand Feature has received from an NRSRO a short-term rating with respect to a class of debt obligations or any debt obligation within that class that is comparable in priority and security to the Demand Feature); and

(2) The issuer of the Demand Feature, or another institution, undertakes to notify promptly the holder of the security in the event that the Demand Feature is substituted with a Demand Feature provided by another issuer.

(10) Event of Insolvency shall mean, with respect to an issuer or guarantor:

(i) An admission of insolvency, the application by the issuer or guarantor for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the issuer of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; or

(ii) The institution of similar proceedings by another person which proceedings are not contested by the issuer or guarantor; or

(iii) The institution of similar proceedings by a government agency responsible for regulating the activities of the issuer or guarantor, whether or not contested by the issuer or guarantor.

(11) First Tier Security shall mean any Eligible Security that:

(i) Has received a short-term rating (or that has been issued by an issuer that has received a short-term rating with respect to a class of debt obligations, or any debt obligation within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(ii) Is a security described in paragraph (a)(9)(ii) of this section whose issuer has received from the Requisite NRSROs a short-term rating with respect to a class of debt obligations (or any debt obligation within that class) that now is comparable in priority and security with the security, in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(iii) Is an Unrated Security that is of comparable quality to a security meeting the requirements of paragraphs (a)(11)(i) and (ii) of this section, as determined by the fund's board of directors; or

(iv) Is a security issued by a registered investment company that is a money market fund; or

(v) Is a Government Security.

(12) Floating Rate Security shall mean a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and which, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(13) Government Security shall mean any Government security as defined in Section 2(a)(16) of the Act [15 U.S.C. 80a-2(a)(16)].

(14) NRSRO shall mean any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi)(E), (F) and (H) of § 240.15c3-1 of this Chapter that is not an affiliated person, as defined in Section 2(a)(3)(c) of the Act [15 U.S.C. 80a-2(a)(3)(C)], of the issuer of, or any insurer, guarantor or provider of credit support for, the security.

(15) Penny-Rounding Method of pricing shall mean the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(16) Put shall mean a right to sell a specified underlying security or securities within a specified period of time and at an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise, that may be sold, transferred or assigned only with the underlying security or securities. A Put will be considered to be from the party to whom the money market fund will look for payment of the exercise price.

(17) Put Issued By A Non-Controlled Person shall mean a Put issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Put. Control shall mean "control" as defined in Section 2(a)(9) of the Act [15 U.S.C. 80a-2(a)(9)].

(18) Refunded Security shall mean a debt security the principal and interest payments of which are to be paid by Government Securities ("deposited securities") that have been irrevocably placed in an escrow account pursuant to agreement between the issuer of the debt security and an escrow agent that is not an affiliated person, as defined in Section 2(a)(3)(C) of the Act [15 U.S.C. 80a-2(a)(3)(C)], of the issuer of the debt security, and, in accordance with such escrow agreement, are pledged only to the payment of the debt security and, to the extent that excess proceeds are available after all payments of principal, interest, and applicable premiums on the Refunded Securities, the expenses of the escrow agent and, thereafter, to the issuer or another party; provided that:

(i) The deposited securities shall not be redeemable prior to their final maturity;

(ii) At the time the deposited securities are placed in the escrow account, an independent certified public accountant shall have certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities; and

(iii) The escrow agreement shall prohibit the substitution of the deposited securities unless the substituted securities are Government Securities and, at the time of such substitution, the escrow agent shall have received a certification from an independent certified public accountant substantially the same as that required by paragraph (a)(18)(ii) of this section which certification shall give effect to the substitution.

(19) Requisite NRSROs shall mean:

(i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or

(ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund purchases or rolls over the security, that NRSRO.

(20) Second Tier Security shall mean any Eligible Security that is not a First Tier Security. Second Tier Conduit Security shall mean any Conduit Security that is an Eligible Security that is not a First Tier Security.

(21) Single State Fund shall mean a Tax Exempt Fund that holds itself out as primarily distributing income exempt from the income taxes of a specified state or locality.

(22) Standby Commitment shall mean a Put that entitles the holder to achieve same day settlement.

(23) Tax Exempt Fund shall mean any money market fund that holds itself out as distributing income exempt from regular federal income tax.

(24) Total Assets shall mean, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.

(25) Unconditional Demand Feature shall mean an Unconditional Put that is also a Demand Feature.

(26) Unconditional Demand Feature Issued By A Non-Controlled Person shall mean an Unconditional Put that is also a Demand Feature Issued By A Non-Controlled Person.

(27) Unconditional Put shall mean a Put (including any guarantee, financial guarantee (bond) insurance, letter of credit or similar unconditional credit enhancement) that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

(28) United States Dollar-Denominated shall mean, with reference to a security, that all principal and interest payments on such security are payable to security holders in United States dollars under all circumstances and that the interest rate of, the principal amount to be repaid, and the timing of payments related to such security do not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars.

(29) Unrated Security shall mean:

(i) A security with a remaining maturity of 397 calendar days or less issued by an issuer that did not, at the time the security was acquired or rolled over by the fund, have a current short-term rating assigned by any NRSRO:

(A) To the security; or

(B) To the issuer of the security with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security, or a Demand Feature with respect to the security; and

(ii) A security:

(A) That at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less; and

(B) Whose issuer had not at the time it was acquired or rolled over by the fund received from any NRSRO a short-term rating with respect to a class of debt obligations (or any debt obligation within that class) that now is comparable in priority and security with the security; and

(iii) A security that is a rated security and is the subject of an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security (or the issuer) was assigned its rating unless the security has a rating from an NRSRO reflecting the existence of the credit support agreement.

(iv) A security is not an Unrated Security if any debt obligation (reference security) that is issued by the same issuer and is comparable in priority and security with that security has a short-term rating by an NRSRO. The status of such security as an Eligible Security or First Tier Security shall be the same as that of the reference security.

(30) Variable Rate Security shall mean a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and which, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(b) Holding Out. It shall be an untrue statement of material fact within the meaning of Section 34(b) of the Act [15 U.S.C. 80a-33(b)] for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act [15 U.S.C. 80a-24(b)] to:

(1) Adopt the term “money market” as part of its name or title or the name or title of any redeemable securities of which it is the issuer; or

(2) Hold itself out to investors as, or adopt a name which suggests that it is, a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this section. For purposes of this paragraph, a name which suggests that a registered investment company is a money market fund or the equivalent thereof shall include one which uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) Share Price Calculations. The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund”), notwithstanding the requirements of Section 2(a)(41) of the Act [15 U.S.C. 80a-2(a)(41)] and of §§ 270.2a-4 and 270.22c-1 thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method: Provided, however, That:

(1) Board Findings. The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.

(2) Portfolio Maturity. The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; Provided, however, That the money market fund will not:

(i) Except as provided in paragraph (c)(2)(ii) of this section, purchase any instrument with a remaining maturity of greater than 397 calendar days; or

(ii) In the case of a money market fund not using the Amortized Cost Method, purchase a Government Security with a remaining maturity of greater than 762 calendar days; or

(iii) Maintain a dollar-weighted average portfolio maturity that exceeds ninety days.

(3) Portfolio Quality.

(i) General. The money market fund shall limit its portfolio investments, including Puts and repurchase agreements, to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO) and which are at the time of acquisition Eligible Securities.

(ii) Securities Subject to Unconditional Demand Features. A security that is subject to an Unconditional Demand Feature may be determined to be an Eligible Security or a First Tier Security based solely on whether the Unconditional Demand Feature is an Eligible Security or First Tier Security, as the case may be.

(iii) Securities Subject to Conditional Demand Features. A security that is subject to a Conditional Demand Feature ("Underlying Security") may be determined to be an Eligible Security or a First Tier Security only if:

(A) The Conditional Demand Feature is an Eligible Security or First Tier Security, as the case may be; and

(B) At the time of the purchase of the Underlying Security, the money market fund's board of directors has determined that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur; and

(1) The conditions limiting exercise either 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

(2) The terms of the Conditional Demand Feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand Feature in accordance with its terms; and

(C)(1) If the Underlying Security has a remaining maturity of 397 days or less, the Underlying Security (or the debt securities of issuer of the Underlying Security) has received a short-term rating by the Requisite NRSROs within the NRSROs' two highest short-term ratings categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund's board of directors; or

(2) If the Underlying Security has a remaining maturity of more than 397 calendar days, the Underlying Security (or the debt securities of the issuer of the Underlying Security) has received a long-term rating by the Requisite NRSROs within the NRSROs' two highest long-term rating categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund's board of directors.

(4) Portfolio Diversification.

(i) Taxable and National Funds. Immediately after the acquisition of any security (other than a Government Security or a security subject to an Unconditional Demand Feature Issued By A Non-Controlled Person), a money market fund other than a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security.

(ii) Single State Funds. With respect to 75 percent of its Total Assets, immediately after the acquisition of any security (other than a Government Security or a security subject to an Unconditional Demand Feature Issued By A Non-Controlled Person), a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security; Provided, however, That a Single State Fund shall not invest more than five percent of its Total Assets in securities issued by the issuer of the security unless the securities are First Tier Securities.

(iii) Safe Harbor. Notwithstanding paragraph (c)(4)(i) of this section, a money market fund other than a Single State Fund may invest up to twenty-five percent of its Total Assets in the First Tier Securities of a single issuer for a period of up to three Business days after the purchase thereof.

## (iv) Second Tier Securities.

(A) Taxable Funds. Immediately after the acquisition of any Second Tier Security, a money market fund that is not a Tax Exempt Fund shall not have invested more than:

- (1) The greater of one percent of its Total Assets or one million dollars in securities issued by that issuer which, when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Securities; and
- (2) Five percent of its Total Assets in securities which, when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Securities.

(B) Tax Exempt Funds. Immediately after the acquisition of any Second Tier Conduit Security that is not subject to an Unconditional Demand Feature Issued By A Non-Controlled Person, a money market fund that is a Tax Exempt Fund shall not have invested more than:

- (1) The greater of one percent of its Total Assets or one million dollars in securities issued by that issuer which, when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Conduit Securities not subject to an Unconditional Demand Feature Issued By A Non-Controlled Person; and
- (2) Five percent of its Total Assets in Conduit Securities which, when acquired by the money market fund (either initially or upon any subsequent roll over) were Second Tier Conduit Securities not subject to an Unconditional Demand Feature Issued By A Non-Controlled Person.

## (v) Puts.

(A) General. Immediately after the acquisition of any Put or security subject to a Put, with respect to seventy-five percent of the assets of a money market fund, no more than ten percent of the fund's Total Assets may be invested in securities issued by or subject to Puts from the institution that issued the Put, subject to sections (c)(4)(v)(B) and (C) of this section.

(B) Second Tier Puts. Immediately after the acquisition of any Put (or a security after giving effect to the Put) that is a Second Tier Security, a money market fund shall not have invested more than five percent of its Total Assets in securities issued by or subject to Puts from the institution that issued the Put.

(C) Puts Issued by Non-Controlled Persons. Immediately after the acquisition of any security subject to a Put, a money market fund shall not have invested more than ten percent of its Total Assets in securities issued by, or subject to Puts from the institution that issued the Put, unless, with respect to any security subject to Puts from that institution, the Put is a Put Issued By A Non-Controlled Person.

## (vi) Diversification Calculations.

(A) General. For purposes of making calculations under paragraphs (c)(4)(i) through (iv) of this section:

- (1) Repurchase Agreements. The acquisition of a repurchase agreement may be deemed to be an acquisition of the underlying securities, provided that the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully.
- (2) Refunded Securities. The acquisition of a Refunded Security shall be deemed to be an acquisition of a Government Security.
- (3) Conduit Securities. A Conduit Security shall be deemed to be issued by the issuer (other than the Municipal Issuer) ultimately responsible for payments of interest and principal on the security.
- (4) Asset Backed Securities. An Asset Backed Security shall be deemed to be issued by the Special Purpose Entity that issued the Asset Backed Security, Provided, however, any person whose obligations constitute ten percent or more of the principal amount of the Qualifying Assets shall be deemed to be an issuer of the portion of the Asset Backed Security such obligations represent. For purposes of the foregoing, if the Qualifying Assets held by the Special Purpose Entity



are themselves Asset Backed Securities (“Secondary Asset Backed Securities”), then the Special Purpose Entity shall be treated as holding directly the Secondary Asset Backed Securities.

(5) Shares in Master Funds. A money market fund substantially all of the assets of which consist of shares of another money market fund acquired in reliance on Section 12(d)(1)(E) of the Act [*15 U.S.C. 80a-12(d)(1)(E)*] shall be deemed to be in compliance with this section if the board of directors reasonably believes that the money market fund in which it has invested is in compliance with this section.

(B) Put Diversification Calculations. In making calculations under the Put diversification requirements of paragraph (c)(4)(v) of this section, the following rules apply:

(1) Issuer-Provided Puts. In the case of a security subject to a Put from the same institution that issued the underlying security, the value of the securities subject to the Put may be excluded from the Put diversification requirements of paragraph (c)(4)(v) of this section.

(2) Fractional Puts. In the case of a security subject to a Put from an institution by which the institution guarantees a specified portion of the value of the security, the institution shall be deemed to guarantee the specified portion thereof, Provided, however, if the security is an Asset Backed Security and the Put is a guarantee of all or a portion of the first losses with respect to the security, the institution providing the Put shall be deemed to have guaranteed the entire principal amount of the security.

(3) Layered Puts. In the case of a security subject to Puts from multiple institutions that have not limited the extent of their obligations as described in paragraph (c)(4)(vi)(B)(2) of this section, each institution shall be deemed to have guaranteed the entire principal amount of the security, Provided, however, in the case of a security subject to an Unconditional Demand Feature and a Put (or Puts) that is not a Demand Feature, the Put diversification requirements of paragraph (c)(4)(v) of this section need only be satisfied as to the institution issuing the Unconditional Demand Feature.

(4) Puts Not Relied Upon. If the fund’s board of directors determines that the fund is not relying on a Put to determine the quality (pursuant to paragraphs (c)(3)(ii) or (c)(3)(iii) of this section), or maturity (pursuant to paragraph (d) of this section), or liquidity of the portfolio security and maintains a record of this determination (pursuant to paragraphs (c)(8)(ii) and (c)(9)(vi) of this section), the Put diversification requirements of paragraph (c)(4)(v) of this section need not be satisfied as with respect to such put.

(vii) Diversification Safe Harbor. A money market fund that satisfies the applicable diversification requirements of paragraph (c)(4) of this section shall be deemed to have satisfied the diversification requirements of Section 5(b)(1) of the Act [*15 U.S.C. 80a-5(b)(1)*] and the rules adopted thereunder.

(5) Downgrades, Defaults and Other Events.

(i) Downgrades.

(A) General. Upon the occurrence of either of the events specified in paragraphs (c)(5)(i)(A)(1) and (2) of this section with respect to a portfolio security, the board of directors of the money market fund shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders:

(1) A portfolio security of a money market fund ceases to be a First Tier Security (either because it no longer has the highest rating from the Requisite NRSROs or, in the case of an Unrated Security, the board of directors of the money market fund determines that it is no longer of comparable quality to a First Tier Security); and

(2) The money market fund’s investment adviser (or any person to whom the fund’s board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated Security or Second Tier Security held by the money market fund has, since the security was acquired by the fund, been given a rating by any NRSRO below the NRSRO’s second highest rating category.

(B) Securities to Be Disposed Of. The reassessments required by paragraph (c)(5)(i)(A) of this section shall not be required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five Business days of the specified event and, in the case of events specified in paragraph (c)(5)(i)(A)(2) of this section, the board is subsequently notified of the adviser's actions.

(C) Special Rule for Certain Securities Subject to Demand Features. In the event that after giving effect to a rating downgrade, more than five percent of the fund's Total Assets are invested in securities issued by or subject to Demand Features from a single institution that are Second Tier Securities, the board of directors (or its delegate) shall cause the fund to reduce its investment in securities issued by or subject to Demand Features from that institution to no more than five percent of its Total Assets by exercising the Demand Features at the next succeeding exercise date(s), absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund.

(ii) Defaults and Other Events. Upon the occurrence of any of the events specified in paragraphs (c)(5)(ii)(A) through (D) of this section with respect to a portfolio security, the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security):

(A) The default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(B) A portfolio security ceases to be an Eligible Security;

(C) A portfolio security has been determined to no longer present minimal credit risks; or

(D) An Event of Insolvency occurs with respect to the issuer of or the provider of any Put with respect to a portfolio security other than a Put with respect to which a non-reliance determination has been made pursuant to paragraph (c)(4)(vi)(B)(4) of this section.

(iii) Notice to the Commission. In the event of a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Put to which it is subject, where immediately before default the securities (or the securities subject to the Put) accounted for  $\frac{1}{2}$  of 1 percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically or by means of a facsimile transmission, followed by letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management.

(iv) Defaults for Purposes of Paragraphs (c)(5)(ii) and (iii). For purposes of paragraphs (c)(5)(ii) and (iii) of this section, an instrument subject to a Demand Feature or unconditional credit enhancement shall not be deemed to be in default (and an Event of Insolvency with respect to the security shall not be deemed to have occurred) if:

(A) In the case of an instrument subject to a Demand Feature, the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest; or

(B) The provider of the credit enhancement is continuing, without protest, to make payments as due on the instrument.

(6) Required Procedures: Amortized Cost Method. In the case of a money market fund using the Amortized Cost Method:

(i) General. In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to

stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) Specific Procedures. Included within the procedures adopted by the board of directors shall be the following:

(A) Shadow Pricing. Written procedures shall provide:

(1) That the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute which reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions;

(2) For the periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and

(3) For the maintenance of records of the determination of deviation and the board's review thereof.

(B) Prompt Consideration of Deviation. In the event such deviation from the money market fund's amortized cost price per share exceeds  $\frac{1}{2}$  of 1 percent, the board of directors shall promptly consider what action, if any, should be initiated by the board of directors.

(C) Material Dilution or Unfair Results. Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(7) Required Procedures: Penny-Rounding Method. In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.

(8) Specific Procedures: Amortized Cost and Penny-Rounding Methods. Included within the procedures adopted by the board of directors for money market funds using either the amortized cost or penny-rounding methods shall be the following:

(i) Securities for Which Maturity is Determined by Reference to Demand Features. In the case of a security for which maturity is determined by reference to a Demand Feature, written procedures shall require ongoing review of the security's continued minimal credit risks, which review must be based on, among other things, financial data for the most recent fiscal year of the issuer of the Demand Feature and, in the case of a security subject to a Conditional Demand Feature, the issuer of the security, whether such data is publicly available or provided under the terms of the security's governing documentation.

(ii) Securities Subject to Puts. In the case of a security subject to one or more Puts, written procedures shall require periodic evaluation of the determination described in paragraph (c)(4)(vi)(B)(4)(puts not relied upon) of this section.

(iii) Adjustable Rate Securities Without Demand Features. In the case of a Variable Rate or Floating Rate Security that does not have a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section, written procedures shall require periodic review of whether the security, upon readjustment of its interest rate, can reasonably be expected to have a market value that approximates its amortized cost.

(iv) Asset Backed Securities. In the case of an Asset Backed Security, written procedures shall require the fund to periodically determine whether a person other than the Special Purpose Entity is the issuer of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(vi)(A)(4) of this section.

## (9) Record Keeping and Reporting.

(i) Written Procedures. For a period of not less than six years following the replacement of such procedures with new procedures (the first two years in an easily accessible place), a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(5) through (c)(8) and (e) of this section shall be maintained and preserved.

(ii) Board Considerations and Actions. For a period of not less than six years (the first two years in an easily accessible place) a written record shall be maintained and preserved of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth in this section, to be included in the minutes of the board of directors' meetings.

(iii) Credit Risk Analysis. For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed in accordance with paragraph (c)(8)(i) of this section, a written record of the determination that a portfolio security presents minimal credit risks and the NRSRO ratings (if any) used to determine the status of the security as an Eligible Security, First Tier Security or Second Tier Security shall be maintained and preserved in an easily accessible place.

(iv) Determinations with Respect to Adjustable Rate Securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(8)(iii) of this section (that a Variable Rate or Floating Rate Security that does not have a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section can reasonably be expected, upon readjustment of its interest rate at all times during the life of the instrument, to have a market value that approximates its amortized cost).

(v) Determinations with Respect to Asset Backed Securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(8)(iv) of this section (whether a person other than the Special Purpose Entity is the issuer of all or a portion of an Asset Backed Security pursuant to paragraph (c)(vi)(4) of this section). The written record shall include the identities of the issuers of the Qualifying Assets whose obligations constitute ten percent or more of the principal value of the Qualifying Assets, the percentage of the Qualifying Assets constituted by the securities of each such issuer and the percentage of the fund's Total Assets that are invested in securities of each such issuer.

(vi) Evaluations with Respect to Securities Subject to Puts. For a period of not less than three years from the date when the evaluation was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the evaluation required by paragraph (c)(8)(ii) (regarding securities subject to one or more Puts) of this section.

(vii) Inspection of Records. The documents preserved pursuant to this paragraph (c)(9) shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act [15 U.S.C. 80a-30(b)] as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act [15 U.S.C. 80a-30(a)]. If any action was taken under paragraphs (c)(5)(ii) (with respect to defaulted securities and events of insolvency) or (c)(6)(ii) (with respect to a deviation from the fund's share price of more than ½ of 1 percent) of this section, the money market fund will file an exhibit to the Form N-SAR [17 CFR 274.101] filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

(d) Maturity of Portfolio Securities. For purposes of this section, the maturity of a portfolio security shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, except as provided in paragraphs (d)(1) through (8) of this section:

(1) Adjustable Rate Government Securities. A Government Security which is a Variable Rate Security where the variable rate of interest is readjusted no less frequently than every 762 days shall be deemed to have a maturity equal to the period

remaining until the next readjustment of the interest rate. A Government Security which is a Floating Rate Security shall be deemed to have a remaining maturity of one day.

(2) Short-Term Variable Rate Securities. A Variable Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity equal to the earlier of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(3) Long-Term Variable Rate Securities. A Variable Rate Security, the principal amount of which is scheduled to be paid in more than 397 days, that is subject to a Demand Feature shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) Short-Term Floating Rate Securities. A Floating Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity of one day.

(5) Long-Term Floating Rate Securities. A Floating Rate Security, the principal amount of which is scheduled to be paid in more than 397 days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(6) Repurchase Agreements. A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.

(7) Portfolio Lending Agreements. A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(8) Money Market Fund Securities. An investment in a money market fund shall be treated as having a maturity equal to the period of time within which the acquired money market fund is required to make payment upon redemption, unless the acquired money market fund has agreed in writing to provide redemption proceeds to the investing money market fund within a shorter time period, in which case the maturity of such investment shall be deemed to be the shorter period.

(e) Delegation. The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (c)(1), (c)(5)(i)(c), (c)(5)(ii), (c)(6)(i), (c)(6)(ii)(A), (B), and (C), and (c)(7) of this section) provided:

(1) Written Guidelines. The Board shall establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this section) and procedures under which the delegate makes such determinations:

(2) Oversight. The Board shall exercise adequate oversight (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security or Event of Insolvency with respect to the issuer of the security or any Put to which it is subject that requires notification of the Commission under paragraph (c)(5)(iii) of this section) to assure that the guidelines and procedures are being followed.

5. Section 270.2a41-1 is amended by revising paragraph (a) to read as follows:

§ 270.2a41-1 Valuation of standby commitments by registered investment companies.

(a) A standby commitment as defined in § 270.2a-7(a)(22) may be assigned a fair value of zero, Provided, That:

\* \* \* \*

6. Section 270.12d3-1 is amended by revising paragraph (d)(7)(v) to read as follows:

§ 270.12d3-1 Exemption of acquisitions of securities issued by persons engaged in securities related businesses.

\* \* \* \*

(d) \* \* \*

(7) \* \* \*

(v) Acquisition of Puts, as defined in § 270.2a-7(a)(16), provided that, immediately after the acquisition of any Put, the company will not, with respect to 75 percent of the total value of its assets, have invested more than ten percent of the total value of its assets in securities underlying Puts from the same institution. For the purposes of this section, a Put will be considered to be from the party to whom the company will look for payment of the exercise price.

\* \* \* \*

7. Section 270.17a-9 is added to read as follows:

§ 270.17a-9 Purchase of certain securities from a money market fund by an affiliate, or an affiliate of an affiliate.

The purchase of a security that is no longer an Eligible Security (as defined in paragraph (a)(9) of § 270.2a-7) from an open-end investment company holding itself out as a “money market” fund shall be exempt from Section 17(a) of the Act [15 U.S.C. 80a-17(a)], provided that:

(a) The purchase price is paid in cash; and

(b) 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).

8. Section 270.31a-1 is amended by adding a sentence to the end of paragraph (b)(1) to read as follows:

§ 270.31a-1 Records to be maintained by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.

\* \* \* \*

(b) \* \* \*

(1) \* \* \* In the case of a money market fund, also identify the provider of any put (as defined in § 270.2a-7(a)(16)) or guarantee with respect to a portfolio security and give a brief description of the nature of the put (e.g., unconditional demand feature, conditional demand feature, guarantee, letter of credit, or bond insurance) and, in a subsidiary portfolio investment record, provide the complete legal name and accounting and other information (including sufficient information to calculate coupons, accruals, maturities, puts, and calls) necessary to identify, value, and account for each investment.

\* \* \* \*

## Part 239—Forms Prescribed Under the Securities Act of 1933

## Part 274—Forms Prescribed Under the Investment Company Act of 1940

9. The authority citation for part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-29, 80a-30 and 80a-37, unless otherwise noted.

## Releases

\* \* \* \*

10. The authority citation for Part 274 continues to read as follows:

Authority: *15 U.S.C. 77f, 77g, 77b, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, and 80a-29*, unless otherwise noted.

NOTE: Form N-1A does not and the amendments will not appear in the Code of Federal Regulations.

11. Form N-1A (referenced in *17 CFR 239.15A* and *274.11A*) is amended by redesignating paragraph (a)(vii) as paragraph (a)(viii) and by adding paragraph (a)(vii) and an instruction to the end of paragraph (a)(vii) of Part A, Item 1 to read as follows:

### FORM N-1A

\* \* \* \*

## PART A INFORMATION REQUIRED IN A PROSPECTUS

\* \* \* \*

### Item 1. Cover Page

\* \* \* \*

(vii) In the case of a Registrant that holds itself out as a money market fund primarily distributing income exempt from the income taxes of a specified state or locality (“single state fund”), a prominent statement that the registrant may invest a significant percentage of its assets in a single issuer, and that therefore investment in the Registrant may be riskier than an investment in other types of money market funds.

Instruction: The disclosure required for money market funds by Item 1(a)(vii) may be omitted if the registrant limits investment in a single issuer to five percent of fund assets as to 100 percent of assets.

\* \* \* \*

12. Form N-1A (referenced in *17 CFR 239.15A* and *274.11A*) is amended by adding a sentence and an Instruction to the end of paragraph (c) of Part A, Item 4 to read as follows:

### FORM N-1A

\* \* \* \*

## PART A INFORMATION REQUIRED IN A PROSPECTUS

\* \* \* \*

### Item 4. General Description of Registrant

\* \* \* \*

(c) \* \* \* In the case of a Registrant that holds itself out as a money market fund primarily distributing income exempt from the income taxes of a specified state or locality (“single state fund”), a prominent statement that the registrant is concentrated in securities issued by the state or entities within the state and that therefore investment in the Registrant may be riskier than an investment in other types of money market funds.

\* \* \* \*

NOTE: Form N-3 does not and the amendments will not appear in the Code of Federal Regulations.

13. Form N-3 (referenced in *17 CFR 239.17a* and *274.11b*) is amended by adding Instruction 11.e. to Part A, paragraph (a) of Item 4 to read as follows:

### FORM N-3

\* \* \*

### PART A INFORMATION REQUIRED IN A PROSPECTUS

\* \* \* \*

Item 4. Condensed Financial Information

(a) \* \* \*

Instructions

11. The portfolio turnover rate to be shown at caption 10 shall be calculated as follows:

\* \* \* \*

e. A registrant that holds itself out as a money market fund is not required to provide a portfolio turnover rate in response to this Item.

\* \* \* \*

NOTE: Form N-SAR does not and the amendments will not appear in the Code of Federal Regulations.

14. Form N-SAR (referenced in *17 CFR 274.101*) is amended by revising the definition of “Money Market Fund” in General Instruction G to read as follows:

### FORM N-SAR

\* \* \* \*

### GENERAL INSTRUCTIONS

\* \* \* \*

G. Definitions

\* \* \* \*

Money Market Fund: The term “money market fund” shall mean any open-end fund that meets the maturity, quality and diversification conditions of paragraphs (c)(2), (c)(3), and (c)(4) of Rule 2a-7 [*17 CFR 270.2a-7*].

\* \* \* \*

15. Form N-SAR (referenced in *17 CFR 274.101*) is amended by revising the last sentence of the Instruction to Item 63 to read as follows:

### FORM N-SAR

\* \* \* \*

Instructions to Specific Items

\* \* \* \*



ITEM 63: Dollar weighted average maturity

\*\*\* A money market fund shall determine the weighted average portfolio maturity in the same manner as it would in monitoring compliance with the average portfolio maturity provisions of Rule 2a-7.

16. Form N-SAR (referenced in *17 CFR 274.101*) is amended by adding a sentence at the end of the first paragraph of the Instruction to Item 71 to read as follows:

**FORM N-SAR**

\*\*\*\*

Instructions to Specific Items

\*\*\*\*

ITEM 71: Portfolio turnover rate

\*\*\* A money market fund should enter a portfolio turnover rate of “0” even if it owns securities that have maturities in excess of one year.

\*\*\*\*

17. Guide 21 (Disclosure of Risk Factors) to Form N-1A (referenced in *17 CFR 239.15A* and *274.11A*) is amended by adding a paragraph to the end of the Guide to read as follows:

Guide 21. Disclosure of Risk Factors

\*\*\*\*

In many cases, a substantial portion of the portfolio securities held by tax exempt money market funds is supported by credit and liquidity enhancements from third parties, generally letters of credit from foreign or domestic banks. These securities include variable rate demand notes, tender or “put” bonds and similar securities. Where more than forty percent of a money market fund registrant’s portfolio consists, or is likely to consist, of securities subject to these features, the registrant should, in response to Item 4, state that, because the fund invests in securities backed by banks and other financial institutions, changes in the credit quality of these institutions could cause losses to the fund and effect its share price.

18. Guide 35 is added to Form N-1A (referenced in *17 CFR 239.15A* and *274.11A*) to read as follows:

Guide 35. Money Market Fund Investments in Other Money Market Funds.

Money market funds are permitted to invest in the securities of other money market funds in accordance with the provisions of Rule 2a-7 and Section 12(d)(1) of the 1940 Act. Except when a fund has invested substantially all of its assets in the other money market fund, the investing fund does not need to “look through” the shares of the fund(s) in which it is investing in order to determine compliance with the diversification or Second Tier Security limitations of Rule 2a-7.<sup>204</sup> However, the investment objectives and policies of the money market fund making the investment and the money market fund(s) in which it is investing should not be inconsistent. Paragraph (c)(4)(iv)(A)(5) of Rule 2a-7 describes the obligations of a fund that invests substantially all of its asset in another money market fund.

19. Guide 38 is added to Form N-3 (referenced in *17 CFR 239.17a* and *274.11b*) to read as follows:

Guide 38. Money Market Fund Investments in Other Money Market Funds

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<sup>204</sup> See Investment Company Act Rel. No. 21837 (March 21, 1996) at Section II.G.2.

Money market funds are permitted to invest in the securities of other money market funds in accordance with the provisions of Rule 2a-7 and Section 12(d)(1) of the 1940 Act. Except when a fund has invested substantially all of its assets in the other money market fund, the investing fund does not need to “look through” the shares of the fund(s) in which it is investing in order to determine compliance with the diversification or Second Tier Security limitations of Rule 2a-7.<sup>1</sup> However, the investment objectives and policies of the money market fund making the investment and the money market fund(s) in which it is investing should not be inconsistent. Paragraph (c)(4)(v)(A)(5) of Rule 2a-7 describes the obligations of a fund that invests substantially all of its assets in another money market fund.

By the Commission.  
Jonathan G. Katz  
Secretary  
March 21, 1996

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<sup>1</sup> See Investment Company Act Rel. No. 21837 (March 21, 1996) at Section II.G.2.

## PROPOSED TECHNICAL REVISIONS TO THE RULES AND FORMS REGULATING MONEY MARKET FUNDS

Release Nos. 33-7371; IC-22383

December 10, 1996

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The Commission is publishing for public comment proposed amendments to rules and forms under the Securities Act of 1933 and the Investment Company Act of 1940 that govern money market funds. Proposed technical amendments to Rule 2a-7 under the Investment Company Act of 1940, the rule regulating money market funds, would, among other things, revise terminology used in the rule to reflect common market usage, and codify a number of interpretive positions taken by the staff of the Division of Investment Management. Proposed amendments to the advertising rules applicable to money market funds would clarify the formula used by money market funds to calculate yield and would prevent investors from being confused or misled by presentation of a money market fund's short-term total return in lieu of its yield.

DATES: Comments must be received on or before January 24, 1997.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6-9, Washington, D.C. 20549.

Comments also may be submitted electronically at the following E-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-29-96; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters will also be posted on the Commission's Internet web site (<http://www.sec.gov>).

FOR FURTHER INFORMATION CONTACT: Marjorie S. Riegel, Senior Counsel, Office of Chief Counsel, at (202) 942-0660, Division of Investment Management, Stop 10-6, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") today is proposing for comment technical amendments to Rule 2a-7 [17 CFR 2a-7] ("Rule 2a-7" or the "rule") under the Investment Company Act of 1940 [15 U.S.C. 80a-1, et seq.] ("1940 Act") and conforming amendments to Rules 2a41-1, 12d3-1 and 31a-1 under the 1940 Act [17 CFR 270.2a41-1, 270.12d3-1 and 270.31a-1]. The Commission also is proposing amendments to Rule 482 [17 CFR 230.482] under the Securities Act of 1933 [15 U.S.C. 77a, et seq.] ("1933 Act"); and Forms N-1A [17 CFR 239.15A and 274.11A], N-3 [17 CFR 239.17a and 274.11b] and N-4 [17 CFR 239.17b and 274.11c].

### I. Proposed Technical Amendments to Rule 2a-7

#### A. Background

On March 21, 1996, the Commission adopted amendments to Rule 2a-7 that revised the rule to tighten the risk-limiting conditions imposed on tax exempt money funds and to address the treatment under the rule of certain instruments, such as asset backed securities ("March Amendments").<sup>2</sup> Industry participants<sup>3</sup> have raised a number of questions concerning the application of the March Amendments in different contexts subsequent to their adoption. To respond to many of

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<sup>2</sup> Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (March 21, 1996) [61 FR 13956 (March 28, 1996)] ("Release 21837"). Unless otherwise noted, all references to Rule 2a-7, or to any paragraph of the rule, will be to the applicable paragraph of 17 CFR 270.2a-7, as amended by Release 21837. When a paragraph is renumbered in the rule as it is proposed to be amended, citations will be given both to Rule 2a-7, "as proposed to be amended," and to the rule as amended by Release 21837.

<sup>3</sup> In this Release, the term "industry participants" refers to those representatives of money market funds, investment advisers, law firms, issuers and underwriters of securities, and professional and trade associations that informally have sought advice from the staff concerning the application of the March Amendments, raised interpretive questions, or suggested changes to the rule.

these questions, the Division of Investment Management published an interpretive letter (“Q&A Letter”).<sup>4</sup> The technical amendments proposed for public comment today would: (1) codify a number of interpretive positions taken by the staff in the Q&A Letter; (2) revise terminology used in the rule to reflect common market usage; (3) modify certain of the March Amendments so that the treatment accorded certain instruments (e.g., guarantees) by the rule more closely reflects the treatment accorded to those instruments by the financial markets; and (4) make certain other technical corrections.<sup>5</sup>

## B. Discussion

### 1. Guarantees

#### a. Definition of “Guarantee”

Many money market instruments are subject to guarantees and other forms of unconditional credit support that, among other things, provide the requisite credit quality to make an instrument eligible for investment under Rule 2a-7. Rule 2a-7 characterizes certain of these arrangements as “puts”<sup>6</sup> and “unconditional puts.”<sup>7</sup> This aspect of the definition has caused some confusion among industry participants. The Commission is, therefore, proposing to revise the rule’s terminology by replacing references to “put” and “unconditional put” with a new term “guarantee” that would include a wide-range of arrangements designed to unconditionally support the credit of the issuer of a security.<sup>8</sup> In addition, the Commission would amend the credit quality and diversification provisions of the rule to incorporate the proposed term, as discussed below. Comment is requested on the proposed definition of the term “guarantee.”

#### b. Credit Substitution

One type of guarantee to which Rule 2a-7 specifically refers is an “unconditional demand feature.”<sup>9</sup> Rule 2a-7 permits a fund to rely on the credit quality of the issuer of an unconditional demand feature in determining the credit quality of the security.<sup>10</sup> Recognizing that a money market fund relies on the credit quality of the issuer of the unconditional demand feature rather than the issuer of the security subject to the demand feature in determining whether to invest in the security, the March Amendments permit a fund to exclude securities subject to an unconditional demand feature from the rule’s issuer diversification standards if the demand feature is issued by a “non-controlled person.”<sup>11</sup> Because of the significance of demand features to a fund, the March Amendments provide that a demand feature is not eligible for fund investment unless (i) the demand feature (or provider of the demand feature) is rated by an NRSRO (“Rating

<sup>4</sup> Investment Company Institute (pub. avail. May 9, 1996).

<sup>5</sup> The Commission has suspended the compliance date for certain of the March Amendments. *See* Revisions to the Rules Regulating Money Market Funds, Investment Company Act Release No. 22135 (Aug. 13, 1996) [61 FR 42786 (Aug. 19, 1996)] (“Compliance Date Release”), and Section III of this Release, which requests comment on a new compliance date.

<sup>6</sup> Paragraph (a)(16) of Rule 2a-7 defines the term “put” to mean the right to sell a specified underlying security within a specified period of time and at a specified exercise price that may be sold, transferred, or assigned only with the underlying security.

<sup>7</sup> Paragraph (a)(27) of Rule 2a-7 defines the term “unconditional put” to mean a put (including any guarantee, financial guarantee (bond) insurance, letter of credit or similar unconditional credit enhancement) that by its terms would be readily exercisable in the event of default in payment of principal or interest on the underlying security or securities.

<sup>8</sup> Paragraph (a)(14) of Rule 2a-7, as proposed to be amended. The term “guarantee” would be defined to include an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the guarantee (if required), principal plus accrued interest when due upon default. This definition is for purposes of Rule 2a-7 only, and is not intended to have any effect on the status of these investments under other provisions of the 1940 Act or under the other federal securities laws.

<sup>9</sup> Paragraph (a)(7) of Rule 2a-7 defines the term “demand feature” to mean (i) a put that may be exercisable either: (A) at any time on no more than 30 calendar days’ notice; or (B) at specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days’ notice; or (ii) a feature permitting the holder of an asset backed security unconditionally to receive principal and interest within thirteen months of making demand. An unconditional demand feature is a demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities. *See* paragraphs (a)(25) and (a)(27) of rule 2a-7 (definitions of “unconditional demand feature” and “unconditional put”).

<sup>10</sup> Paragraph (c)(3)(ii) of Rule 2a-7. This provision was added to the rule in 1986. *See* Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (March 12, 1986) [51 FR 9773 (March 21, 1986)].

<sup>11</sup> Paragraphs (c)(4)(i), (c)(4)(ii) and (c)(4)(iv) of Rule 2a-7. The term “unconditional demand feature issued by a non-controlled person” is defined in paragraph (a)(26) of Rule 2a-7.

Requirement”)<sup>12</sup> and (ii) arrangements are in place for a fund holding a security subject to a demand feature to be given notice in the event of a change in the identity of the issuer of the demand feature (“Notification Requirement”).<sup>13</sup>

Money market funds frequently invest in securities subject to financial guarantee (bond) insurance, letters of credit (“LOCs”) and other types of unconditional credit enhancements that may not fall within the definition of “unconditional demand feature” under the rule. As a result, for purposes of the rule, a fund holding securities subject to these types of unconditional credit enhancements may not be able to rely exclusively on the credit quality of the credit enhancement provider in determining the credit quality of the security, and may not exclude such securities from Rule 2a-7’s issuer diversification requirements. Industry participants have noted that the rule’s treatment of securities subject to unconditional credit enhancements that do not fall within the definition of “demand feature” does not reflect the manner in which the financial markets treat these securities. Securities of this type typically trade on the basis of the credit quality of the provider of the credit enhancement.

The Commission is proposing amendments to Rule 2a-7 that would modify the rule’s credit quality standards to permit a fund to rely solely on the credit quality of the issuer of a guarantee in determining the credit quality of the security.<sup>14</sup>

Accordingly, (i) the exclusion from the issuer diversification standards for securities subject to unconditional demand features from a non-controlled person would be expanded to include all securities subject to guarantees from a non-controlled person,<sup>15</sup> (ii) the Rating Requirement would be extended to all guarantees (with certain exceptions),<sup>16</sup> and (iii) the Notification Requirement would be extended to all guarantees for which substitution is permissible.<sup>17</sup>

#### c. Rating Requirement for Guarantees

The March Amendments to Rule 2a-7 limit a money market fund to investing in securities subject to demand features (whether conditional or unconditional) that have received a short-term rating from an NRSRO.<sup>18</sup> The Commission explained that it believed that such a requirement would provide a degree of additional protection by ensuring input into the minimal credit risk determination from an outside source.<sup>19</sup> Because most banks and other institutions issuing demand features are rated, the Commission concluded that obtaining a rating was not an unreasonable or a burdensome requirement for an institution that is in the business of lending its credit and would not significantly diminish the supply of available, high quality, eligible securities.

As noted above, the Commission is proposing to extend the Rating Requirement to guarantees,<sup>20</sup> and to modify this requirement in three other respects:<sup>21</sup>

<sup>12</sup> Paragraph (a)(9)(iii)(D)(1) of Rule 2a-7.

<sup>13</sup> Paragraph (a)(9)(iii)(D)(2) of Rule 2a-7.

<sup>14</sup> Paragraph (c)(3)(iii) of Rule 2a-7, as proposed to be amended. Proposed amendments to the rule’s credit quality provisions would reflect proposed amendments to other provisions of the rule by permitting a fund that holds a security that is subject to a guarantee and a conditional demand feature to substitute the rating of the guarantee for the rating of the underlying security. Paragraph (c)(3)(iv)(C) of Rule 2a-7, as proposed to be amended. Consistent with the current rule, the fund would continue to be required to consider the rating of the conditional demand feature in evaluating the credit quality of the entire instrument. Paragraph (c)(3)(iv)(A) of Rule 2a-7, as proposed to be amended.

<sup>15</sup> Paragraph (c)(4)(i) of Rule 2a-7, as proposed to be amended. The term “guarantee issued by a non-controlled person” is defined in paragraph (a)(15) of Rule 2a-7, as proposed to be amended.

<sup>16</sup> Paragraph (a)(10)(iii)(A) of Rule 2a-7, as proposed to be amended. See, *infra* Section I.B.1.c. of this Release for a description of other proposed amendments to the Rating Requirement.

<sup>17</sup> Paragraph (a)(10)(iii)(B) of Rule 2a-7, as proposed to be amended.

<sup>18</sup> See paragraph (a)(9)(iii)(D)(1) of Rule 2a-7 (definition of “eligible security”). Securities subject to demand features issued on or before June 3, 1996 were “grandfathered,” and are not required to be rated. Release 21837, *supra* note 1 at Section V.B. The June 3 “grandfathering date” was suspended until the Commission adopts the technical amendments proposed for comment in this release. See Compliance Date Release, *supra* note 4.

<sup>19</sup> Release 21837, *supra* note 1, at Section II.C.2.a.

<sup>20</sup> See *supra* Section I.B.1.b. of this Release.

<sup>21</sup> See paragraph (a)(10)(iii)(A) of Rule 2a-7, as proposed to be amended.

\* Conditional demand features would be exempted from the Rating Requirement.<sup>22</sup> Conditional demand features do not act as a complete credit substitute for the credit quality of the underlying security, and a fund should be able, with relative ease, to substitute a new provider of a conditional guarantee for an existing provider that is experiencing credit problems.

\* Any rating from an NRSRO (rather than only a short-term rating) would satisfy the Rating Requirement. A long-term rating would satisfy the primary objective of the Rating Requirement, which is to ensure input into the minimal credit risk determination by an outside source.<sup>23</sup> In addition, the long-term rating assigned to a guarantee may be relevant to a fund in evaluating the ability of the guarantor to perform under the terms of the guarantee.<sup>24</sup>

\* A guarantee issued by a person that is controlled by, controls, or is under common control with the issuer of the security would be excepted from the Rating Requirement. An entity that guarantees a security issued by a controlled person may not be in the business of lending its credit, and such a requirement may be burdensome and result in a diminished supply of high quality, eligible securities.<sup>25</sup>

#### d. Demand Features and Guarantees Not Relied Upon

The March Amendments permit a fund that is not relying on a particular put for satisfaction of the rule's credit quality or maturity standards, or for liquidity, to exclude that put in determining its compliance with the Rule's put diversification standards.<sup>26</sup> The Commission is proposing amendments to the rule that would provide that a demand feature or guarantee that is not relied upon to satisfy the rule's credit quality or diversification standards, or for liquidity, is not subject to any of the rule's requirements.<sup>27</sup>

### 2. Diversification and Quality Standards Applicable to Issuers

#### a. Second Tier Securities

The proposed amendments would clarify the scope of the issuer diversification standards applicable to taxable fund investment in second tier securities, and tax exempt fund investment in second tier conduit securities. Under Rule 2a-7, a taxable fund may not invest more than one percent of its total assets in second tier securities issued by a single issuer, and a tax exempt fund may not invest more than one percent of its total assets in second tier conduit securities issued by a single issuer.<sup>28</sup> Proposed amendments to the rule's issuer diversification provisions would clarify that these limits are not

<sup>22</sup> The proposed definition of the term "guarantee" does not include conditional demand features. *See* paragraph (a)(14) of Rule 2a-7, as proposed to be amended.

<sup>23</sup> Release 21837, *supra* note 1, at Section II.C.2.a.

<sup>24</sup> For example, a rating representing the long-term creditworthiness of a guarantor may be significant to a fund holding a long-term security subject both to a conditional demand feature that is relied upon to shorten the maturity of the underlying security and a guarantee. *See* paragraphs (c)(3)(iv)(A) and (c)(3)(iv)(C) of Rule 2a-7, as proposed to be amended (a long-term security subject to a conditional demand feature is an eligible security only if the conditional demand feature is an eligible security, and the underlying security (or any guarantee of the underlying security) has received a short-term or long-term rating from the requisite NRSROs within the two highest short-term or long-term rating categories).

<sup>25</sup> The proposed amendments also would have the effect of exempting issuer-provided demand features from the Rating Requirement. This proposed provision is consistent with those provisions of the March Amendments that permit a fund to disregard issuer-provided demand features in determining its compliance with the rule's put diversification requirements. Paragraph (c)(4)(vi)(B)(1) of Rule 2a-7; *See* Release 21837, *supra* note 1, at Section II.C.1.c (securities subject to "issuer-provided demand features can be viewed as the functional equivalent of short-term securities that are 'rolled over' periodically.").

<sup>26</sup> Paragraph (c)(4)(vi)(B)(4) of Rule 2a-7.

<sup>27</sup> Paragraph (c)(5) of Rule 2a-7, as proposed to be amended. This proposed amendment would codify a staff interpretive position. Q&A Letter, *supra* note 3, at Q&A 2 (a put that is not relied upon may be disregarded for all purposes under the rule, including the Rating Requirement, and provisions of the rule that require the fund's board of directors to reduce investment in securities subject to downgraded demand features absent a finding). A fund holding securities subject to demand features or guarantees that the fund's board of directors has determined are not being relied upon would be required to establish written procedures requiring periodic re-evaluations of this determination. Paragraph (c)(8)(ii) of Rule 2a-7 (paragraph (c)(9)(ii) of Rule 2a-7 as proposed to be amended).

<sup>28</sup> Paragraphs (c)(4)(iv)(A)(1) and (c)(4)(iv)(B)(1) of Rule 2a-7.

applicable to securities subject to a guarantee issued by a non-controlled person.<sup>29</sup> Accordingly, such securities would only be subject to the rule's guarantee diversification requirements.<sup>30</sup>

#### b. Repurchase Agreements

Rule 2a-7 allows a fund to “look through” a repurchase agreement (“repo”) to the underlying collateral and thereby ignore the counterparty in determining compliance with the rule's diversification limitations when the obligation of the counterparty is “collateralized fully.”<sup>31</sup> A repo is collateralized fully if, among other things, it is collateralized by Government securities or other securities listed in the rule that permit the repo to receive favorable treatment under applicable bankruptcy law. This provision of the rule is intended to ensure that the securities collateralizing the repo can be liquidated promptly in the event of the bankruptcy of the counterparty. Since the publication of the March Amendments, numerous questions have been raised concerning the eligibility of cash and certain types of securities that, although not listed in the rule, may (or may not) constitute appropriate collateral to avoid a stay in the event of a bankruptcy.<sup>32</sup>

Although the determination of how a bankruptcy court might treat a repo is highly relevant for “look through” treatment under Rule 2a-7, the Commission believes that specifying the types of collateral that meet the criteria of relevant provisions of bankruptcy law in Rule 2a-7 is unnecessary to fulfill the underlying purposes of the rule. Therefore, the Commission is proposing to revise the rule to omit references to specific types of acceptable collateral. Under the proposed provision, a repo would be “collateralized fully” if (i) the collateral consists entirely of cash, Government securities, or other securities that are rated in the highest rating category by the requisite NRSROs, and (ii) upon an event of insolvency with respect to the seller, the repo would qualify under a provision of applicable insolvency law providing an exclusion from any general stay of creditors' rights against the seller.<sup>33</sup> Under the proposed amendments, a fund entering into a repo collateralized by traditional types of Government securities (as most do) could conclude easily that the repo qualifies for “look through” treatment (assuming other requirements of the rule are met), while funds wishing to enter into repos using less traditional forms of collateral may rely on opinions of bankruptcy counsel.

#### c. Refunded Securities

The March Amendments permit a fund to “look through” refunded securities<sup>34</sup> to the escrowed securities in determining its compliance with the rule's issuer diversification standards under certain conditions, one of which is that an independent public accountant has certified that the escrowed Government securities, or any subsequent substitution of

<sup>29</sup> Paragraphs (c)(4)(i)(C)(1) and (c)(4)(i)(C)(2) of Rule 2a-7, as proposed to be amended. Rule 2a-7 also limits a taxable fund and a tax exempt fund to investing no more than five percent of total assets in second tier securities and second tier conduit securities respectively. See paragraphs (c)(4)(iv)(A)(2) and (c)(4)(iv)(B)(2) of Rule 2a-7 (“five percent quality test”). The proposed amendments would not make any substantive changes to the five percent quality test, and thus a taxable fund, for example, could not invest more than five percent of its total assets in second tier securities subject to a second tier demand feature. The proposed amendments would reorganize the rule text by including the five percent quality test in the paragraph of the rule that addresses portfolio quality, rather than portfolio diversification. See paragraph (c)(3)(ii) of Rule 2a-7, as proposed to be amended (portfolio quality—second tier securities).

<sup>30</sup> Paragraphs (c)(4)(i) and (c)(4)(iii) of Rule 2a-7, as proposed to be amended.

<sup>31</sup> Paragraphs (a)(4) and (c)(4)(vi)(A)(1) of Rule 2a-7.

<sup>32</sup> See, e.g., Q&A Letter, *supra* note 3, at Q&A 12.

<sup>33</sup> Paragraphs (a)(5)(iv) and (a)(5)(v) of Rule 2a-7, as proposed to be amended. In addition, a money market fund must evaluate the repo counterparty's creditworthiness in order to minimize the risk that money market funds do not enter into repos with parties that present a serious risk of becoming involved in bankruptcy proceedings. The Commission previously published a release setting forth the conditions under which the Division of Investment Management would not recommend enforcement action under Section 12(d)(3) of the 1940 Act if an investment company entered into a repo with persons engaged in securities-related businesses. Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 13005 (Feb. 2, 1983) [48 FR 5824 (Feb. 9, 1983)] (“Repo Release”). One of the conditions stated in the Repo Release was that the repo be “fully collateralized,” although a description of “fully collateralized” did not include all of the conditions in Rule 2a-7, as amended by the March Amendments. A money market fund entering into a repo that is “collateralized fully” within the meaning of paragraph (a)(4) of Rule 2a-7 (paragraph (a)(5) of Rule 2a-7, as proposed to be amended) would meet the “fully collateralized” requirement of the Repo Release.

Investment companies other than money market funds are not required to comply with this provision of Rule 2a-7 to avoid violating Section 12(d)(3).

<sup>34</sup> Paragraph (a)(18) of Rule 2a-7 generally defines “refunded securities” as securities whose payment is funded and secured by Government securities placed in an escrow account.

the escrowed securities, will satisfy all payments of principal, interest and applicable premiums on the refunded securities (collectively, the “accountant’s certifications”).<sup>35</sup> NRSROs in rating refunded securities typically require an independent third party to make the same determination.<sup>36</sup> Therefore, the Commission is proposing to provide that the accountant’s certifications need not be obtained if, in connection with the placement of Government securities into the escrow account, the refunded securities have received a rating from an NRSRO in the highest category for debt obligations.<sup>37</sup>

#### d. Three-Day Safe Harbor

Rule 2a-7 permits a taxable or national fund to invest up to twenty-five percent of its total assets in the first tier securities of a single issuer for up to three business days (“three-day safe harbor”).<sup>38</sup> The proposed amendments restore unintentionally omitted language stating that a fund may not make more than one investment at any time during the three day period.<sup>39</sup>

### 3. Asset Backed Securities and Synthetic Securities

#### a. Rating Requirement

The March Amendments provide separate credit quality, diversification and maturity standards for asset backed securities and synthetic securities (collectively, “ABSs”). The amendments provide that an ABS is not an eligible security unless it has received a rating from an NRSRO. The ABS covered by the rule include interests in pools of receivables, such as credit card debt, as well as short-term synthetic tax exempt securities.<sup>40</sup> The Commission adopted the rating requirement because an NRSRO rating would ensure that an independent legal, structural and credit analysis of the ABS had taken place. In addition, the Commission stated that, in light of the role that the NRSROs have played in the development of structured finance, a rating requirement should not be burdensome.<sup>41</sup>

The Commission is proposing to modify the rating requirement for ABS to exempt from the rating requirement any ABS substantially all the qualifying assets of which consist of the obligations of one or more municipal issuers.<sup>42</sup> In proposing the rating requirement for ABSs, the Commission noted that when an ABS consists of a large pool of financial assets, such as credit card receivables or mortgages, the ABS may not be susceptible to conventional means of credit risk analysis because credit quality is based not on a single issuer but an actuarial analysis of a pool of financial assets.<sup>43</sup> Industry participants have suggested that this is usually not the case with respect to synthetic structures and municipal pools, whose qualifying assets generally consist of no more than a few municipal issuers (or, in the case of some pools, several municipalities located in a particular state). Thus, the credit analysis for these structures is typically no different than that required for a security directly issued by the municipality.<sup>44</sup>

The Commission is also proposing to revise the rule to clarify that, consistent with other proposed provisions of the rule, an ABS subject to a guarantee (which generally would be required to be rated<sup>45</sup>), would itself not be required to be rated

<sup>35</sup> Paragraphs (a)(18)(ii), (a)(18)(iii) and (c)(4)(vi)(A)(2) of Rule 2a-7.

<sup>36</sup> See, e.g., Standard & Poor’s Municipal Finance Criteria, 176-177 (1996).

<sup>37</sup> Paragraph (a)(19)(iii) of Rule 2a-7, as proposed to be amended.

<sup>38</sup> Paragraph (c)(4)(iii) of Rule 2a-7 (paragraph (c)(4)(i)(A) of Rule 2a-7, as proposed to be amended). Because single state funds are required to be diversified only as to seventy-five percent of their assets, they have available a twenty-five percent basket to accommodate purchases in excess of five percent. Paragraph (c)(4)(ii) of Rule 2a-7 (paragraph (c)(4)(i)(B) of Rule 2a-7, as proposed to be amended). As a result, the three-day safe harbor of Rule 2a-7 is not available for single state funds.

<sup>39</sup> Paragraph (c)(4)(i)(A) of Rule 2a-7, as proposed to be amended.

<sup>40</sup> Synthetic securities are described in Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] (“Release 19959”) at Section II.C.4.

<sup>41</sup> Release 21837, *supra* note 1 at Section II.E.4.

<sup>42</sup> Paragraph (a)(10)(ii)(B) of Rule 2a-7, as proposed to be amended.

<sup>43</sup> Release 19959, *supra* note 39, at text accompanying n.111.

<sup>44</sup> Industry representatives have also suggested that because many synthetics are not rated, the rating requirement may restrict available supply. ABSs that involve the securitization of financial assets, on the other hand, are typically rated, and the rating requirement does not impose any unnecessary burden.

<sup>45</sup> Paragraph (a)(10)(iii)(A) of Rule 2a-7, as proposed to be amended.



by an NRSRO.<sup>46</sup> Under the proposed amendments, a fund holding an ABS fully supported by a guarantee would be permitted to substitute the credit quality of the guarantee in determining the credit quality of the ABS,<sup>47</sup> and to exclude the ABS in determining its compliance with the rule's issuer diversification standards.<sup>48</sup>

#### b. Diversification Standards

The March Amendments treat the special purpose entity as the issuer of the ABS and therefore require that Rule 2a-7's diversification standards be met with respect to the special purpose entity. The amendments create an exception to this treatment, however, requiring a fund to "look through" the special purpose entity to any issuer of qualifying assets whose obligations constitute ten percent or more of the principal amount of the qualifying assets of the special purpose entity ("ten percent obligor").<sup>49</sup> For diversification purposes, a fund is required to treat these ten percent obligors as if they issued a proportionate amount of the special purpose entity.<sup>50</sup>

Some or all of the qualifying assets of certain ABSs ("primary ABSs") also consist of other ABSs ("secondary ABSs"). The proposed amendments would clarify that a ten percent obligor that is also the issuer of secondary ABSs would be deemed to have issued a portion of the assets of the primary ABS that such secondary ABSs represent. For purposes of identifying ten percent obligors, the proposed amendments would provide that a fund should continue down the chain of ten percent obligors until a special purpose entity with no ten percent obligors is reached.<sup>51</sup> Finally, the Commission is proposing to clarify that in the case of the obligations of a ten percent obligor that are treated as being held directly by the fund, any demand features and guarantees supporting the obligations are treated as being held by the fund and should be subject to the rule's demand feature and guarantee diversification tests.<sup>52</sup> Comment is requested on the proposed amendments.

Some industry participants have raised concern about the ABS diversification test because a fund could invest more than ten percent of its total assets in ABSs issued by a special purpose entity with one or more ten percent obligors.<sup>53</sup> A fund's investment of a significant portion of its total assets in a single ABS might expose the fund and investors to an undue amount of structural risk (e.g., the risk that the special purpose entity might be affected by the bankruptcy of the sponsor). Comment is requested whether the rule should restrict direct and indirect fund investment in the obligations of a single special purpose entity to a specified percentage of fund assets (e.g., ten percent of fund assets).

#### c. Demand Features and Guarantees

<sup>46</sup> Paragraph (a)(10)(ii)(B) of Rule 2a-7, as proposed to be amended.

<sup>47</sup> Paragraph (c)(3)(iii) of Rule 2a-7, as proposed to be amended.

<sup>48</sup> Paragraph (c)(4)(i) of Rule 2a-7, as proposed to be amended.

<sup>49</sup> Paragraph (c)(4)(vi)(A)(4) of Rule 2a-7.

<sup>50</sup> *Id.*; Paragraph (c)(4)(ii)(D)(1) of Rule 2a-7, as proposed to be amended.

<sup>51</sup> Paragraphs (c)(4)(ii)(D)(1) and (c)(4)(D)(ii)(2) of Rule 2a-7, as proposed to be amended. The proposed amendments reflect the approach illustrated in materials prepared by the staff of the Division of Investment Management. *See* Materials for 1996 ICI Conference on Money Market Fund Regulation: Asset Backed Securities and Synthetic Securities—Application of Paragraph (c)(4)(vi)(A)(4) of Rule 2a-7 (May 9, 1996) (copies available upon request). Some industry participants have urged that the rule's diversification requirements be amended to require money market funds to look through to the receivables underlying asset backed securities, and have maintained that a fund holding an asset backed security is exposed only to the credit quality of the ultimate obligors and not the special purpose entity. The Commission is not proposing to follow this approach for several reasons. First, the status of an ABS as an eligible investment for a money market fund is not based on the creditworthiness of each obligor, but rather on the creditworthiness of the entire pool of assets, which typically is evaluated and rated based on the actuarial experience of similar pools with similar features (such as an overcollateralization). Second, applying the rule's diversification tests to the ultimate obligors of an ABS could permit a fund to invest a significant percentage of its total assets in a single ABS. Third, the suggested approach would create significant administrative burdens on funds that purchase ABSs, because the funds would have to identify and monitor each obligor (or each guarantor of each obligor), and determine whether the value of these obligations, together with any other securities issued by that obligor that the funds hold directly or propose to acquire, would exceed the applicable diversification requirements.

<sup>52</sup> Paragraph (c)(4)(ii)(D)(3) of Rule 2a-7, as proposed to be amended.

<sup>53</sup> For example, a fund could invest fifty percent of its total assets in ABSs issued by a special purpose entity whose qualifying assets consist of the obligations of ten individual ten percent obligors. Under the rule's diversification tests, each ten percent obligor would be deemed to be the issuer of five percent of the fund's total assets [(ten percent obligation) x (fifty percent investment)]. This result would be technically consistent with the diversification provisions of the rule, even though such an investment would expose fifty percent of the fund's total assets to the structural risk inherent in the special purpose entity issuing the ABSs.

Under Rule 2a-7, a fund holding an ABS subject to a demand feature from a controlled person is subject to the rule's ten percent diversification limitation applicable to demand features and puts, and thus may not be able to include this investment in its "twenty-five percent basket."<sup>54</sup> The sponsor of an ABS may own residual interests in the special purpose entity, in which case the sponsor may "control" the special purpose entity within the meaning of Section 2(a)(9) of the 1940 Act.<sup>55</sup>

The Commission restricted fund use of the twenty-five percent basket to non-controlled persons to minimize a fund's concentration of assets in a single economic enterprise.<sup>56</sup> This provision of the rule, then, was designed to limit a fund's aggregate exposure to the risks of related, active businesses. Permitting a fund to invest more than five percent of its total assets in an ABS subject to a demand feature provided by a sponsor, however, would not have this effect, because the special purpose entity, unlike an active enterprise, is a limited purpose vehicle created solely for the purpose of issuing fixed income securities based on the cash flow of the qualifying assets. The Commission is therefore proposing amendments to the definitions of "demand feature issued by a non-controlled person" and "guarantee issued by a non-controlled person" to include sponsors of special purpose entities.<sup>57</sup> The effect of such an amendment would be to permit a fund holding an ABS to include any sponsor-provided demand feature or guarantee in the twenty-five percent basket.<sup>58</sup>

#### d. Asset Backed Securities: Other Issues

Some types of ABSs may consist of qualifying assets whose cash flow has been "swapped" to a financial institution that ultimately acts as the primary source of payment to funds holding the ABSs. In these circumstances, it may be appropriate for the fund to treat the financial institution as the issuer of the ABSs under the rule's diversification tests, because the fund is relying on the creditworthiness of that institution. Comment is requested on whether and how the rule should be amended to address swaps and similar arrangements.

### 4. Other Proposed Amendments

#### a. Definition of Eligible Security—Certain Unrated Securities

Rule 2a-7 provides that an unrated security that, when issued was a long-term security but when purchased by the fund had a remaining maturity of less than 397 calendar days, may be considered to be an eligible security based on whether the security is comparable in quality to a rated security, unless the security has received a long-term rating from any NRSRO that is not within the three highest categories of long-term ratings.<sup>59</sup> Proposed amendments to the rule permit

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<sup>54</sup> The diversification standards applicable to puts under Rule 2a-7 apply with respect to seventy-five percent of a fund's total assets—a fund need not comply with the rule's put diversification standards with respect to the remaining twenty-five percent of its total assets ("twenty-five percent basket") as long as: (1) the fund holds securities in the basket that are subject to, or issued by, providers of puts that are first tier securities; and (2) the puts held in the basket are puts issued by non-controlled persons. *See* paragraphs (a)(17) (definition of "put issued by a non-controlled person") and (c)(4)(v) of Rule 2a-7.

<sup>55</sup> Section 2(a)(9) of the 1940 Act defines "control" to mean the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than twenty-five per centum of the voting securities of a company is presumed to control such company.

<sup>56</sup> Release 21837, *supra* note 1, at Section II.C.1.b.

<sup>57</sup> Paragraphs (a)(9) and (a)(15) of Rule 2a-7, as proposed to be amended.

<sup>58</sup> Another effect would be that a sponsor-provided guarantee would be subject to the rating requirement for guarantees. *See supra* Section I.B.1.c of this Release (a guarantee issued by a non-controlled person is subject to the rating requirement described therein).

<sup>59</sup> Paragraph (a)(9)(iii)(B) of Rule 2a-7.

a fund to treat such a security as an eligible security if that security had a long-term rating from the requisite NRSROs<sup>60</sup> within the three highest rating categories.<sup>61</sup>

#### b. Acquisition of Portfolio Securities

Several provisions of the rule that are applicable to the purchase of portfolio securities refer to the purchase or “rollover” of the security;<sup>62</sup> some refer only to the purchase<sup>63</sup> or acquisition<sup>64</sup> of a security by the fund.<sup>65</sup> To make the rule more uniform, and to clarify that the failure of a fund to exercise a demand feature does not have similar consequences under the rule as a decision to rollover commercial paper, the proposed amendments would add to the rule the defined term “acquisition,” which would include a rollover of a security (but not the exercise of a demand feature.)<sup>66</sup>

#### c. Single State Funds

The March Amendments provide that a single state fund is limited to investing no more than five percent of its assets in the securities of a single issuer (other than Government securities), but only with respect to seventy-five percent of its total assets. The remaining twenty-five percent of a single state fund’s assets (“twenty five percent basket”) may be invested in the securities of one or more issuers, provided they are first tier securities.<sup>67</sup> The March Amendments define a single state fund as a tax exempt fund that holds itself out as primarily distributing income exempt from the income taxes of a specified state or locality.<sup>68</sup> Since the adoption of the March Amendments, the Commission has become aware that a few money market funds whose investment objectives are to distribute income exempt from the income taxes of a particular state cannot hold themselves out as single state funds because they may not primarily distribute such income. The proposed amendments would modify the current definition by permitting a fund to qualify as a single state fund, and make use of the twenty-five percent basket, if it holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state.<sup>69</sup>

#### d. Standby Commitments

Under the rule, a “standby commitment” is defined as a put that entitles the holder to same day settlement,<sup>70</sup> and may be purchased by the fund only if the board (or its delegate) finds that the issuer presents minimal credit risks.<sup>71</sup> The Commission is proposing to delete the definition of “standby commitment” and all references thereto from the rule. Changes to other definitions make the use of this term in the rule unnecessary; a standby commitment that falls within the definition of a demand feature would be treated as a demand feature under the rule. Standby commitments that do not fall within the definition of demand feature could not act as a substitute for the credit quality, and could not be relied

<sup>60</sup> The term “requisite NRSROs” is defined in paragraph (a)(19) of Rule 2a-7 (paragraph (a)(20) of Rule 2a-7, as proposed to be amended) to mean:

(i) any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or (ii) if only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund purchases or rolls over the security, that NRSRO.

<sup>61</sup> Paragraph (a)(10)(ii)(A) of Rule 2a-7, as proposed to be amended. To eliminate duplicative text in the definitions of “eligible security,” “first tier security” and “unrated security,” the proposed amendments would delete subparagraph (ii) from each definition. *See* paragraphs (a)(10), (a)(12) and (a)(27) of Rule 2a-7, as proposed to be amended.

<sup>62</sup> *See, e.g.*, paragraph (a)(19) of Rule 2a-7 (definition of “requisite NRSROs”).

<sup>63</sup> *See, e.g.*, paragraph (c)(3)(iii) of Rule 2a-7 (securities subject to conditional demand features).

<sup>64</sup> *See, e.g.*, paragraphs (c)(3)(i) (portfolio quality—general); (c)(4)(i) (issuer diversification—taxable and national funds); (c)(4)(ii) (issuer diversification—single state funds); (c)(4)(v) (put diversification); and (c)(5)(i)(A)(2) (downgrade of unrated security or second tier security held by the fund) of Rule 2a-7.

<sup>65</sup> *See also* paragraph (c)(4)(iv) of Rule 2a-7 (diversification tests applicable to second tier securities—references to “acquisition” and “rollover” but not to “purchase”).

<sup>66</sup> Paragraph (a)(1) of Rule 2a-7, as proposed to be amended.

<sup>67</sup> Paragraph (c)(4)(ii) of Rule 2a-7.

<sup>68</sup> Paragraph (a)(21) of Rule 2a-7.

<sup>69</sup> Paragraph (a)(22) of Rule 2a-7, as proposed to be amended.

<sup>70</sup> Paragraph (a)(22) of Rule 2a-7.

<sup>71</sup> Paragraph (a)(9)(iii)(A) of Rule 2a-7.

upon to shorten the maturity of the security, would not expose the fund to any significant risks with respect to the issuer of the standby commitment, and thus would not be subject to any of the rule's quality or diversification requirements.<sup>72</sup> Comment is requested on the proposed amendment.

#### e. Downgrades, Defaults and Other Events

Proposed amendments to Rule 2a-7 would clarify that a fund's investment adviser (or other person) is required to reassess whether an unrated security or a second tier security continues to present minimal credit risks to the fund when it becomes aware that the security has been downgraded by any NRSRO below that NRSRO's two highest short-term rating categories.<sup>73</sup> This amendment would eliminate any confusion caused by the language of the rule, as amended by the March Amendments, that some industry participants have suggested could be read to require such a reassessment upon assignment of any rating below the two highest rating categories, whether short-term or long-term.

#### f. Recordkeeping Requirements

The Commission is proposing amendments to the rule's recordkeeping and procedural requirements. First, the proposed amendments would replace certain rule text inadvertently omitted and restore the requirement that a fund's board of directors (or its delegate) document the minimal credit risk determination with respect to all securities in the fund's portfolio.<sup>74</sup> Second, the proposed amendments would clarify that a fund would not be required to establish procedures concerning demand features and guarantees not relied upon if it does not hold such instruments.<sup>75</sup> Finally, proposed amendments to the procedures concerning these securities reflect modifications to the diversification test for asset backed securities.<sup>76</sup>

#### g. Investment Companies Holding Themselves Out as Money Market Funds

Paragraph (b) of Rule 2a-7 provides that it is "an untrue statement of material fact" for a registered investment company to use "money market" or a similar term as part of its name, or to hold itself out to investors as a money market fund or its equivalent unless the fund meets the risk-limiting conditions of Rule 2a-7. Proposed amendments to paragraph (b) of the rule would restate, using additional rulemaking authority recently provided to the Commission,<sup>77</sup> the rule's prohibition on the use of a name by an investment company that would suggest the company is a money market fund, unless that company is a money market fund that operates in compliance with the rule.<sup>78</sup>

## II. Proposed Amendments to the Advertising Rules

The Commission is also proposing to amend the Commission's advertising rules to clarify the formula used by money market funds to calculate yield and to seek to ensure that investors are not confused by presentation of a money market fund's short-term total return in lieu of its yield.

<sup>72</sup> In the 1985 release proposing amendments to Rule 2a-7, the Commission explained that a fund usually pays nothing or only a nominal consideration for a standby commitment, and the commitment may be "exercised only as a last resort, because the broker, dealer, or other financial institution [providing the standby commitment] would suffer a loss on the transaction if the exercise price is greater than the market value of the underlying securities at the time of exercise." Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14607 (July 1, 1985) [50 FR 27982 (July 9, 1985)]. If there is a practical, contractual or other impediment to its exercise, a standby commitment would not be a "demand feature" under Rule 2a-7 because it is not readily exercisable at the time intervals specified in paragraph (a)(7) of the rule.

<sup>73</sup> Paragraph (c)(6)(i)(A)(2) of Rule 2a-7, as proposed to be amended.

<sup>74</sup> Paragraph (c)(10)(iii) of Rule 2a-7, as proposed to be amended.

<sup>75</sup> Paragraph (c)(9)(ii) of Rule 2a-7, as proposed to be amended.

<sup>76</sup> Paragraphs (c)(9)(iv) and (c)(10)(v) of Rule 2a-7, as proposed to be amended.

<sup>77</sup> The National Securities Markets Improvement Act of 1996 (P. L. No. 104-290) amended Section 35(d) of the 1940 Act to provide that "it shall be unlawful for any registered investment company to adopt as a part of the name or title of such company, or of any securities of which it is the issuer, any word or words that the Commission finds are materially deceptive or misleading. The Commission is authorized, by rule or regulation, or order, to define such names and titles as are materially deceptive and misleading."

<sup>78</sup> Paragraph (b) of Rule 2a-7, as proposed to be amended.

## A. Calculation of Yield

The Commission adopted a uniform method of calculating money market fund yield in 1980 that explicitly limited income reflected in yield to investment income.<sup>79</sup> In 1983, the Commission revised the formula to correct a flaw in the formula at which time the limitation on investment income was unintentionally omitted.<sup>80</sup> Recently, questions have been raised regarding the inclusion of income other than investment income in the advertised yield of a money market fund. To resolve such questions, the Commission is proposing to amend the formula to clarify that income included in yield is limited to investment income.<sup>81</sup>

## B. Use of Total Return

Some money market funds, instead of advertising their performance by quoting a seven-day yield calculated in accordance with Commission rules, have used quotations of total return covering short periods of time. Even though sales material may properly identify the performance figure as “total return,” the Commission is concerned that many investors will not recognize the distinction or, if they do, will not appreciate the difference between total return and yield. As a result, investors may assume incorrectly that a fund quoting the higher total return figure is a better performing fund than the other money market funds quoting yield.<sup>82</sup> In addition, investors may incorrectly assume that the higher “total return” is the yield they can expect to receive upon an investment in the fund.

In seeking to ensure that the distinction between money market fund yields and short-term total return is clear, the Commission is proposing to amend Rules 482 under the Securities Act of 1933 and 34b-1 under the 1940 Act to require that total return used in advertisements and sales literature cover a period of at least one year. In addition, the Commission is proposing to require that quotations of total return in advertisements and sales literature be accompanied by a quotation of current yield, computed in accordance with Commission rules, and set forth with equal prominence.

## III. Request for Comment

In connection with its review of the rules and forms regulating money market funds, the staff has become aware of a fund sponsor that established a program linking a money market fund with a debit card available for use by the fund’s shareholders. Under the program, rebates earned by the fund on credit card transactions entered into by the fund’s shareholders are distributed to the shareholders in the form of income.<sup>83</sup> This type of income is not investment income and its inclusion in the money market fund’s standardized yield is not permitted.<sup>84</sup> The Commission solicits comment on an appropriate method for disclosing, in connection with performance information, these rebate amounts and other types of arrangements involving non-investment income. For example, should a fund be able to advertise a separate rate of return (as a percentage) for the rebate feature covering the same period of time as the standardized yield?

## IV. Transition Period

The release adopting the March Amendments provided that money market funds would be required to comply with certain of the amendments by October 3, 1996, which was approximately six months from the date of publication of the March Amendments in The Federal Register.<sup>85</sup> On August 13, 1996, the Commission suspended the compliance date

<sup>79</sup> Advertising by Investment Companies, Investment Company Act Release No. 11379 (Sept. 30, 1980) [45 FR 67079 (Oct. 9, 1980)].

<sup>80</sup> “Money Market” Funds’ Inclusion of a Standardized Yield Computation in Prospectuses, Investment Company Act Release No. 13049 (Feb. 28, 1983) [48 FR 10297 (Mar. 11, 1983)]. In this release, the Commission stated that “limiting the yield to net investment income better indicates the earning potential of a fund’s portfolio and thus both promotes comparability of yield and reduces the potential for misleading investors....”

<sup>81</sup> The proposed amendments would revise Item 22 of Form N-1A [17 CFR 239.15A and 274.11A], Item 25 of Form N-3 [17 CFR 239.17a and 274.11b], and Item 21 of Form N-4 [17 CFR 239.17b and 274.11c].

<sup>82</sup> This practice typically occurs during a period of declining interest rates when the fund’s total return will be higher than its current yield because it will include periods of time during which the fund held higher yielding securities. It may also occur in order to avoid the limitation on income included in yield to investment income. See discussion *supra*.

<sup>83</sup> See Robert D. Hershey, Jr., Sophia Collier, Soda Entrepreneur, Uncorks a Money Market Fund, N.Y. Times, at sec. 3, p. 11.

<sup>84</sup> Such funds clearly can, however, for example, advertise the dollar value of the rebate, or specify the dollar amounts received per certain dollars invested in the fund over some stated period of time.

<sup>85</sup> Release 21837, *supra* note 1, at Section V.B.

for the March Amendments until the final version of these proposed amendments is published in The Federal Register.<sup>86</sup> Comment is requested on an appropriate compliance date for these technical amendments, and whether the release adopting these technical amendments should provide for a compliance period of comparable length to that of the March Amendments.

## V. Cost/Benefit Analysis

The proposals discussed above constitute refinements to the rules regulating money market funds, and would not increase costs for money market funds, their advisers, or other market participants. The proposed technical amendments would clarify the application of the quality and diversification tests under Rule 2a-7 consistent with investor protection. The Commission requests specific comment on its assessment of the costs and benefits associated with the proposal, including specific estimates of costs and benefits.

## VI. Paperwork Reduction Act

Certain provisions of the proposed amendments contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (*44 U.S.C. 3501 et seq.*), and the Commission has submitted proposed amendments to the Office of Management and Budget for review in accordance with *44 U.S.C. 3507(d)*. The title for the collection of information is “Rules Regulating Money Market Funds.” The Supporting Statement to the Paperwork Reduction Act submission notes that, because the proposed technical amendments to Rule 2a-7 would clarify existing reporting and recordkeeping obligations, it is estimated that they would have no effect on the annual reporting burden of money market funds. The Supporting Statement also notes that the proposed amendments to the advertising rules would not impose any new paperwork burden on money market funds because the majority of money market funds do not include income other than investment income in calculating their yield, and do not advertise total return based on short periods of time.

Pursuant to *44 U.S.C. 3506(c)(2)(B)*, the Commission solicits comments concerning: whether the proposed collection of information is necessary for the proper performance of the function of the Commission, including whether the information shall have practical utility; on the accuracy of the Commission’s estimate of the burden of the proposed collection of information; on the quality, utility, and clarity of the information to be collected; and whether the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information or technology, may be minimized.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and should send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549 with reference to File No. S7-29-96. The Office of Management and Budget is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to the Office of Management and Budget is best assured of having its full effect if the Office of Management and Budget receives it within 30 days of publication.

## VII. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with *5 U.S.C. 603* regarding proposed technical amendments to Rule 2a-7, and proposed amendments to the advertising rules applicable to money market funds. The analysis states that the proposed technical amendments to Rule 2a-7 are not intended to effect major substantive changes to the rule, but are designed to codify interpretive positions taken by the staff of the Division of Investment Management; revise terminology in the rule to reflect common usage; modify certain of the March

<sup>86</sup> Compliance Date Release, *supra* note 4. The March Amendments clarified that floating rate and variable rate securities (“adjustable rate securities”) must reasonably be expected to have market values that approximate their amortized cost values on each interest rate adjustment date through their final maturity dates. *See* Release 21837, *supra* note 1, at Section II.F.4 and paragraphs (a)(12) and (a)(30) of Rule 2a-7 (definitions of “floating rate security” and “variable rate security”). Because these provisions of the March Amendments merely clarified the application of existing provisions of the rule, whether a fund or its adviser must reasonably expect the market value of an adjustable rate security to approximate its amortized cost value was not affected by the Compliance Date Release.

Amendments so that the treatment accorded certain instruments by Rule 2a-7 more closely reflects the treatment accorded to those instruments by the financial markets; and make certain other technical corrections. The analysis also states that, in light of the nature of the proposed technical amendments to the rule, it would be inconsistent with the purposes of the Regulatory Flexibility Act to propose to exempt small entities from the coverage of these amendments.

The analysis also discusses the proposed amendments to the advertising rules for money market funds. The analysis explains that the proposed amendments are designed to clarify the formula used by money market funds to calculate yield and to prevent investors from being confused or misled by the presentation of a money market fund's short-term total return in lieu of its yield. The analysis states that the concerns that caused the Commission to undertake this proposed rulemaking are equally applicable to funds of all sizes. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Marjorie S. Riegel, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 10-6, Washington, D.C. 20549.

## VII. Text of Rule and Form Amendments

List of Subjects in 17 CFR Parts 230, 239, 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Commission is proposing to amend chapter II, title 17 of the Code of Federal Regulations as follows:

### Part 230—General Rules and Regulations, Securities Act of 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78d, 78l, 78m, 78n, 78o, 78w, 79ll(d), 79t, 80a-8, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

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2. Section 230.482 is amended by revising paragraph (d) to read as follows:

Section 230.482 Advertising by an investment company as satisfying requirements of section 10

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(d) In the case of a money market fund:

(1) Any quotation of the money market fund's yield in an advertisement shall be:

(i) A quotation of current yield based on the method of computation prescribed in Form N-1A (Sections 239.15A and 274.11A of this chapter), Form N-3 (Sections 239.17a and 274.11b of this chapter), or Form N-4 (Sections 239.17b and 274.11c of this chapter) and identifying the length of and the date of the last day in the base period used in computing that quotation; or (ii) A quotation of current yield described in paragraph (d)(1)(i) of this section and a corresponding quotation of effective yield based on the method of computation prescribed in Form N-1A (Sections 239.15A and 274.11A of this chapter), Form N-3 (Sections 239.17a and 274.11b of this chapter), or Form N-4 (Sections 239.17b and 274.11c of this chapter); provided, that when both a quotation of current yield and effective yield are used in the same advertisement, each quotation shall relate to an identical base period and shall be given equal prominence; and (2) Any quotation of total return shall cover a period of no less than one year and shall be accompanied by a quotation of the fund's current yield described in paragraph (d)(1)(i) of this section.

### Part 270—Rules and Regulations, Investment Company Act of 1940

3. The authority citation for Part 270 is amending by adding a third paragraph in the sub-authority to read as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(b), 80a-37, 80a-39 unless otherwise noted;

\* \* \* \* \*

4. Section 270.2a-7 is revised to read as follows:

§ 70.2a-7 Money market funds.

(a) Definitions.

(1) Acquisition (or Acquire) shall mean any purchase or subsequent rollover (but does not include the failure to exercise a Demand Feature).

(2) Amortized Cost Method of valuation shall mean the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(3) Asset Backed Security shall mean a fixed income security (other than a Government security) issued by a Special Purpose Entity (as hereinafter defined), substantially all of the assets of which consist of Qualifying Assets (as hereinafter defined). Special Purpose Entity shall mean a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities which entitle their holders to receive payments that depend primarily on the cash flow from Qualifying Assets, but does not include a registered investment company. Qualifying Assets shall mean financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(4) Business Day shall mean any day, other than Saturday, Sunday, or any customary business holiday.

(5) Collateralized Fully in the case of a repurchase agreement shall mean that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the money market fund reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price (as defined hereinafter) provided in the agreement;

(ii) The money market fund or its custodian either has actual physical possession of the collateral or, in the case of a security registered on a book entry system, the book entry is maintained in the name of the money market fund or its custodian;

(iii) The collateral consists entirely of cash items, Government Securities or other securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the Requisite NRSROs; and

(iv) Upon an event of insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any general stay of creditors' rights against the seller.

(v) Resale Price shall mean the Acquisition price paid to the seller of the securities plus the accrued resale premium on such Acquisition price. The accrued resale premium shall be the amount specified in the repurchase agreement or the daily amortization of the difference between the Acquisition price and the resale price specified in the repurchase agreement.

(6) Conditional Demand Feature shall mean a Demand Feature that is not an Unconditional Demand Feature. A Conditional Demand Feature is not a Guarantee.

(7) Conduit Security shall mean a security issued by a Municipal Issuer (as hereinafter defined) involving an arrangement or agreement entered into, directly or indirectly, with a person other than a Municipal Issuer, which arrangement or agreement provides for or secures repayment of the security. Municipal Issuer shall mean a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality of a state or territory of the United States. A Conduit Security does not include a security that is:

(i) Fully and unconditionally guaranteed by a Municipal Issuer; or



(ii) Payable from the general revenues of the Municipal Issuer or other Municipal Issuers (other than those revenues derived from an agreement or arrangement with a person who is not a Municipal Issuer that provides for or secures repayment of the security issued by the Municipal Issuer); or

(iii) Related to a project owned and operated by a Municipal Issuer; or

(iv) Related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a Municipal Issuer.

(8) Demand Feature shall mean:

(i) A feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise. A Demand Feature must be exercisable either:

(A) At any time on no more than 30 calendar days' notice; or

(B) At specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice; or

(ii) A feature permitting the holder of an Asset Backed Security unconditionally to receive principal and interest within 397 calendar days of making demand.

(9) Demand Feature Issued By A Non-Controlled Person shall mean a Demand Feature issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature; and a sponsor of an Asset Backed Security with respect to an Asset Backed Security. Control shall mean "control" as defined in Section 2(a)(9) of the Act [*15 U.S.C. 80a-2(a)(9)*].

(10) Eligible Security shall mean:

(i) A security with a remaining maturity of 397 calendar days or less that has received a short-term rating (or that has been issued by an issuer that has received a short-term rating with respect to a class of debt obligations, or any debt obligation within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in one of the two highest short-term rating categories (within which there may be sub-categories or gradations indicating relative standing); or (ii) An Unrated Security that is of comparable quality to a security meeting the requirements of paragraph (a)(10)(i) of this section, as determined by the money market fund's board of directors; Provided, however, that:

(A) A security that at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less and that is an Unrated Security is not an Eligible Security if the security has received a long-term rating from any NRSRO that is not within the NRSRO's three highest long-term ratings categories (within which there may be sub-categories or gradations indicating relative standing) unless the security has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories;

(B) An Asset Backed Security (other than an Asset Backed Security substantially all of whose Qualifying Assets consist of obligations of one or more Municipal Issuers, as that term is defined in paragraph (a)(7) of this section) shall not be an Eligible Security unless it has received a rating from an NRSRO.

(iii) In addition to the foregoing, in the case of a security that is subject to a Demand Feature or Guarantee:

(A) The Guarantee has received a rating or is issued by an issuer that has received a rating from an NRSRO (unless the Guarantee is issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the Guarantee); and

(B) The issuer of the Demand Feature or Guarantee, or another institution, has undertaken promptly to notify the holder of the security in the event the Demand Feature or Guarantee is substituted with another Demand Feature or Guarantee (if such substitution is permissible under the terms of the Demand Feature or Guarantee).

(11) Event of Insolvency shall mean, with respect to a person:

- (i) An admission of insolvency, the application by the person for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; or
- (ii) The institution of similar proceedings by another person which proceedings are not contested by the person; or
- (iii) The institution of similar proceedings by a government agency responsible for regulating the activities of the person, whether or not contested by the person.

(12) First Tier Security shall mean any Eligible Security that:

- (i) Has received a short-term rating (or that has been issued by an issuer that has received a short-term rating with respect to a class of debt obligations, or any debt obligation within that class, that is comparable in priority and security with the security) by the Requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); or
- (ii) Is an Unrated Security that is of comparable quality to a security meeting the requirements of paragraph (a)(12)(i) of this section, as determined by the fund's board of directors; or
- (iii) Is a security issued by a registered investment company that is a money market fund; or
- (iv) Is a Government Security.

(13) Floating Rate Security shall mean a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and which, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(14) Guarantee shall mean an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the Guarantee (if required), at a specified time a price equal to the principal amount of the underlying security plus accrued interest when due or upon default, or, in the case of an Unconditional Demand Feature, an obligation that entitles the holder to receive upon exercise the approximate amortized cost of the underlying security or securities, plus accrued interest, if any. A Guarantee includes a letter of credit, financial guaranty (bond) insurance, and an Unconditional Demand Feature (other than an Unconditional Demand Feature provided by the issuer of the security).

(15) Guarantee Issued By A Non-Controlled Person shall mean a Guarantee issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Guarantee; and a sponsor of a Special Purpose Entity with respect to an Asset Backed Security. Control shall mean "control" as defined in Section 2(a)(9) of the Act [15 U.S.C. 80a-2(a)(9)].

(16) Government Security shall mean any Government security as defined in Section 2(a)(16) of the Act [15 U.S.C. 80a-2(a)(16)].

(17) NRSRO shall mean any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi)(E), (F) and (H) of § 40.15c3-1 of this Chapter that is not an affiliated person, as defined in Section 2(a)(3)(C) of the Act [15 U.S.C. 80a-2(a)(3)(C)], of the issuer of, or any insurer, or provider of credit support for, the security.

(18) Penny-Rounding Method of pricing shall mean the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(19) Refunded Security shall mean a debt security the principal and interest payments of which are to be paid by Government Securities ("deposited securities") that have been irrevocably placed in an escrow account pursuant to agreement between the issuer of the debt security and an escrow agent that is not an affiliated person, as defined in Section 2(a)(3)(C) of the Act [15 U.S.C. 80a-2(a)(3)(C)], of the issuer of the debt security, and, in accordance with such

escrow agreement, are pledged only to the payment of the debt security and, to the extent that excess proceeds are available after all payments of principal, interest, and applicable premiums on the Refunded Securities, the expenses of the escrow agent and, thereafter, to the issuer or another party; provided that:

- (i) The deposited securities shall not be redeemable prior to their final maturity;
- (ii) The escrow agreement shall prohibit the substitution of the deposited securities unless the substituted securities are Government Securities; and
- (iii) At the time the deposited securities are placed in the escrow account, or at the time a substitution of the deposited securities is made, an independent certified public accountant shall have certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities; Provided, however, an independent public accountant need not have provided the certification described herein if the security, as a Refunded Security, has received a rating from an NRSRO in the highest category for debt obligations (within which there may be sub-categories or gradations including relative standing).

(20) Requisite NRSROs shall mean:

- (i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or
- (ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund Acquires the security, that NRSRO.

(21) Second Tier Security shall mean any Eligible Security that is not a First Tier Security. Second Tier Conduit Security shall mean any Conduit Security that is an Eligible Security that is not a First Tier Security.

(22) Single State Fund shall mean a Tax Exempt Fund that holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and, where applicable, subdivisions thereof.

(23) Tax Exempt Fund shall mean any money market fund that holds itself out as distributing income exempt from regular federal income tax.

(24) Total Assets shall mean, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.

(25) Unconditional Demand Feature shall mean a Demand Feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

(26) United States Dollar-Denominated shall mean, with reference to a security, that all principal and interest payments on such security are payable to security holders in United States dollars under all circumstances and that the interest rate of, the principal amount to be repaid, and the timing of payments related to such security do not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars.

(27) Unrated Security shall mean:

(i) A security with a remaining maturity of 397 calendar days or less issued by an issuer that did not, at the time the security was Acquired by the fund, have a current short-term rating assigned by any NRSRO:

(A) To the security; or

(B) To the issuer of the security with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security, or a Demand Feature with respect to the security; and

(ii) A security that is a rated security and is the subject of an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security (or the issuer) was

assigned its rating unless the security has a rating from an NRSRO reflecting the existence of the credit support agreement.

(iii) A security is not an Unrated Security if any debt obligation (reference security) that is issued by the same issuer and is comparable in priority and security with that security has a short-term rating by an NRSRO. The status of such security as an Eligible Security or First Tier Security shall be the same as that of the reference security.

(28) Variable Rate Security shall mean a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and which, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(b) Holding Out and Use of Names and Titles.

(1) It shall be an untrue statement of material fact within the meaning of Section 34(b) of the Act [15 U.S.C. 80a-33(b)] for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act [15 U.S.C. 80a-24(b)] to hold itself out to investors as a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of this section.

(2) It shall constitute the use of a materially deceptive or misleading name or title within the meaning of Section 35(d) of the Act [15 U.S.C. 80a-34(d)] for a registered investment company to adopt the term “money market” as part of its name or title or the name or title of any redeemable securities of which it is the issuer, or to adopt a name which suggests that it is, a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this section.

(3) For purposes of this paragraph, a name which suggests that a registered investment company is a money market fund or the equivalent thereof shall include one which uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) Share Price Calculations. The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund”), notwithstanding the requirements of Section 2(a)(41) of the Act [15 U.S.C. 80a-2(a)(41)] and of § 70.2a-4 and 270.22c-1 thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; Provided, however, That:

(1) Board Findings. The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.

(2) Portfolio Maturity. The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; Provided, however, That the money market fund will not:

(i) Except as provided in paragraph (c)(2)(ii) of this section, Acquire any instrument with a remaining maturity of greater than 397 calendar days; or

(ii) In the case of a money market fund not using the Amortized Cost Method, Acquire a Government Security with a remaining maturity of greater than 762 calendar days; or

(iii) Maintain a dollar-weighted average portfolio maturity that exceeds ninety days.

(3) Portfolio Quality.

(i) General. The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO) and which are at the time of Acquisition Eligible Securities.

(ii) Second Tier Securities. Immediately after the Acquisition of any Second Tier Security:

(A) Taxable Funds. A money market fund that is not a Tax Exempt Fund shall not have invested more than Five Percent of its Total Assets in securities which are Second Tier Securities; and

(B) Tax Exempt Funds. A money market fund that is a Tax Exempt Fund shall not have invested more than Five Percent of its Total Assets in Conduit Securities which are Second Tier Conduit Securities.

(iii) Securities Subject to Guarantees. A security that is subject to a Guarantee may be determined to be an Eligible Security or a First Tier Security based solely on whether the Guarantee is an Eligible Security or First Tier Security, as the case may be.

(iv) Securities Subject to Conditional Demand Features. A security that is subject to a Conditional Demand Feature ("Underlying Security") may be determined to be an Eligible Security or a First Tier Security only if:

(A) The Conditional Demand Feature is an Eligible Security or First Tier Security, as the case may be; and

(B) At the time of the Acquisition of the Underlying Security, the money market fund's board of directors has determined that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur; and

(1) The conditions limiting exercise either 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

(2) The terms of the Conditional Demand Feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand Feature in accordance with its terms; and

(C) The Underlying Security or any Guarantee of such security (or the debt securities of the issuer of the Underlying Security or Guarantee that are comparable in priority and security with the Underlying Security or Guarantee) has received either a short-term rating or a long-term rating, as the case may be, by the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund's board of directors to a security that has received a rating from the Requisite NRSROs within the NRSRO's two highest short-term or long-term rating categories, as the case may be.

(4) Portfolio Diversification.

(i) Issuer Diversification. The money market fund shall be diversified with respect to issuers of securities Acquired by the fund as provided in paragraphs (c)(4)(i) and (c)(4)(ii) of this section, other than with respect to Government Securities and securities subject to a Guarantee Issued By A Non-Controlled Person.

(A) Taxable and National Funds. Immediately after the Acquisition of any security, a money market fund other than a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security; Provided, however, that such a fund may invest up to twenty-five percent of its Total Assets in the First Tier Securities of a single issuer for a period of up to three Business Days after the Acquisition thereof, Provided, Further, that the fund may not invest in the securities of more than one issuer in accordance with the foregoing proviso at any time.

(B) Single State Funds. With respect to seventy-five percent of its Total Assets, immediately after the Acquisition of any security, a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security; Provided, however, That a Single State Fund shall not invest more than five percent of its Total Assets in securities issued by the issuer of the security unless the securities are First Tier Securities.

## (C) Second Tier Securities.

(1) Taxable Funds. Immediately after the Acquisition of any Second Tier Security, a money market fund that is not a Tax Exempt Fund shall not have invested more than the greater of one percent of its Total Assets or one million dollars in securities issued by that issuer which are Second Tier Securities.

(2) Tax Exempt Funds. Immediately after the Acquisition of any Second Tier Conduit Security, a money market fund that is a Tax Exempt Fund shall not have invested more than the greater of one percent of its Total Assets or one million dollars in securities issued by that issuer which are Second Tier Conduit Securities.

(ii) Issuer Diversification Calculations. For purposes of making calculations under paragraph (c)(4)(i) of this section:

(A) Repurchase Agreements. The Acquisition of a repurchase agreement may be deemed to be an Acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully.

(B) Refunded Securities. The Acquisition of a Refunded Security shall be deemed to be an Acquisition of a Government Security.

(C) Conduit Securities. A Conduit Security shall be deemed to be issued by the issuer (other than the Municipal Issuer) ultimately responsible for payments of interest and principal on the security.

## (D) Asset Backed Securities.

(1) General. An Asset Backed Security shall be deemed to be issued by the Special Purpose Entity that issued the Asset Backed Security, Provided, however, any person whose obligations constitute ten percent or more of the principal amount of the Qualifying Assets of that Special Purpose Entity (“Ten Percent Obligor”) shall be deemed to be an issuer of the portion of the Asset Backed Security such obligations represent; and

(2) Secondary Asset Backed Securities. If the Ten Percent Obligor is itself a Special Purpose Entity issuing Asset Backed Securities (“Secondary ABS”), then that obligor shall be deemed to have issued a portion of the assets of the primary Asset Backed Security that such Secondary ABS represents. For purposes of identifying Ten Percent Obligors, continue down the chain of Ten Percent Obligors until a Special Purpose Entity with no Ten Percent Obligor is reached.

(3) Demand Features and Guarantees. In the case of a Ten Percent Obligor deemed to be an issuer, the fund shall satisfy the diversification requirements of paragraph (c)(4)(iii) of this section with respect to any Demand Feature or Guarantee to which the Ten Percent Obligor’s obligations are subject.

(E) Shares in Master Funds. A money market fund substantially all of the assets of which consist of shares of another money market fund Acquired in reliance on Section 12(d)(1)(E) of the Act [15 U.S.C. 80a-12(d)(1)(E)] shall be deemed to be in compliance with this section if the board of directors of the money market fund holding the assets of another money market fund reasonably believes that the fund in which it has invested is in compliance with this section.

(iii) Diversification Rules for Demand Features and Guarantees. The money market fund shall be diversified with respect to Demand Features and Guarantees Acquired by the fund as provided in paragraphs (c)(4)(iii) and (c)(4)(iv) of this section, other than with respect to a Demand Feature issued by the same institution that issued the underlying security.

(A) General. Immediately after the Acquisition of any Demand Feature or Guarantee or security subject to a Demand Feature or Guarantee, a money market fund, with respect to seventy-five percent of its Total Assets, shall not have invested more than ten percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, subject to paragraphs (c)(4)(iii)(B) and (C) of this section.

(B) Second Tier Demand Features or Guarantees. Immediately after the Acquisition of any Demand Feature or Guarantee (or a security after giving effect to the Demand Feature or Guarantee) that is a Second Tier Security, a money

market fund shall not have invested more than five percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee.

(C) Demand Features or Guarantees Issued by Non-Controlled Persons. Immediately after the Acquisition of any security subject to a Demand Feature or Guarantee, a money market fund shall not have invested more than ten percent of its Total Assets in securities issued by, or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, unless, with respect to any security subject to Demand Features or Guarantees from that institution (other than securities issued by such institution), the Demand Feature or Guarantee is a Demand Feature or Guarantee Issued By A Non-Controlled Person.

(iv) Demand Feature and Guarantee Diversification Calculations.

(A) Fractional Demand Features or Guarantees. In the case of a security subject to a Demand Feature or Guarantee from an institution by which the institution guarantees a specified portion of the value of the security, the institution shall be deemed to guarantee the specified portion thereof, Provided, however, if the security is an Asset Backed Security and the Demand Feature or Guarantee is with respect to all or a portion of the first losses with respect to the security, the institution providing the Demand Feature or Guarantee shall be deemed to have provided the Demand Feature or Guarantee with respect to the entire principal amount of the security.

(B) Layered Demand Features or Guarantees. In the case of a security subject to Demand Features or Guarantees from multiple institutions that have not limited the extent of their obligations as described in paragraph (c)(4)(iv)(A) of this section, each institution shall be deemed to have provided the Demand Feature or Guarantee with respect to the entire principal amount of the security.

(v) Diversification Safe Harbor. A money market fund that satisfies the applicable diversification requirements of paragraph (c)(4) of this section shall be deemed to have satisfied the diversification requirements of Section 5(b)(1) of the Act [15 U.S.C. 80a-5(b)(1)] and the rules adopted thereunder.

(5) Demand Features and Guarantees Not Relied Upon. If the fund's board of directors has determined that the fund is not relying on a Demand Feature or Guarantee to determine the quality (pursuant to paragraph (c)(3) of this section), or maturity (pursuant to paragraph (d) of this Section), or liquidity of a portfolio security, and maintains a record of this determination (pursuant to paragraphs (c)(9)(ii) and (c)(10)(vi) of this section), then the fund may disregard such Demand Feature or Guarantee for all purposes of this section.

(6) Downgrades, Defaults and Other Events.

(i) Downgrades.

(A) General. Upon the occurrence of either of the events specified in paragraphs (c)(6)(i)(A)(1) and (2) of this section with respect to a portfolio security, the board of directors of the money market fund shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders:

(1) A portfolio security of a money market fund ceases to be a First Tier Security (either because it no longer has the highest rating from the Requisite NRSROs or, in the case of an Unrated Security, the board of directors of the money market fund determines that it is no longer of comparable quality to a First Tier Security); and

(2) The money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated Security or Second Tier Security held by the money market fund has, since the security was Acquired by the fund, been given a rating by any NRSRO below the NRSRO's second highest short-term rating category.

(B) Securities to Be Disposed Of. The reassessments required by paragraph (c)(6)(i)(A) of this section shall not be required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five Business Days of the specified event and, in the case of events specified in paragraph (c)(6)(i)(A)(2) of this section, the board is subsequently notified of the adviser's actions.

(C) Special Rule for Certain Securities Subject to Demand Features. In the event that after giving effect to a rating downgrade, more than five percent of the fund's Total Assets are invested in securities issued by or subject to Demand Features from a single institution that are Second Tier Securities, the fund shall reduce its investment in securities issued by or subject to Demand Features from that institution to no more than five percent of its Total Assets by exercising the Demand Features at the next succeeding exercise date(s), absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund.

(ii) Defaults and Other Events. Upon the occurrence of any of the events specified in paragraphs (c)(6)(ii)(A) through (D) of this section with respect to a portfolio security, the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security):

(A) The default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(B) A portfolio security ceases to be an Eligible Security;

(C) A portfolio security has been determined to no longer present minimal credit risks; or

(D) An Event of Insolvency occurs with respect to the issuer of a portfolio security or the provider of any Demand Feature or Guarantee.

(iii) Notice to the Commission. In the event of a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Demand Feature or Guarantee to which it is subject, where immediately before default the securities (or the securities subject to the Demand Feature or Guarantee) accounted for  $\frac{1}{2}$  of 1 percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically or by means of a facsimile transmission, followed by letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management.

(iv) Defaults for Purposes of Paragraphs (c)(6)(ii) and (iii). For purposes of paragraphs (c)(6)(ii) and (iii) of this section, an instrument subject to a Demand Feature or Guarantee shall not be deemed to be in default (and an Event of Insolvency with respect to the security shall not be deemed to have occurred) if:

(A) In the case of an instrument subject to a Demand Feature, the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest; or

(B) The provider of the Guarantee is continuing, without protest, to make payments as due on the instrument.

(7) Required Procedures: Amortized Cost Method. In the case of a money market fund using the Amortized Cost Method:

(i) General. In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) Specific Procedures. Included within the procedures adopted by the board of directors shall be the following:

(A) Shadow Pricing. Written procedures shall provide:



(1) That the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute which reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions;

(2) For the periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and

(3) For the maintenance of records of the determination of deviation and the board's review thereof.

(B) Prompt Consideration of Deviation. In the event such deviation from the money market fund's amortized cost price per share exceeds  $\frac{1}{2}$  of 1 percent, the board of directors shall promptly consider what action, if any, should be initiated by the board of directors.

(C) Material Dilution or Unfair Results. Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(8) Required Procedures: Penny-Rounding Method. In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.

(9) Specific Procedures: Amortized Cost and Penny-Rounding Methods. Included within the procedures adopted by the board of directors for money market funds using either the amortized cost or penny-rounding methods shall be the following:

(i) Securities for Which Maturity is Determined by Reference to Demand Features. In the case of a security for which maturity is determined by reference to a Demand Feature, written procedures shall require ongoing review of the security's continued minimal credit risks, which review must be based on, among other things, financial data for the most recent fiscal year of the issuer of the Demand Feature and, in the case of a security subject to a Conditional Demand Feature, the issuer of the security whose financial condition must be monitored under paragraph (c)(3)(iv) of this section, whether such data is publicly available or provided under the terms of the security's governing documentation.

(ii) Securities Subject to Demand Features or Guarantees. In the case of a security subject to one or more Demand Features or Guarantees which the fund's board of directors has determined that the fund is not relying on to determine the quality (pursuant to paragraph (c)(3) of this section), maturity (pursuant to paragraph (d) of this section) or liquidity of the security subject to the Demand Feature or Guarantee, written procedures shall require periodic evaluation of such determination.

(iii) Adjustable Rate Securities Without Demand Features. In the case of a Variable Rate or Floating Rate Security that does not have a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section, written procedures shall require periodic review of whether the interest rate formula, upon readjustment of its interest rate, can reasonably be expected to cause the security to have a market value that approximates its amortized cost value.

(iv) Asset Backed Securities. In the case of an Asset Backed Security, written procedures shall require the fund to periodically determine the number of Ten Percent Obligors (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section.

(10) Record Keeping and Reporting.

(i) Written Procedures. For a period of not less than six years following the replacement of such procedures with new procedures (the first two years in an easily accessible place), a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(6) through (c)(9) and (e) of this section shall be maintained and preserved.

(ii) Board Considerations and Actions. For a period of not less than six years (the first two years in an easily accessible place) a written record shall be maintained and preserved of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth in this section, to be included in the minutes of the board of directors' meetings.

(iii) Credit Risk Analysis. For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks and the NRSRO ratings (if any) used to determine the status of the security as an Eligible Security, First Tier Security or Second Tier Security shall be maintained and preserved in an easily accessible place.

(iv) Determinations with Respect to Adjustable Rate Securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(9)(iii) of this section (that a Variable Rate or Floating Rate Security that does not have a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section can reasonably be expected, upon readjustment of its interest rate at all times during the life of the instrument, to have a market value that approximates its amortized cost).

(v) Determinations with Respect to Asset Backed Securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(9)(iv) of this section (the number of Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(iv)(D) of this section). The written record shall include the identities of the Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section), the percentage of the Qualifying Assets constituted by the securities of each Ten Percent Obligor and the percentage of the fund's Total Assets that are invested in securities of each Ten Percent Obligor.

(vi) Evaluations with Respect to Securities Subject to Demand Features or Guarantees. For a period of not less than three years from the date when the evaluation was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the evaluation required by paragraph (c)(9)(ii) (regarding securities subject to one or more Demand Features or Guarantees) of this section.

(vii) Inspection of Records. The documents preserved pursuant to this paragraph (c)(10) shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act [*15 U.S.C. 80a-30(b)*] as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act [*15 U.S.C. 80a-30(a)*]. If any action was taken under paragraphs (c)(6)(ii) (with respect to defaulted securities and events of insolvency) or (c)(7)(ii) (with respect to a deviation from the fund's share price of more than ½ of 1 percent) of this section, the money market fund will file an exhibit to the Form N-SAR [*17 CFR 274.101*] filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

(d) Maturity of Portfolio Securities. For purposes of this section, the maturity of a portfolio security shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, except as provided in paragraphs (d)(1) through (d)(8) of this section:

(1) Adjustable Rate Government Securities. A Government Security which is a Variable Rate Security where the variable rate of interest is readjusted no less frequently than every 762 calendar days shall be deemed to have a maturity equal to

the period remaining until the next readjustment of the interest rate. A Government Security which is a Floating Rate Security shall be deemed to have a remaining maturity of one day.

(2) Short-Term Variable Rate Securities. A Variable Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity equal to the earlier of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(3) Long-Term Variable Rate Securities. A Variable Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) Short-Term Floating Rate Securities. A Floating Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity of one day.

(5) Long-Term Floating Rate Securities. A Floating Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(6) Repurchase Agreements. A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.

(7) Portfolio Lending Agreements. A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(8) Money Market Fund Securities. An investment in a money market fund shall be treated as having a maturity equal to the period of time within which the Acquired money market fund is required to make payment upon redemption, unless the Acquired money market fund has agreed in writing to provide redemption proceeds to the investing money market fund within a shorter time period, in which case the maturity of such investment shall be deemed to be the shorter period.

(e) Delegation. The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (c)(1) (board findings), (c)(6)(i)(C) (rule for certain securities subject to second tier Demand Features), (c)(6)(ii) (defaults and other events), (c)(7)(i) (general required procedures: Amortized Cost Method), (c)(7)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), and (C) (material dilution or unfair results), and (c)(8) (required procedures: Penny Rounding Method) of this section) provided:

(1) Written Guidelines. The Board shall establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this section) and procedures under which the delegate makes such determinations:

(2) Oversight. The Board shall take any measures reasonably necessary (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security or Event of Insolvency with respect to the issuer of the security or any Guarantee to which it is subject that requires notification of the Commission under paragraph (c)(6)(iii) of this section) to assure that the guidelines and procedures are being followed.

5. Section 270.2a41-1 is amended by revising paragraph (a) to read as follows:

§ 70.2a41-1 Valuation of standby commitments by registered investment companies.

(a) A standby commitment means a right to sell a specified underlying security or securities within a specified period of time and at an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise, that may be sold, transferred or assigned only with the underlying security or securities. A standby commitment entitles the holder to receive same day settlement, and will be considered to be from the party to whom the investment company will look for payment of the exercise price. A standby commitment may be assigned a fair value of zero, Provided, That:

\* \* \* \* \*

6. Section 270.12d3-1 is amended by revising paragraph (d)(7)(v) to read as follows:

§70.12d3-1 Exemption of acquisitions of securities issued by persons engaged in securities related businesses.

\* \* \* \* \*

(d) \* \* \*

(7) \* \* \*

(v) Acquisition of Demand Features or Guarantees, as these terms are defined in § 70.2a-7(a)(8) and § 70.2a-7(a)(14) respectively, provided that, immediately after the acquisition of any Demand Feature or Guarantee, the company will not, with respect to 75 percent of the total value of its assets, have invested more than ten percent of the total value of its assets in securities underlying Demand Features or Guarantees from the same institution. For the purposes of this section, a Demand Feature or Guarantee will be considered to be from the party to whom the company will look for payment of the exercise price.

\* \* \* \* \*

7. Section 270.17a-9 is amended by revising the text to read as follows:

§ 70.17a-9 Purchase of certain securities from a money market fund by an affiliate, or an affiliate of an affiliate.

The purchase of a security that is no longer an Eligible Security (as defined in paragraph (a)(10) of § 70.2a-7) from an open-end investment company holding itself out as a “money market” fund shall be exempt from section 17(a) of the Act [15 U.S.C. 80a-17(a)], provided that:

(a) The purchase price is paid in cash; and

(b) 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).

\* \* \* \* \*

8. Section 270.31a-1 is amended by revising the sentence at the end of paragraph (b)(1) to read as follows:

§ 70.31a-1 Records to be maintained by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \* In the case of a money market fund, also identify the provider of any Demand Feature or Guarantee (as defined in § 70.2a-7(a)(8) or § 70.2a-7(a)(14) respectively) and give a brief description of the nature of the Demand Feature or Guarantee (e.g., unconditional demand feature, conditional demand feature, put, letter of credit, or bond insurance) and, in a subsidiary portfolio investment record, provide the complete legal name and accounting and other information

(including sufficient information to calculate coupons, accruals, maturities, puts, and calls) necessary to identify, value, and account for each investment.

\* \* \* \* \*

9. Section 34b-1 is amended by revising paragraph (b) to read as follows:

§ 70.34b-1 Sales literature deemed to be misleading.

\* \* \* \* \*

(b)(1) Except as provided in paragraph (b)(2) of this section:

(i) In the case of sales literature regarding a money market fund:

(A) Any quotation of yield or similar quotation purporting to demonstrate the income earned or distributions made by the money market fund, shall be accompanied by a quotation of current yield specified by paragraph (d)(1) of § 30.482 of this chapter;

(B) Any quotation of tax equivalent yield or other similar quotation purporting to demonstrate the tax equivalent yield earned or distributions made by the money market fund shall be accompanied by a quotation of tax equivalent yield as specified in paragraph (d)(1) of § 30.482 of this chapter; and

(C) Any quotation of total return shall cover a period of no less than one year and shall be accompanied by a quotation of the fund's current yield described in paragraph (b)(1)(i) of this section which shall be given equal prominence.

(ii) In the case of sales literature regarding a company other than a money market fund:

(A) Any quotation of yield or similar quotation purporting to demonstrate the income earned or distributions made by the company shall be accompanied by a quotation of current yield specified by paragraph (e)(1) of § 30.482 of this chapter; and

(B) Any quotation of tax equivalent yield of other similar quotation purporting to demonstrate the tax equivalent yield earned or distributions made by the company shall be accompanied by a quotation of tax equivalent yield as specified in paragraph (e)(1) of § 30.482 of this chapter.

(2) The requirements specified in paragraphs (b)(1) and (2) of this section shall not apply to any quarterly, semi-annual, or annual report to shareholders under Section 30 of the Act [*15 U.S.C. 80a-29*], containing performance data for a period commencing no earlier than the first day of the period covered by the report; nor shall the requirements of paragraphs (e)(3)(ii) and (f) of § 30.482(e)(3)(ii) and (f) of this chapter apply to any such periodic report containing any other performance data.

### **Part 239—Forms Prescribed Under the Securities Act of 1933**

### **Part 274—Forms Prescribed Under the Investment Company Act of 1940**

10. The authority citation for part 239 continues to read, in part, as follows:

Authority: *15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-29, 80a-30 and 80a-37*, unless otherwise noted.

\* \* \* \* \*

11. The authority citation for Part 274 continues to read as follows:

Authority: *15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, and 80a-29*, unless otherwise noted.

12. Part B, Item 22(a) of Form N-1A (referenced in § 239.15A and 274.11A) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase “and income other than investment income” after the phrase “exclusive of capital changes” in each paragraph.

(b) Adding at the end of Instruction 2 the following: “Exclude income other than investment income.”

\* \* \* \* \*

NOTE: Form N-1A does not and the amendments will not appear in the Code of Federal Regulations.

13. Guide 21 (Disclosure of Risk Factors) to Form N-1A (referenced in *17 CFR 239.15A* and *274.11A*) is amended by revising the word “effect” to read “affect” in the sentence of the last paragraph.

\* \* \* \* \*

NOTE: Guide 21 to Form N-1A does not and the amendments will not appear in the Code of Federal Regulations.

14. Guide 35 (Money Market Fund Investments in Other Money Market Funds) to Form N-1A (referenced in *17 CFR 239.15A* and *274.11A*) is amended by revising the last sentence to read as follows:

\* \* \* Paragraph (c)(4)(ii)(E) of Rule 2a-7 describes the obligations of a fund that invests substantially all of its assets in another money market fund.

NOTE: Guide 35 to Form N-1A does not and the amendments will not appear in the Code of Federal Regulations.

15. Item 25(a) of Form N-3 (referenced in § 239.17a and 274.11b) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase “and income other than investment income” after the phrase “exclusive of capital changes” in each paragraph.

(b) Adding at the end of Instruction 3 the following: “Exclude income other than investment income.”

\* \* \* \* \*

NOTE: Form N-3 does not and the amendments will not appear in the Code of Federal Regulations.

16. Guide 38 to Form N-3 (Money Market Fund Investments in Other Money Market Funds) (referenced in *17 CFR 239.17a* and *274.11b*) is amended by revising the last sentence to read as follows:

\* \* \* Paragraph (c)(4)(ii)(E) of Rule 2a-7 describes the obligations of a fund that invests substantially all of its assets in another money market fund.

NOTE: Guide 38 to Form N-3 does not and the amendments will not appear in the Code of Federal Regulations.

17. Part B, Item 21(a) of Form N-4 (referenced in § 239.17b and 274.11c) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase “and income other than investment income” after the phrase “exclusive of capital changes” in each paragraph.

(b) Adding at the end of Instruction 3 the following: “Exclude income other than investment income.”

\* \* \* \* \*

NOTE: Form N-4 does not and the amendments will not appear in the Code of Federal Regulations.

By the Commission.  
Jonathan G. Katz  
Secretary  
December 10, 1996

## ADOPTION OF TECHNICAL REVISIONS TO THE RULES AND FORMS REGULATING MONEY MARKET FUNDS

Release Nos. 33-7479; IC-22921  
December 2, 1997

ACTION: Final Rules

SUMMARY: The Commission is adopting amendments to rules and forms under the Securities Act of 1933 and the Investment Company Act of 1940 that govern money market funds. Technical amendments to Rule 2a-7 under the Investment Company Act of 1940, the rule regulating money market funds, among other things, revise terminology used in the rule to reflect common market usage and resolve certain interpretive issues under the rule. Amendments to the advertising rules applicable to money market funds, among other things, clarify the formula used by money market funds to calculate yield.

DATES: Effective Date: The rule and form amendments adopted in this Release will become effective February 10, 1998. Compliance Date: See Section III of this Release.

FOR FURTHER INFORMATION CONTACT: David P. Mathews, Senior Counsel, Office of Regulatory Policy, (202) 942-0690, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 10-2, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (“Commission”) is adopting technical amendments to Rule 2a-7 [17 CFR 270.2a-7] (“Rule 2a-7” or the “rule”) under the Investment Company Act of 1940 [15 USC 80a-1, *et seq.*] (“1940 Act”), the rule governing the operations of money market funds (“funds”).<sup>1</sup> The Commission is adopting conforming amendments to Rules 241-1, 12d3-1, 17a-9 and 31a-1 under the 1940 Act [17 CFR 270.2a41-1, 270.12d3-1, 270.17a-9 and 270.31a-1] to reflect the amendments to Rule 2a-7. The Commission also is adopting amendments to Rule 482 [17 CFR 230.482] under the Securities Act of 1933 [15 USC 77a, *et seq.*] (“1933 Act”) and Rule 34b-1 under the 1940 Act [17 CFR 270.34b-1]; and to Forms N-1A [17 CFR 239.15A and 274.11A], N-3 [17 CFR 239.17a and 274.11b] and N-4 [17 CFR 239.17b and 274.11c].

### I. Technical Amendments to Rule 2a-7

#### A. Background

On March 21, 1996, the Commission adopted amendments to Rule 2a-7 under the 1940 Act (“1996 Amendments”) to tighten the rule’s risk-limiting conditions imposed on tax exempt money market funds and to address the treatment under the rule of certain instruments, such as asset backed securities.<sup>2</sup> These risk-limiting conditions include requirements that a fund limit itself to investing in high quality securities<sup>3</sup> and that the fund’s portfolio be diversified.<sup>4</sup> After the adoption of the 1996 Amendments, industry participants raised numerous questions concerning the application

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<sup>1</sup> Unless otherwise noted, all references to “Rule 2a-7, as amended,” or any paragraph of the rule, will be to 17 CFR 270.2a-7 as amended by this Release.

<sup>2</sup> Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] (“Release 21837”). Unless otherwise noted, all references to the “1996 Amendments” in this Release are to Rule 2a-7 as adopted in Release 21837. The compliance date for the 1996 Amendments to Rule 2a-7 was suspended pending the adoption of technical amendments. *See infra* note 5 and accompanying text.

<sup>3</sup> The portfolio or credit quality provisions of the rule generally limit funds to investments in U.S. dollar-denominated securities that present minimal credit risks and that are, at the time of acquisition, “eligible securities” as defined by the rule. *See* paragraph (c)(3) of Rule 2a-7, as amended (“portfolio quality standards” or “credit quality standards”). “Eligible security” is defined in paragraph (a)(10) of Rule 2a-7, as amended.

<sup>4</sup> The diversification provisions of the rule generally limit the amount of assets that a fund may invest in a single issuer of securities, and the amount of assets that may be subject to credit enhancements, such as letters of credit or puts, provided by the same credit enhancement provider. *See* paragraph (c)(4) of Rule 2a-7, as amended (“diversification standards”).

of the amendments in different contexts. The Commission thereafter suspended the compliance date of certain of the 1996 Amendments pending the proposal and adoption of technical amendments to address these concerns.<sup>5</sup>

On December 10, 1996, the Commission issued a release proposing technical amendments to Rule 2a-7 (“Proposing Release”).<sup>6</sup> The proposed amendments would: (1) codify certain interpretive views expressed by the Division of Investment Management;<sup>7</sup> (2) revise terminology used in the rule to reflect common market usage; (3) modify certain of the 1996 Amendments so that the rule’s treatment of certain instruments (e.g., guarantees) more closely reflects the treatment of those instruments by the financial markets; and (4) make certain other technical corrections. The Commission also proposed amendments to clarify the Commission’s advertising rules regarding how money market funds calculate current yield and represent short-term total return in conjunction with current yield quotations.

The Commission received comments on the proposed amendments from seventeen commenters, including nine mutual fund complexes.<sup>8</sup> Commenters supported the proposed technical amendments to Rule 2a-7, and suggested further amendments to certain provisions of the rule primarily relating to the treatment of asset backed securities. Most commenters that addressed the proposed amendments to the Commission’s advertising rules relating to money market fund yield and total return generally supported them. The Commission is adopting the technical amendments substantially as proposed with certain modifications that reflect, in part, many of the commenters’ suggestions. The Commission also is establishing a new compliance date for the 1996 Amendments, as further amended by the technical amendments adopted in this Release.<sup>9</sup>

## B. Discussion

### 1. Guarantees

#### a. Definition of “Guarantee”

Rule 2a-7 currently characterizes certain features that enhance the credit or liquidity of portfolio securities as “puts” and “unconditional puts.”<sup>10</sup> To clarify terminology used in Rule 2a-7, the Commission proposed to replace these terms with a new term—“guarantee”—that would include a wide-range of arrangements designed to unconditionally support the credit of the issuer of a security.<sup>11</sup> Commenters generally supported the proposed amendments which the Commission is adopting substantially as proposed.<sup>12</sup>

<sup>5</sup> Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 22135 (Aug. 13, 1996) [61 FR 42786 (Aug. 19, 1996)]. The Commission suspended the 1996 Amendments’ compliance date for Rule 2a-7, 2a41-1, 12d3-1 and 31a-1 under the 1940 Act. [17 CFR 270.2a-7, .2a41-1, .12d3-1 and .31a-1]. The compliance date was not suspended with respect to the adoption of Rule 17a-9 under the 1940 Act [17 CFR 270.17a-9] and the 1996 Amendments’ revisions of the rules and forms relating to money market fund disclosure, advertising and reporting.

<sup>6</sup> Technical Revisions to the Rules and Forms Regulating Money Market Funds, Investment Company Act Release No. 22383 (Dec. 10, 1996) [61 FR 66621 (Dec. 18, 1996)] (“Proposing Release”).

<sup>7</sup> See Investment Company Institute (pub. avail. May 9, 1996).

<sup>8</sup> The comment letters and a summary of the comments prepared by the Commission staff are available to the public and are included in File No. S7-29-96.

<sup>9</sup> The new compliance date is discussed *infra* in Section III.B. of this Release.

<sup>10</sup> The 1996 Amendments defined a “put” as the right to sell a specified underlying security within a specified period of time at a specified exercise price that may be sold, transferred or assigned only with the underlying security. An “unconditional put” was defined as a put (including any guarantee, financial guarantee (bond) insurance, letter of credit or similar unconditional credit enhancement) that by its terms would be readily exercisable in the event of default in payment of principal or interest on the underlying security. See paragraphs (a) (16) and (a)(27) of Rule 2a-7, as adopted by the 1996 Amendments.

<sup>11</sup> See Proposing Release, *supra* note 6, at n.7 and accompanying text.

<sup>12</sup> Under the new definition, a guarantee is any unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the guarantee (if required), principal plus accrued interest when due upon default. Paragraph (a) (15) of Rule 2a-7, as amended. In order to permit guarantees that are payable at any time, the Commission has eliminated a requirement in the proposed definition that the issuer of the guarantee be obligated to pay upon default “at a specified time.” The Commission also is adopting amendments to the credit quality and diversification provisions of the rule to incorporate the new term “guarantee,” as discussed *infra* in Sections I.B.1.b. and c. of this Release. The definition of “guarantee” is for purposes of Rule 2a-7 only, and is not intended to have any effect on the status of these investments under other provisions of the 1940 Act or under other federal securities laws.



## b. Credit Substitution

Since 1986, Rule 2a-7 has permitted a fund to rely exclusively on the credit quality of the issuer of an “unconditional demand feature” in determining whether a security meets the rule’s credit quality standards.<sup>13</sup> The 1996 Amendments also permitted a fund to exclude from the rule’s issuer diversification standards a security subject to an unconditional demand feature provided by a person that does not control, or is not controlled by or under common control with, the issuer of the security (“non-controlled person”).<sup>14</sup> Reflected in this approach is the recognition that the holder of a security typically relies exclusively on the credit quality of the issuer of the unconditional demand feature in deciding to invest in the security.

In addition to enhancing credit quality, money market funds also rely on demand features to shorten the maturities of adjustable rate securities or provide a source of liquidity.<sup>15</sup> Because of the significance of demand features to a money market fund’s ability to maintain a stable net asset value, the 1996 Amendments further provided that a demand feature is not eligible for fund investment unless (i) the demand feature (or the issuer of the demand feature) is rated by an NRSRO (“Rating Requirement”);<sup>16</sup> and (ii) arrangements are in place for a fund holding a security subject to a demand feature to be given notice in the event of a change in the identity of the issuer of the demand feature (“Notification Requirement”).

The Commission proposed to extend these provisions to other types of guarantees commonly held by funds, such as bond insurance, letters of credit and similar unconditional guarantees.<sup>17</sup> Like securities subject to unconditional demand features, securities subject to guarantees typically trade on the basis of the credit of the guarantor, rather than the issuer. Commenters strongly supported the proposed amendments which the Commission is adopting as proposed.<sup>18</sup>

Under the rule as amended, a fund holding a security subject to a guarantee (as defined in the rule) may rely exclusively on the credit quality of the issuer of the guarantee in determining whether the security meets the rule’s credit quality

<sup>13</sup> See Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)]. A “demand feature” means (i) a feature exercisable either: (A) at any time on no more than 30 calendar days’ notice, or (B) at specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days’ notice; or (ii) a feature permitting the holder of an asset backed security unconditionally to receive principal and interest within 397 calendar days of making demand. An “unconditional demand feature” is a demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities. See paragraphs (a)(8) and (a)(26) of Rule 2a-7, as amended.

<sup>14</sup> Under the 1996 Amendments; a security subject to an unconditional demand feature from a person in a control relationship with the issuer of the security (*i.e.*, one that controls, is controlled by or under common control with the issuer) remains subject to the issuer diversification standards in order to reduce a fund’s exposure to credit risks presented by a single economic enterprise. See Release 21837, *supra* note 2, at nn.42-47 and accompanying text.

<sup>15</sup> Tax exempt funds, for example, typically invest in long-term adjustable rate securities subject to demand features. The interest rates on these securities periodically adjust to reflect short-term rates. The demand features permit funds to demand payment of the security at relatively short intervals, and if unconditional, also serve to enhance credit quality—thus providing the basis for making the securities eligible for money market fund investment.

<sup>16</sup> “NRSRO” is the acronym used in Rule 2a-7 to stand for a “nationally recognized statistical rating organization.” See paragraph (a)(17) of Rule 2a-7, as amended. NRSROs are designated as such by the Commission’s Division of Market Regulation through the no-action letter process for purposes of the Commission’s net capital rule [17 CFR 240.15c3-1].

<sup>17</sup> Proposing Release, *supra* note 6, at nn.8-16 and accompanying text.

<sup>18</sup> See paragraphs (c)(3)(iii) (determination of whether a security meets the rule’s credit quality standards may be based exclusively on the credit quality of the security’s guarantee); (c)(4)(i) (excluding securities subject to guarantees from non-controlled persons from the rule’s issuer diversification standards); (a)(10)(iii)(A) (extending the Rating Requirement to guarantees); (a)(10)(iii)(B) (extending the Notification Requirement to guarantees); and (a)(16) (definition of “guarantee issued by a non-controlled person”) of Rule 2a-7, as amended. The amended rule also permits a fund that holds a security subject to a guarantee and a conditional demand feature to substitute the rating of the guarantee for the rating of the underlying security. Paragraph (c)(3)(iv)(C) of Rule 2a-7, as amended. Consistent with the amended rule, however, a fund must also consider the rating of the conditional demand feature in evaluating the credit quality of the entire instrument. Paragraph (c)(3)(iv)(A) of Rule 2a-7, as amended.

standards.<sup>19</sup> In addition, securities subject to guarantees issued by non-controlled persons are not subject to the rule's issuer diversification standards.<sup>20</sup>

### c. Rating Requirement for Guarantees

The 1996 Amendments precluded funds from investing in securities subject to demand features (whether unconditional or conditional) that have not received a short-term rating from an NRSRO. The Commission proposed, in light of its proposal to extend the rule's treatment of unconditional demand features to all guarantees, to extend the Rating Requirement to guarantees, subject to certain exceptions.<sup>21</sup> Commenters generally supported the proposal, which the Commission is adopting substantially as proposed.

Under Rule 2a-7, as amended, all guarantees must be rated by an NRSRO,<sup>22</sup> except (i) a guarantee issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the guarantee,<sup>23</sup> (ii) a guarantee with respect to a repurchase agreement ("repo") that is collateralized fully,<sup>24</sup> (iii) a guarantee issued by the U.S. Government,<sup>25</sup> or (iv) a guarantee not relied upon for quality, maturity or liquidity purposes.<sup>26</sup> Conditional demand features, which are not within the definition of a "guarantee" under the amended rule, are not subject to the Rating Requirement.<sup>27</sup>

### d. Demand Features and Guarantees Not Relied Upon

The 1996 Amendments permitted a fund that is not relying on a particular put to disregard that put for purposes of meeting Rule 2a-7's put and demand feature diversification standards. The Commission is revising the rule to extend this provision to guarantees, and to expand the provision to permit funds to disregard a demand feature or a guarantee that is not relied upon to satisfy the rule's credit quality or maturity standards, or for liquidity, for all purposes under the rule.<sup>28</sup>

<sup>19</sup> Paragraph (c)(3)(iii) of Rule 2a-7, as amended.

<sup>20</sup> Paragraph (c)(4)(i) of Rule 2a-7, as amended. Guarantees, however, are subject to the guarantee and demand feature diversification standards of paragraphs (c)(4)(iii), (c)(4)(iv) and (c)(5) of Rule 2a-7, as amended. A security subject to a guarantee that is provided by a person in a control relationship with the issuer of the security remains subject to the rule's issuer diversification standards. See paragraphs (a)(16) (definition of "guarantee issued by a non-controlled person") and (c)(4)(i) of Rule 2a-7, as amended.

<sup>21</sup> Proposing Release, *supra* note 6, at nn.17-24 and accompanying text.

<sup>22</sup> Paragraph (a)(10)(iii)(A) of Rule 2a-7, as amended. Unlike the 1996 Amendments, which required a short-term rating, the amended rule allows any rating from an NRSRO to satisfy the Rating Requirement.

<sup>23</sup> Paragraph (a)(10)(iii)(A)(1) of Rule 2a-7, as amended. The Commission proposed to exclude this type of guarantee from the Rating Requirement because a guarantor that guarantees securities issued by a person in a control relationship with the guarantor may not be in the business of lending its credit, and such a requirement may be burdensome and result in a diminished supply of high quality, eligible securities available for money market fund investment.

<sup>24</sup> Paragraph (a)(10)(iii)(A)(2) of Rule 2a-7, as amended. The Commission has relaxed the Rating Requirement with respect to guarantees of repos that are "collateralized fully." One commenter noted that funds often rely on unconditional puts (i.e., "guarantees" under the amended rule's terminology) with respect to "term repos"—which are repos for periods longer than one day. The puts could be exercised if a repo counterparty's credit quality deteriorated or to cover short-term cash outflows. The issuers of unconditional puts with respect to term repos are typically government securities dealers that are not rated by NRSROs. Since a repo that is "collateralized fully" already has significant protection from the risk of a counterparty's default or insolvency, requiring puts (or guarantees) of such repos to be rated would add little additional protection, and could cause funds to forgo a beneficial method of liquidity enhancement. See *infra* Section I.B.2.b. of this Release (treatment of repos that are "collateralized fully").

<sup>25</sup> Paragraph (a)(10)(iii)(A)(3) of Rule 2a-7, as amended; see *infra* Section I.B.2.e. of this Release (discussing guarantees issued by the U.S. Government).

<sup>26</sup> Paragraph (c)(5) of Rule 2a-7, as amended; see also *infra* Section I.B.1.d. of this Release (demand features and guarantees not relied upon).

<sup>27</sup> A conditional demand feature is any demand feature that is not an unconditional demand feature. Paragraph (a)(6) of Rule 2a-7, as amended.

<sup>28</sup> Paragraph (c)(5) of Rule 2a-7, as amended. A fund holding securities subject to demand features or guarantees that are not being relied upon for credit quality, maturity or liquidity must establish written procedures requiring periodic re-evaluations of this determination. Paragraph (c)(9)(ii) of Rule 2a-7, as amended. Funds are not required to establish procedures concerning demand features and guarantees not relied upon if they do not hold such instruments. *Id.*

## 2. Diversification and Credit Quality Standards Applicable to Issuers

### a. Second Tier Securities

Rule 2a-7 provides that a taxable fund may not invest more than one percent of its total assets in second tier securities issued by a single issuer.<sup>29</sup> In the case of tax exempt funds, this one percent limitation on investments in second tier securities applies only to second tier “conduit securities” that are issued by municipalities, but whose ultimate obligors are not government or municipal entities.<sup>30</sup> The Commission is adopting the proposed amendments to the rule that clarify that these limitations are not applicable to a security that is guaranteed by a non-controlled person.<sup>31</sup> Securities subject to guarantees from non-controlled persons are subject only to the rule’s guarantee and demand feature diversification standards.<sup>32</sup>

### b. Repurchase Agreements

Rule 2a-7 permits a fund to “look-through” a repo to the underlying collateral and disregard the counterparty in determining compliance with the rule’s diversification standards if the obligation of the counterparty is “collateralized fully.” The 1996 Amendments sought to define “collateralized fully” to limit the collateral to that which could be liquidated promptly even in the event of bankruptcy of the counterparty.

Because of questions concerning the treatment of cash and other types of collateral not specifically addressed in the 1996 Amendments, the Commission proposed to revise the “look-through” provisions of the rule to focus on the treatment of the repo under applicable insolvency law rather than exclusively on the type of collateral. Under the proposed amendments, a repo would be “collateralized fully” if (i) the collateral consists entirely of cash, Government securities, or other securities that are rated in the highest rating category by the requisite NRSROs, and (ii) upon an event of insolvency with respect to the seller, the repo qualifies under a provision of applicable insolvency law providing an exclusion from any “general stay” of creditors rights against the seller.<sup>33</sup>

Commenters supported the proposed revisions, but three commenters urged that the rule’s language be modified to refer to an “automatic stay” rather than a “general stay.” These commenters pointed out that even repos protected from automatic stays under federal insolvency law may be subject to a court-ordered general stay obtained by the Securities Investor Protection Corporation (“SIPC”) or the Federal Deposit Insurance Corporation (“FDIC”). Because no provision of insolvency law protects a purchaser of a repo from such orders, the proposed amendments might have precluded money market funds from relying on the rule’s “look-through” provision for most repos, even though it is the policy of both

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<sup>29</sup> A “second tier security” is an eligible security that is not a first tier security. Paragraph (a)(22) of Rule 2a-7, as amended. “First tier securities” are (i) securities that have received short-term debt ratings in the highest category from the requisite NRSROs; (ii) comparable unrated securities; (iii) securities issued by money market funds; and (iv) Government securities. Paragraph (a)(12) of Rule 2a-7, as amended. “Requisite NRSROs” means (i) any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or (ii) if only one NRSRO has issued a rating with respect to a security or class of debt obligations of an issuer, that NRSRO. Paragraph (a)(21) of Rule 2a-7, as amended.

<sup>30</sup> “Conduit securities” are issued to finance non-government projects, such as private hospitals, housing projects, or industrial development projects. See paragraph (a)(7) of Rule 2a-7, as amended (definition of “conduit security”).

<sup>31</sup> Paragraphs (c)(4)(i)(C)(1) and (2) of Rule 2a-7, as amended. Rule 2a-7 also limits a taxable fund and a tax exempt fund to investing no more than five percent of total assets in second tier securities and second tier conduit securities respectively (“five percent quality test”). Paragraph (c)(3)(ii) of Rule 2a-7, as amended (portfolio quality standards—second tier securities). The amendments do not make substantive changes to the five percent quality test. Thus, a taxable fund, for example, could not invest more than five percent of its total assets in second tier securities subject to a second tier demand feature. The amendments, however, reorganize the rule text to include the five percent quality test in paragraph (c)(3) of the rule, which addresses portfolio quality standards, rather than paragraph (c)(4), which addresses diversification standards.

<sup>32</sup> Paragraphs (c)(4)(iii) and (c)(4)(iv) of Rule 2a-7, as amended.

<sup>33</sup> Proposing Release, *supra* note 6, at nn.30-36 and accompanying text.

SIPC (as to broker-dealer counterparties) and FDIC (as to bank counterparties) generally to allow the prompt liquidation of repos in insolvency proceedings.<sup>34</sup>

The Commission is adopting the proposed amendments, revised in part to reflect the commenters' suggestions.<sup>35</sup> The Commission notes that, under the revised rule, a fund entering into a repo collateralized by Government securities (which most are) should be able to conclude that the repo qualifies for "look-through" treatment (assuming the other requirements of the rule are met), while funds wishing to enter into repos using less traditional forms of collateral may rely on opinions of bankruptcy counsel.<sup>36</sup>

### c. Refunded Securities

Money market funds often invest in "refunded securities," which are securities the payment for which is funded and secured by Government securities placed in an escrow account. Rule 2a-7 permits a fund to "look-through" refunded securities to the escrowed Government securities in determining its compliance with the rule's issuer diversification standards under certain conditions.<sup>37</sup> One condition contained in the 1996 Amendments required certification by an independent public accountant that the escrowed Government securities, or any subsequent substitution of the escrowed securities, would satisfy all payments of principal, interest and applicable premiums on the refunded securities (collectively, the "accountant's certification"). The Proposing Release noted that NRSROs, in rating refunded securities, typically require an independent third party to make the same determination.<sup>38</sup> Therefore, the Commission proposed, and is now adopting, an amendment to the rule eliminating the accountant's certification requirement if a refunded security has received a rating from an NRSRO in the highest category for debt obligations.<sup>39</sup>

### d. Three-Day Safe Harbor

Rule 2a-7 permits a taxable or national fund to invest up to twenty-five percent of its total assets in the first tier securities of a single issuer for up to three business days ("three-day safe harbor"). The Commission proposed, and is adopting, amendments that restore unintentionally omitted language from the rule text stating that a fund relying on the three-

<sup>34</sup> The United States Bankruptcy Code [*11 USC 559*] protects certain repos from the automatic stay provision, but provides that SIPC may obtain a court order barring the closeout of repo transactions with member broker-dealer firms. As a matter of policy, however, SIPC honors repos and allows their liquidation under most circumstances. See Letter dated February 4, 1986, from Michael E. Don, Deputy General Counsel of SIPC, to Robert A. Portnoy, Deputy Executive Director and General Counsel of the Public Securities Association. FDIC, as conservator or receiver for insolvent depository institutions, similarly has the ability to avoid contracts entered into by such institutions, but may not avoid transfers of property in connection with repos under most circumstances. See *12 USC 1821(e)(8)(A), (C) and (D)*; FDIC Statement of Policy on Qualified Financial Contracts (Dec. 12, 1989).

<sup>35</sup> Paragraph (a)(5)(iv) of Rule 2a-7, as amended. Commenters also suggested that the text of this provision refer only to applicable "federal" insolvency law. Although repos entered into by funds typically involve domestic counterparties subject to federal insolvency law, funds may enter into repos with non-U.S. counterparties that are not subject to federal insolvency laws. Therefore, the amended rule continues to apply to any applicable insolvency law.

<sup>36</sup> In addition, a money market fund must evaluate the repo counterparty's creditworthiness in order to minimize the risk that money market funds will enter into repos with parties that present a serious risk of becoming involved in bankruptcy proceedings. The Commission previously published a release setting forth the conditions under which the Division of Investment Management would not recommend enforcement action under Section 12(d)(3) of the 1940 Act [*15 USC 80a-12(d)(3)*] (limiting fund investments in certain securities-related businesses) if an investment company entered into a repo with persons engaged in securities-related businesses. Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 13005 (Feb. 2, 1983) [*48 FR 5824* (Feb. 9, 1983)] ("Repo Release"). Among other things, the Repo Release requires that the repo be "fully collateralized." The definition of "fully collateralized" in the Repo Release does not include all of the conditions in Rule 2a-7. A money market fund entering into a repo that is "collateralized fully" within the meaning of paragraph (a)(5) of Rule 2a-7, as amended, will be deemed to meet the "fully collateralized" requirement of the Repo Release. Investment companies other than money market funds are not required to comply with this provision of Rule 2a-7 to be deemed to hold repos that are "fully collateralized" for purposes of the Repo Release.

<sup>37</sup> Paragraph (c)(4)(ii)(B) of Rule 2a-7, as amended. This "look-through" treatment would not be available to refunded securities subject to a swap agreement i.e., the payments from the escrowed Government securities are exchanged for payments made by a swap counterparty) because the swap counterparty, rather than the escrowed Government securities, acts as the ultimate source of payment for the refunded securities. See J.P. Morgan Structured Obligations Corp. (pub. avail. July 27, 1994); see generally *infra* Section I.B.3.d. of this Release (swap arrangements).

<sup>38</sup> See, e.g., Standard & Poor's Municipal Finance Criteria, 176-77 (1996).

<sup>39</sup> Paragraph (a)(20)(iii) of Rule 2a-7, as amended (definition of "refunded security").

day safe harbor may not make more than one investment in reliance on the safe harbor at any time during the three day period.<sup>40</sup>

e. Government Guarantees

Two commenters suggested that the Commission exclude guarantees issued by the U.S. Government from the rule's guarantee and demand feature diversification standards as finally amended, and thus treat government guarantees in the same manner as securities issued directly by the U.S. Government<sup>41</sup> The Commission is amending the demand feature and guarantee diversification standards accordingly.<sup>42</sup>

f. Definition of "Rated Security"

Two commenters recommended that the Commission adopt a new defined term, "rated security," which would permit Rule 2a-7's definitions of "unrated security," "eligible security" and "first tier security" to be shortened and clarified. The Commission is adopting the new term "rated security" and amending other provisions in the rule to incorporate the new term.<sup>43</sup>

3. Asset Backed Securities and Synthetic Securities

The 1996 Amendments revised Rule 2a-7 to accommodate asset backed securities and synthetic securities (collectively "ABS"). Rule 2a-7 defines an ABS as a fixed income security<sup>44</sup> issued by a "special purpose entity" substantially all of the assets of which consist of "qualifying assets."<sup>45</sup> Rule 2a-7 provides separate credit quality,<sup>46</sup> diversification<sup>47</sup> and maturity<sup>48</sup>

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<sup>40</sup> Paragraph (c)(4)(i)(A) of Rule 2a-7, as amended. The three-day safe harbor is not available for single state funds. Single state funds, however, are required to be diversified only as to seventy-five percent of their assets, and so have available a twenty-five percent basket to accommodate purchases in excess of five percent of fund assets. Paragraph (c)(4)(i)(B) of Rule 2a-7, as amended.

<sup>41</sup> A security guaranteed as to principal and interest by a U.S. Government agency is a "Government security" as defined in Section 2(a)(16) of the 1940 Act [*15 USC 80a-2(a)(16)*] and paragraph (a)(14) of Rule 2a-7, as amended. Investments in Government securities are excluded from the rule's issuer diversification standards because they are presumed to present little, if any, credit risks. The same rationale applies to security guaranteed by a U.S. Government agency, which by definition also is a "Government security."

<sup>42</sup> Paragraph (c)(4)(iii) of Rule 2a-7, as amended. Guarantees issued by the U.S. Government are deemed to be first tier securities. Paragraph (a)(12)(iv) of Rule 2a-7, as amended (definition of "first tier security").

<sup>43</sup> A "rated security" is defined generally as (i) a security (or the issuer with respect to a comparable security) that has received a short-term rating from an NRSRO; or (ii) a security subject to a guarantee if the guarantee (or the guarantor with respect to a comparable guarantee) has received a short-term rating from an NRSRO. A security is not a rated security, however, if it is subject to an external credit support agreement that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement, or the credit support agreement has received a short-term rating. Paragraph (a)(19) of Rule 2a-7, as amended. The Commission is making conforming amendments to paragraphs (a)(10) (definition of "eligible security") and (a)(12) (definition of "first tier security") of Rule 2a-7, as amended, and amending the definition of "unrated security." Under the amended definition, an "unrated security" is a security that is not a "rated security." Paragraph (a)(28) of Rule 2a-7, as amended.

<sup>44</sup> For purposes of Rule 2a-7's definition of "asset backed security," the term "fixed income security" has the same meaning as that term is defined in Rule 3a-7(b)(2) under the 1940 Act [*17 CFR 270.3a-7(b)(2)*]. Rule 3a-7 excludes structured financing, such as ABSs, from the definition of "investment company."

<sup>45</sup> Paragraph (a)(3) of Rule 2a-7, as amended. Paragraph (a)(3) defines "special purpose entity" as a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities that entitle holders to receive payments from the cash flows of the "qualifying assets." Paragraph (a)(3) defines "qualifying assets" as either fixed or revolving financial assets that by their terms convert into cash within a finite time period.

<sup>46</sup> Paragraph (a)(10)(ii)(B) of Rule 2a-7, as amended.

<sup>47</sup> Paragraph (c)(4)(ii)(D) of Rule 2a-7, as amended.

<sup>48</sup> Paragraph (d) of Rule 2a-7, as amended.

standards for ABSs. The ABSs covered by the rule include interests in pools of receivables, such as credit card debt, as well as short-term synthetic tax exempt securities.<sup>49</sup>

#### a. Rating Requirement

In recognition of the independent legal, structural and credit analysis conducted by NRSROs before assigning a rating to an ABS, the 1996 Amendments required that all ABSs purchased by money market funds receive a rating from an NRSRO.<sup>50</sup> In light of the role that NRSROs have played in the development of structured finance, the Commission believed that this ABS rating requirement was appropriate and would not be burdensome.

The Commission proposed to further amend the rule to exclude from this rating requirement ABSs substantially all of the qualifying assets of which consist of municipal securities.<sup>51</sup> The Commission was persuaded by the assertions of industry participants that, as applied to these ABSs, the rating requirement was burdensome and unnecessary.<sup>52</sup> Commenters generally supported the amendment, which the Commission is adopting as proposed.<sup>53</sup>

#### b. Diversification Standards

##### i. Look-Through to Secondary ABSs

Rule 2a-7 treats the special purpose entity as the issuer of the ABS and requires the rule's issuer diversification standards to be met with respect to the special purpose entity. The rule contains an exception to this treatment, which requires a fund to "look-through" the special purpose entity to any issuer of qualifying assets whose obligations constitute ten percent or more of the principal amount of the qualifying assets of the special purpose entity ("ten percent obligor"). For diversification purposes, a fund must treat these ten percent obligors as if they issued a proportionate amount of the special purpose entity.<sup>54</sup> The "look-through" to ten percent obligors is designed to ensure that a fund does not invest indirectly more than five percent of its assets in a particular issuer.

Some or all of the qualifying assets of certain ABSs ("primary ABSs") also consist of other ABSs ("secondary ABSs"). The Commission proposed amendments to clarify that a ten percent obligor of a primary ABS that is also the issuer of secondary ABSs would be deemed to have issued a portion of the assets of the primary ABS that such secondary ABSs represent. For purposes of identifying ten percent obligors the proposed amendments provided that a fund should "continue down the chain" of ten percent obligors until a special purpose entity with no ten percent obligors is reached.<sup>55</sup>

<sup>49</sup> A synthetic security is created typically by placing a long-term fixed rate municipal bond into a trust that issues short-term variable or floating rate securities subject to a conditional demand feature. This process effectively converts long-term fixed rate bonds into short-term variable or floating rate demand instruments that meet the rule's maturity requirements. Synthetic securities were developed to address a shortage in the supply of short-term tax exempt securities eligible for money market fund investment. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] at nn.100-05 and accompanying text ("Release 19959") (discussing the development and characteristics of synthetic securities).

<sup>50</sup> The 1996 Amendments excluded unrated ABSs from the definition of an "eligible security."

<sup>51</sup> Proposing Release, *supra* note 6, at nn.41-43 and accompanying text.

<sup>52</sup> Industry participants noted that when ABSs consist of a large pool of financial assets, such as credit card receivables, they may not be susceptible to conventional means of credit risk analysis because credit quality is based on an actuarial analysis of a pool of financial assets, rather than a single issuer. The credit analysis for synthetic structures and municipal pools whose qualifying assets consist of one or a few municipal issuers, however, is typically no different than that required for a security directly issued by a municipality. Since many synthetic securities are not rated, applying the ABS rating requirement to them would have restricted the available supply of ABSs suitable for money market fund investment. ABSs involving large pools of financial assets, on the other hand, are typically rated.

<sup>53</sup> Paragraph (a)(10)(ii)(B) of Rule 2a-7, as amended. An ABS subject to a guarantee is not itself required to be rated. Under Rule 2a-7, as amended, an ABS subject to a guarantee that has received a short-term rating is considered a "rated security." Paragraph (a)(19) of Rule 2a-7, as amended. Moreover, an ABS subject to a guarantee may be determined to be an eligible security based solely on whether the guarantee is an eligible security. Paragraph (c)(3)(iii) of Rule 2a-7, as amended.

<sup>54</sup> Paragraph (c)(4)(ii)(D)(1)(i) of Rule 2a-7, as amended.

<sup>55</sup> Proposing Release, *supra* note 6, at nn.48-50 and accompanying text. The approach set forth in the Proposing Release was illustrated in materials prepared by the staff of the Division of Investment Management and made available at the 1996 ICI Conference on Money Market Fund Regulation. See Materials for 1996 ICI Conference on Money Market Fund Regulation: Asset Backed Securities and Synthetic Securities—Application of Paragraph (c)(4)(vi)(A)(4) of Rule 2a-7 (May 9, 1996).

Commenters supported this general approach, which the Commission is adopting, but raised several concerns that have led the Commission to further revise and clarify the rule.

One commenter observed that the benefits and materiality of the required “look-through” to secondary ABSs diminish rapidly. This commenter asserted that the risks posed by remote special purpose entities are likely to be outweighed by the costs incurred by funds to create compliance systems that identify, and treat as proportionate issuers, ten percent obligors beyond those comprising the qualifying assets of secondary ABSs. The Commission agrees and has amended the ABS “look-through” provision so that, instead of “continuing down the chain” indefinitely, funds are required to identify and treat as proportionate issuers of a primary ABS only ten percent obligors of the primary ABS and ten percent obligors of any secondary ABSs.<sup>56</sup>

Another commenter urged that a particular type of ABS issuer, a “restricted special purpose entity,” be excluded from treatment as a ten percent obligor under the rule, and thus not be counted for diversification purposes. A “restricted special purpose entity” is one that does not issue its ABSs to anyone other than another specific ABS issuer. For example, a company that provides financing for automobile purchasers may establish a restricted special purpose entity to securitize its automobile loans. The restricted special purpose entity will only sell ABSs to another special purpose entity that issues ABSs to money market funds or other investors. No diversification risk would appear to be posed to funds in this instance because funds cannot directly or indirectly invest in the restricted special purpose entity (i.e., a secondary ABS) other than through the purchase of ABSs from a particular primary ABS issuer.<sup>57</sup> The Commission has decided to further amend the rule to exclude restricted special purpose entities from treatment as ten percent obligors.<sup>58</sup>

#### ii. Demand Features and Guarantees Securing Obligations of Ten Percent Obligor

The Commission is adopting a proposed amendment to clarify that in the case of any ten percent obligors deemed to be issuers for purposes of the rule’s diversification standards, any demand features or guarantees supporting the obligations of the ten percent obligors are treated as being held by the fund and are subject to the rule’s demand feature and guarantee diversification standards.<sup>59</sup>

#### iii. Special Purpose Entity Gap

In the Proposing Release, the Commission explained that it was possible under the rule for a large portion of a fund to be exposed to a single ABS, as a result of a fund investing in a special purpose entity with one or more ten percent obligors.<sup>60</sup> The Commission noted that this could expose the fund to an undue amount of structural risk (e.g., the risk that the special purpose entity might be effected by the bankruptcy of its sponsor), and requested comment whether the rule should restrict fund investment in the obligations of a single special purpose entity.

<sup>56</sup> Paragraphs (c)(4)(ii)(D)(1)(i) and (ii) of Rule 2a-7, as amended. Under this provision, funds must “look through” to any ten percent obligor of a primary ABS, and to any ten percent obligor of a secondary ABS, and treat each such obligor as an issuer of a portion of the primary ABS. Funds need not, however, “look-through to the qualifying assets of any ten percent obligor of a “tertiary ABS” (i.e., a ten percent obligor of a secondary ABS that is itself a special purpose entity issuing ABSs) for purposes of compliance with the rule’s diversification standards. Although the rule does not specifically prohibit a multi-layered ABS designed to avoid the “look-through” to secondary ABSs, the Commission would collapse the multiple layers of such an ABS and view remote ten percent obligors as proportionate issuers for purposes of determining compliance with the rule’s issuer diversification standards. The Appendix to this Release illustrates the operation of the “look-through” to secondary ABSs under the amended rule.

<sup>57</sup> This commenter further noted that compliance costs of tracking ten percent obligors may cause funds to avoid any ABS whose issuer discloses the existence of ten percent obligors. Since a large number of ABSs may be structured such that all or a significant portion of ten percent obligors are restricted special purpose entities, allowing funds to disregard these ten percent obligors would further increase the supply of desirable ABSs for money market fund investment, avert the imposition of unnecessary constraints on the asset backed commercial paper market, and expose funds to little, if any, additional risks.

<sup>58</sup> Paragraph (c)(4)(ii)(D)(2) of Rule 2a-7, as amended. The amended rule provides that a restricted special purpose entity may issue its securities to other persons that control, are controlled by or are under common control with, the restricted special purpose entity if such persons are not ABS issuers.

<sup>59</sup> Paragraph (c)(4)(ii)(D)(3) of Rule 2a-7, as amended. If the fund is not relying on a demand feature or guarantee of a ten percent obligor for purposes of credit quality or maturity, or for liquidity, the fund may disregard the demand feature or guarantee for all purposes. See paragraph (c)(5) of Rule 2a-7, as amended.

<sup>60</sup> Proposing Release, *supra* note 6, at n.52 and accompanying text.

Although the three industry participants that responded to the request for comment urged adoption of such a cap, the Commission has decided not to amend the rule in this manner. The Commission is concerned that such a cap would add complexity to the rule without meaningfully limiting structural risks. While a cap would limit a fund's investment in a particular special purpose entity, it would not prevent a fund from investing large amounts of its assets in multiple identically-structured special purpose entities established by the same sponsor. A structural flaw in an ABS that exposes investors in one special purpose entity to the bankruptcy of the sponsor would likely effect all of the special purpose entities similarly structured. Therefore, the Commission is not persuaded that a cap would effectively contain a fund's exposure to structural risk, and in any event, Rule 2a-7 looks to the ratings of the NRSROs to provide an independent review of ABS structures.<sup>61</sup> Fund advisers, however, should consider the fund's exposure to structural risk when evaluating whether an investment in a particular ABS is consistent with the fund's objective of maintaining a stable net asset value.

#### iv. Sponsor-Provided Demand Features and Guarantees

Rule 2a-7 provides that a fund may not invest, with respect to seventy-five percent of its total assets, more than ten percent of its total assets in securities issued by or subject to puts from the same institution (or under the amended rule's terminology, "guarantee" or "demand feature").<sup>62</sup> A fund is not subject to the ten percent limitation with respect to the remaining twenty-five percent of its total assets ("twenty-five percent basket") if the securities held in the basket are first tier securities and the puts are issued by non-controlled persons.<sup>63</sup> As a result, a fund holding an ABS subject to a put from its sponsor is not able to include this investment in its twenty-five percent basket if the sponsor is in a control relationship with the special purpose entity.<sup>64</sup>

The twenty-five percent basket is restricted to securities subject to puts from non-controlled persons in order to minimize a fund's exposure to the credit risk of a single economic enterprise and limit the aggregate exposure to the risks of related, active businesses.<sup>65</sup> Permitting a fund to invest more than ten percent of its total assets in an ABS subject to a demand feature or guarantee issued by a sponsor, however, would not have this effect, because the special purpose entity, unlike an active enterprise, is a limited purpose vehicle created solely for the purpose of issuing fixed income securities based on the cash flow of the qualifying assets. Therefore, the Commission proposed to amend Rule 2a-7 to allow funds to treat a demand feature or guarantee from an ABS sponsor as a demand feature or guarantee from a non-controlled person. Commenters supported the proposed amendment, which the Commission is adopting as proposed.<sup>66</sup>

#### v. First Loss Guarantees

Some ABSs are supported by a guarantee that covers all losses up to an amount of expected losses likely to be experienced by the ABS. Because a fund's exposure to such a "first loss guarantee" is similar to its exposure to a guarantee of the entire security,<sup>67</sup> the 1996 Amendments required a fund to treat a first loss guarantor as a guarantor of the entire ABS.

<sup>61</sup> NRSROs, prior to assigning a rating, not only analyze the quality of the assets underlying an ABS, but also conduct an independent analysis of the structural integrity of the ABS. *See* Release 19959, *supra* note 49, at nn.108-12 and accompanying text.

<sup>62</sup> Paragraph (c)(4)(iii) of Rule 2a-7, as amended.

<sup>63</sup> *Id.* The amended rule refers to such instruments as guarantees or demand features from "non-controlled persons." *See* paragraphs (a)(9) and (a)(16) of Rule 2a-7, as amended. The Appendix to this Release illustrates of the operation of the twenty-five percent basket under the amended rule when securities are subject to guarantees or demand features from multiple providers.

<sup>64</sup> This may occur, for example, if an ABS sponsor owns a residual equity interest in the special purpose entity. In this case, the ABS sponsor might "control" the special purpose entity within the meaning of Section 2(a)(9) of the 1940 Act [*15 USC 80a-2(a)(9)*]. *See* Proposing Release, *supra* note 6, at n.54 and accompanying text. An ABS sponsor may not, however, be deemed to "control" the special purpose entity under other federal securities laws or for other purposes.

<sup>65</sup> Release 21837, *supra* note 2, at n.73 and accompanying text

<sup>66</sup> Paragraphs (a)(9) ("demand feature issued by a non-controlled person") and (a)(16) ("guarantee issued by a non-controlled person") of Rule 2a-7, as amended. Although a guarantee provided by a person in a control relationship with the issuer of the underlying security is excluded from the Rating Requirement for guarantees, the exclusion does not apply to a sponsor-provided guarantee of an ABS under the amended rule. Thus, sponsor-provided guarantees of ABSs must be rated. Paragraph (a)(10)(iii)(A) of Rule 2a-7, as amended; *see also supra* Section I.B.1.c. of this Release.

<sup>67</sup> The failure of a first loss guarantor covering the first ten percent of all losses likely to be incurred by an ABS is likely to have a more significant effect on the value of the ABS than the failure of a fractional guarantor supporting only a portion of any losses incurred.



Commenters urged that first loss guarantees be treated similar to other fractional guarantees under the rule and raised numerous questions about the application of the provision to certain ABS structures.

The Commission continues to believe that investment in an ABS subject to a first loss guarantee can potentially result in a fund being overexposed to the credit risk of the first loss guarantor. The number and nature of questions raised by the 1996 Amendments, however, have convinced the Commission that these risks are better managed by the fund's investment adviser. The Commission, therefore, is revising the rule to permit funds to treat a first loss guarantee as any other fractional guarantee when calculating compliance with the rule's guarantee and demand feature diversification standards.<sup>68</sup> Advisers should, however, carefully consider potential exposure to the credit risks of a first loss guarantor when evaluating whether investment in an ABS is consistent with the fund's objective of maintaining a stable net asset value.

#### c. Periodic Determinations Regarding Ten Percent Obligor

The 1996 Amendments required a fund to adopt written procedures requiring periodic determinations of the number of ten percent obligors deemed to be issuers of all or a portion of an ABS. The Commission is amending this requirement so that periodic determinations are not required with respect to any ABS that a fund's board of directors initially has determined will never have, or is unlikely to have, any ten percent obligors.<sup>69</sup> This determination may be based upon a structural analysis of the ABS or upon representations in the offering materials or governing documents of an ABS that it will never have ten percent obligors. Funds also must maintain a record of this determination.<sup>70</sup>

#### d. Swap Arrangements

The Proposing Release noted that certain ABSs may consist of qualifying assets whose cash flow has been "swapped" to a financial institution (the "swap counterparty") that ultimately acts as the primary source of payment to funds holding the ABSs (i.e., a "total return swap"). The Commission requested comment whether the swap counterparty in this instance should be treated as the issuer of the ABSs for diversification purposes and on the appropriate treatment of swaps and similar arrangements under the rule.

Commenters suggested various approaches to the treatment of swaps under the rule.<sup>71</sup> All acknowledged, however, the difficulty of addressing swaps and similar arrangements by rule due to the constantly evolving nature of swap transactions and the wide variations in the types of swaps used to structure ABSs offerings. The Commission has determined not to amend the rule at this time to specifically address the treatment of swaps or similar arrangements. Swaps and similar arrangements that fall within the rule's definition of a guarantee or demand feature, however, should be treated as such for purposes of guarantee and demand feature diversification.<sup>72</sup> A fund's adviser, however, should seek to ensure that investments by the fund in securities subject to swap arrangements are consistent with Rule 2a-7's overriding policy of

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<sup>68</sup> Paragraph (c)(4)(iv)(A) of Rule 2a-7, as amended. ABSs also may be subject to "second loss guarantees" that guarantee a specific amount of losses in excess of losses covered by a first loss guarantee. Funds should treat second loss guarantees of ABSs in the same manner as any other fractional guarantees or demand features under the amended rule. Sponsors of ABSs may provide additional credit risk protection by structuring an offering such that the value of qualifying assets in the pool exceeds the amount of the ABS offering. For example, a \$1 billion dollar ABSs offering might be collateralized by an asset pool of \$1.1 billion. The \$100 million of "overcollateralization" may be applied to cover any first losses incurred before drawing upon third party guarantees or other credit enhancements. Although overcollateralization would be relevant in determining whether the ABS presents minimal credit risks, this type of seller-provided credit enhancement does not fall within the rule's definition of a guarantee or demand feature and may be disregarded for purposes of the rule's diversification standards. *See* paragraphs (a)(8) (definition of "demand feature") and (a)(15) (definition of "guarantee") of Rule 2a-7, as amended.

<sup>69</sup> Paragraph (c)(9)(iv) of Rule 2a-7, as amended. The board of directors may delegate this determination, and most other determinations required by the rule, to the fund's adviser or to the officers of the fund. The board, however, may not delegate certain specific determinations required under Rule 2a-7. *See* paragraph (e) of Rule 2a-7, as amended.

<sup>70</sup> Paragraph (c)(10)(v) of Rule 2a-7, as amended.

<sup>71</sup> Six commenters addressed this issue and generally suggested that a swap counterparty acting as the primary source of payment to a fund be treated as an issuer and subject to the issuer diversification standards. Most of these commenters suggested that counterparties in swaps that support or guarantee the obligations of an ABS issuer or other party to pay (but are not the sole source of payment on the ABS) be treated as guarantees subject to the guarantee and demand feature diversification standards.

<sup>72</sup> *See* paragraphs (a)(8), (a)(15), (c)(4)(iii) and (c)(4)(iv) of Rule 2a-7, as amended.

limiting funds to investments that are consistent with maintaining a stable net asset value and do not expose the fund excessively to credit risks posed by swap counterparties.

#### 4. Other Amendments to Rule 2a-7

##### a. Investments in Other Money Market Funds

The 1996 Amendments permitted a fund (“acquired fund”) to treat an investment in another money market fund (“acquired fund”) as a first tier security, but limited investment in any single money market fund to no more than five percent of fund assets. The 1996 Amendments created an exception, however, for a fund investing substantially all of its assets in shares of another money market fund in reliance on Section 12(d)(1)(E) of the 1940 Act (e.g., a master-feeder arrangement).<sup>73</sup> The 1996 Amendments deemed this type of a fund to be in compliance with Rule 2a-7’s diversification standards if the acquiring fund’s board of directors reasonably believed that the acquired fund is in compliance with Rule 2a-7.

Several commenters pointed out that, as a result of Commission exemptive orders<sup>74</sup> and amendments to the 1940 Act’s limitations on “funds of funds” arrangements<sup>75</sup> some money market funds may now invest more than five percent but less than substantially all of their assets in shares of another money market fund. The Commission is amending the rule to expand the exception to cover all investments by a fund in the shares of another money market fund in excess of the otherwise applicable issuer diversification standards.<sup>76</sup>

Under the amended rule, shares of money market funds are considered to be first tier securities,<sup>77</sup> and are thus subject to the rule’s issuer diversification standards with respect to first tier securities.<sup>78</sup> A fund may, however, within the limitations of Section 12(d)(1) of the 1940 Act, invest in shares of another money market fund in excess of the rule’s issuer diversification standards, but only if the acquiring fund’s board of directors reasonably believes that the acquired fund is in compliance with Rule 2a-7.<sup>79</sup>

##### b. Definition of Eligible Security—Certain Unrated Securities

Under the 1996 Amendments, an unrated security that was a long-term security when issued, but had a remaining maturity of less than 397 calendar days when purchased by the fund, was an eligible security based on whether the security is comparable in quality to a rated security (i.e., one with a short-term rating), unless the unrated security had received a long-term rating from any NRSRO that was not within the three highest categories of long-term ratings.

<sup>73</sup> 15 USC 80a-12(d)(1)(E).

<sup>74</sup> See, e.g., Daily Money Fund, et al., Investment Company Act Release Nos. 22285 (Oct. 16, 1996) (Order) and 22236 (Sept. 20, 1996) (Notice).

<sup>75</sup> In 1996, the 1940 Act’s restrictions on fund investments in other funds were relaxed by, among other things, adding new Section 12(d)(1)(G) [15 USC 80a-12(d)(1)(G)] that excepts “affiliated” funds of funds from the restrictions of Section 12(d)(1)(A) under certain conditions. See The National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

<sup>76</sup> Paragraph (c)(4)(ii)(E) of Rule 2a-7, as amended.

<sup>77</sup> Paragraph (a)(12) of Rule 2a-7, as amended.

<sup>78</sup> See paragraph (c)(4)(i) of Rule 2a-7, as amended.

<sup>79</sup> Paragraph (c)(4)(ii)(E) of Rule 2a-7, as amended. A taxable or national fund could take advantage of the three day safe harbor of paragraph (c)(4)(i)(A) and a single state fund could use its “twenty-five percent basket” under paragraph (c)(4)(i)(B) to invest up to twenty-five percent of fund assets in the securities of a single money market fund without the board making a “reasonable belief” finding, even though, in both cases, the investment would be in excess of five percent of fund assets. Under the rule, an acquiring fund that holds securities of a particular issuer (“Issuer A”), and invests in shares of an acquired fund that also holds securities of Issuer A, would not aggregate those positions to determine its compliance with the rule’s diversification standards with respect to Issuer A.

The Commission is adopting a proposed amendment to the rule permitting a fund to treat such a security as an eligible security if that security has a long-term rating from the “requisite NRSROs”<sup>80</sup> within the three highest rating categories.<sup>81</sup>

c. Additional Amendments

The Commission proposed additional amendments designed to further clarify and make technical corrections to the rule. Commenters supported the amendments, and the Commission is adopting them as follows:

(i) Acquisition of Portfolio Securities. The Commission is adding the new defined term “acquisition” to make the rule more uniform in its application to fund investments and to clarify that the failure of a fund to exercise a demand feature does not have similar consequences under the rule as a decision to “roll over” commercial paper.<sup>82</sup>

(ii) Single State Funds. The Commission is amending the definition of a “single state fund” to include a fund seeking to “maximize” the amount of income exempt from income taxes of a particular state.<sup>83</sup>

(iii) Standby Commitments. As proposed, the Commission has deleted the term “standby commitment” and all references to that term from the rule.<sup>84</sup>

(iv) Downgrades, Defaults, and Other Events. The Commission is amending the rule to require a fund’s board of directors to reassess whether an unrated or second tier security continues to present minimal credit risks only when the fund’s adviser (or other person delegated portfolio management responsibilities) becomes aware that the security has been downgraded by any NRSRO below that NRSRO’s two highest short-term rating categories.<sup>85</sup>

(v) Recordkeeping Requirements. The Commission is adding rule text inadvertently omitted from the 1996 Amendments that requires the board of directors to document minimal credit risk determinations of portfolio securities.<sup>86</sup>

(vi) Holding Out. Using new rule making authority, the Commission is restating the rule’s prohibition on a fund’s use of names suggesting that it is a money market fund, unless it complies with Rule 2a-7.<sup>87</sup>

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<sup>80</sup> Paragraph (a)(21) of Rule 2a-7, as amended (definition of “requisite NRSROs”).

<sup>81</sup> Paragraph (a)(10)(ii)(A) of Rule 2a-7, as amended. For example, an unrated “stub” security may have long-term ratings from three NRSROs. One of these NRSROs may give the security a long-term rating in the NRSRO’s fourth highest category, which would have precluded the fund from purchasing the security before the adoption of these amendments. Under the revised rule, however, the fund may look to the other ratings and treat the security as an eligible security if the two other NRSROs have given the security long-term ratings within one of their three highest long-term rating categories. If any NRSRO has given the security (or the issuer of the security with respect to a class of debt obligations that is comparable in priority and security) a short-term rating however, the short-term rating would override the long-term ratings and reference to long-term ratings would be unnecessary to determine whether the security was an eligible security. Long-term ratings may be relevant, however, to an evaluation of whether the issuer presents minimal credit risks under paragraph (c)(3)(i) of Rule 2a-7, as amended.

<sup>82</sup> Paragraph (a)(1) of Rule 2a-7, as amended.

<sup>83</sup> Paragraph (a)(23) of Rule 2a-7, as amended. The effect of the amendment would be to permit this type of a fund to take advantage of the twenty-five percent basket in determining compliance with the rule’s diversification standards, even if it did not primarily distribute income exempt from state income taxes. See paragraph (a)(4)(i)(B) of Rule 2a-7, as amended; see also Proposing Release, *supra* note 6, at nn.66-68 and accompanying text.

<sup>84</sup> See Proposing Release, *supra* note 6, at nn.69-71 and accompanying text. Under the amended rule, a standby commitment that meets the definition of a demand feature must be treated as such. See paragraph (a)(8) of Rule 2a-7, as amended (definition of “demand feature”). A standby commitment that is not a demand feature is not subject to the rule’s credit quality or diversification standards.

<sup>85</sup> Paragraph (c)(6)(i)(A)(2) of Rule 2a-7, as amended; see Proposing Release, *supra* note 6, at n.72 and accompanying text.

<sup>86</sup> Paragraph (c)(10)(iii) of Rule 2a-7, as amended; see Proposing Release, *supra* note 6, at nn.74-75 and accompanying text.

<sup>87</sup> Paragraph (b) of Rule 2a-7, as amended. The National Securities Markets Improvement Act of 1996 [Pub. L. No. 104-290, 110 Stat. 3416 (1996)] amended Section 35(d) of the 1940 Act [15 USC 80a-34(d)] to make it unlawful to adopt as a fund name or title, or as a title of fund securities, words that the Commission finds are materially deceptive or misleading, and to authorize the Commission to define names and titles deemed to be “materially deceptive and misleading.”

## II. Amendments to the Advertising Rules Applicable to Money Market Funds

The Commission is adopting amendments to the Commission's money market fund advertising rules and forms to clarify the formula used by money market funds to calculate yield and to reduce the potential for investors being misled or confused by the presentation of a money market fund's short-term-total return.

### A. Calculation of Yield

The Commission proposed to amend its money market fund yield formula to clarify that only investment income may be included in the yield of a money market fund. Three commenters supported the amendment; one opposed it and urged the Commission to specifically permit inclusion of non-investment income. The Commission is concerned that inclusion of non-investment income will distort yield and diminish the utility of money market fund yield to investors. The Commission, therefore, has decided to adopt the proposed amendment to the money market fund yield formula.<sup>88</sup>

### B. Use of Total Return

The Proposing Release noted that some money market fund advertisements have used short-term total return instead of yield and expressed concern that many investors may not understand the difference.<sup>89</sup> The Commission proposed to amend its rules to require that total return quotations in advertisements and sales literature cover a period of at least one year, and that such quotations be accompanied by a quotation of current yield, computed in accordance with Commission rules and set forth with equal prominence.

All commenters that addressed this proposal objected to the proposed requirement that total return quotations cover at least one year. They argued that the proposal would preclude total return quotations during a fund's first year and in other circumstances in which the purpose of the advertisement was other than to circumvent the Commission's yield formula. The Commission has decided not to require all money market fund total return quotations to cover a period of one year. Instead, the Commission is revising its rules to require that (i) quotations of total return be accompanied by quotations of current yield and that both quotations be placed next to each other and shown in the same size print,<sup>90</sup> and (ii) if there is a material difference between the quoted total return and the quoted yield, a statement that the yield quotation more closely reflects the current earnings of the fund than the total return quotation.<sup>91</sup>

## III. Effective Date/Compliance Date

### A. Effective Date

The rule amendments adopted in this Release will become effective February 10, 1998. The Office of Management and Budget has determined that the technical amendments to Rule 2a-7 are "major rules" and the amendments to the Commission's money market fund advertising rules and forms are "minor rules" under Chapter 8 of the Administrative Procedure Act,<sup>92</sup> which was added by the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA").<sup>93</sup> SBREFA requires all final agency rules to be submitted to Congress for review and requires generally that the effective

<sup>88</sup> See Item 22 of Form N-1A [17 CFR 239.15A and 274.11A], Item 25 of Form N-3 [17 CFR 239.17a and 274.11b], and Item 21 of Form N-4 [17 CFR 239.17b and 274.11c], as amended.

<sup>89</sup> Proposing Release, *supra* note 6, at n.81 and accompanying text. As a result, investors may assume incorrectly that a fund quoting the higher total return figure is a better performing fund than other money market funds quoting yield. For example, during a period of declining interest rates, the fund's total return will be higher than its current yield because it will include periods of time during which the fund held higher yielding securities. In addition, investors may incorrectly assume that the higher "total return" is the yield they can expect to receive upon an investment in the fund.

<sup>90</sup> Quotations of total return and current yield in an advertisement delivered electronically must be presented together and in a manner that presents each quotation with identical prominence in light of the particular electronic medium used to transmit the advertisement.

<sup>91</sup> See paragraph (d)(2) of Rule 482 under the 1933 Act, as amended [17 CFR 230.482(d)(2)]; paragraph (b)(1)(ii)(C) of Rule 34b-1 under the 1940 Act, as amended [17 CFR 270.34b-1(b)(1)(ii)(C)].

<sup>92</sup> 5 USC 801.

<sup>93</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996). Under SBREFA, a rule is "major" if it is likely to result in (i) an annual effect on the economy of \$100 million or more, (ii) a major increase in costs or prices for consumers or individual industries, or (iii) significant adverse effects on competition, investment, or innovation. 5 USC 804(2).

date of a major rule be delayed for sixty days pending Congressional review. A major rule may become effective at the end of the sixty-day review period, unless Congress passes a joint resolution disapproving the rule.<sup>94</sup>

## B. Compliance Dates

The Proposing Release requested comment whether the Commission should provide for a six-month transition period for compliance.<sup>95</sup> Commenters supported a six-month period to give fund boards of directors sufficient time to review and approve fund procedures. Several commenters also suggested that the “grandfathering” of certain securities provided for by the release adopting the 1996 Amendments be extended,<sup>96</sup> whereas one commenter opposed such extension. The Commission has decided to delay the date for compliance with the amended rule for six months and to extend the “grandfathering” of fund investments in certain securities, as described below.

### 1. General Compliance Date

All money market funds must be in compliance with Rule 2a-7, as amended, (and with conforming amendments reflecting the revisions to Rule 2a-7 by July 1, 1998, except with respect to “grandfathered securities” as provided below.<sup>97</sup> Funds must comply with the amendments to the advertising rules and forms applicable to money market funds by February 10, 1998.

### 2. “Grandfathered” Securities

To minimize disruption to funds and markets as a result of the adoption of these amendments, the Commission is “grandfathering” certain securities first issued on or before February 10, 1998 that do not meet the following requirements of the amended rule:

- (i) The Rating Requirement for guarantees;<sup>98</sup>
- (ii) The Notification Requirement, which provides that, in order for a security subject to a guarantee or demand feature to be an eligible security, the fund must receive notice from the demand feature or guarantee provider (or another institution) if there is a substitution of the provider of the demand feature or guarantee;<sup>99</sup>
- (iii) The requirements for ABSs regarding maturity determinations and ratings;<sup>100</sup>
- (iv) The requirement that a demand feature and a guarantee include the ability to recover principal and any accrued interest;<sup>101</sup> and
- (v) The requirement that a security subject to a conditional demand feature is an eligible security only if the fund’s board of directors makes certain determinations regarding the conditional demand feature’s exercisability.<sup>102</sup>

<sup>94</sup> 5 USC 801(a)(3).

<sup>95</sup> See Proposing Release, *supra* note 6, at nn.84-85 and accompanying text.

<sup>96</sup> The 1996 Amendments “grandfathered” fund investments in certain securities issued on or before June 3, 1996.

<sup>97</sup> Rule 2a-7 requires a fund to meet the rule’s diversification standards with respect to a particular issuer on the date the fund acquires a security of that issuer. Paragraphs (c)(4)(i) and (ii) (with respect to issuer diversification) and (c)(4)(ii) and (iv) (with respect to diversification of demand features and guarantees) of Rule 2a-7, as amended. A tax exempt fund holding a greater percentage of its total assets in the securities of an issuer than the applicable diversification standard permits as of July 1, 1998 may not purchase additional securities or “roll over” current holdings until the purchase or roll over of such securities will not cause the fund to exceed the applicable diversification standards immediately after the purchase or roll over. Funds are not required to exercise puts or otherwise dispose of portfolio holdings to meet the new diversification standards.

<sup>98</sup> Paragraph (a)(10)(iii)(A) of Rule 2a-7, as amended.

<sup>99</sup> Paragraph (a)(10)(iii)(B) of Rule 2a-7, as amended.

<sup>100</sup> Paragraphs (a)(8)(ii) (definition of demand feature for ABSs) and (a)(10)(ii)(B) (rating requirement for ABSs) of Rule 2a-7, as amended. Funds are required, however, to apply the issuer diversification standards for ABSs in accordance with Section I.B.3.b. of this Release, *supra*. See paragraph (c)(4)(ii)(D) of Rule 2a-7, as amended.

<sup>101</sup> Paragraphs (a)(8) and (a)(15) of Rule 2a-7, as amended.

<sup>102</sup> Paragraph (c)(3)(iv)(B) of Rule 2a-7, as amended.

A fund may continue to hold these “grandfathered” securities or acquire these securities provided that they satisfy the other provisions of the rule, as amended, and are issued on or before February 10, 1998.

## IV. Cost/Benefit Analysis and Effects on Competition, Efficiency and Capital Formation

### A. Technical Amendments to Rule 2a-7

The technical amendments to Rule 2a-7 make refinements and corrections to the 1996 Amendments. They are intended to permit money market funds the maximum amount of flexibility in selecting their investments consistent with the objective of maintaining a stable net asset value. This additional flexibility will promote market efficiency by allowing funds to invest in a wider variety of instruments that present risks consistent with that objective. For example, the technical amendments expand the investment opportunities of funds, without increasing risks, by allowing funds to substitute the credit quality of guarantee providers for the issuers of securities subject to guarantees (instead of only those subject to unconditional demand features) for purposes of compliance with the rule’s credit quality standards. By resolving interpretive issues, the technical amendments also address competitive inequities that might arise among funds if, for example, funds draw different conclusions as to the permissibility of a particular investment that may increase fund yield.

As discussed above,<sup>103</sup> the 1996 Amendments tighten the risk-limiting conditions of Rule 2a-7 applicable to tax exempt money market funds and clarify the rule’s treatment of certain instruments, such as ABSs. The technical amendments potentially will benefit investors to the extent that Rule 2a-7, as finally amended, operates to decrease the likelihood that a fund will not maintain a stable net asset value and provides investors greater opportunities to obtain higher yields without exposure to risks inconsistent with their investment expectations.

The costs of the technical amendments to funds and fund advisers (and ultimately fund shareholders) are likely to be minimal, since the amendments do not impose additional procedural requirements or reporting burdens on funds. The Commission believes that the direct or indirect benefits derived from the technical amendments cannot be quantified because it is impossible to predict with certainty how funds will structure their portfolio holdings in response to these amendments.<sup>104</sup> In addition, any costs or benefits are likely to affect not only funds, but also a wide variety of market participants.<sup>105</sup>

In the Proposing Release, the Commission requests specific comment on the costs and benefits associated with the proposals. No commenters provided specific estimates of any costs or benefits. One noted generally the increase in time and costs incurred to document compliance with Rule 2a-7 since 1991, and suggested that procedural requirements focus less on periodic reviews of existing information and more on actions required by a board or fund managers in response to new information.<sup>106</sup> In response to these concerns, the technical amendments create exceptions to the rule’s periodic review requirements when those requirements are not necessary to prevent the fund from inadvertently holding ineligible securities.<sup>107</sup>

<sup>103</sup> See *supra* Section I.A. of this Release.

<sup>104</sup> For example, many money market funds currently do not invest in ABSs, or invest only in those ABSs that do not raise the diversification issues addressed in this Release. The Commission expects that more funds will invest in ABSs, although there is no empirical basis for predicting the size of that expected effect.

<sup>105</sup> Many of the complex money market fund instruments affected by the technical amendments are specifically designed to comply with Rule 2a-7. The primary effect of the amendments will be to change how those instruments are structured, rather than to prohibit funds from investing in currently-available money market instruments. Thus, to the extent the amendments impose costs or provide benefits, these costs and benefits may be shared by funds, investors, issuers, and the investment banks or other entities that structure money market instruments.

<sup>106</sup> The technical amendments do not require additional periodic reviews. The rule’s procedural requirements, including periodic reviews of certain determinations, were adopted before the proposal of the technical amendments. The costs and benefits of these procedures were analyzed previously in connection with the adoption of Rule 2a-7 in 1983, and in connection with amendments to Rule 2a-7 in 1986, 1991 and 1996.

<sup>107</sup> For example, the amended rule does not require periodic determinations of the number of ten percent obligors of an ABS that the board determines will never have, or is unlikely to have, ten percent obligors. See paragraphs (c)(9)(iv) and (c)(9)(v) of Rule 2a-7, as amended.

Section 2(c) of the 1940 Act provides that whenever the Commission is engaged in rulemaking and is required to consider whether an action is necessary or appropriate in the public interest, the Commission also must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>108</sup> For the reasons stated in the cost/benefit analysis above, the Commission has concluded that the technical amendments will promote efficiency, competition and capital formation.

### **B. Amendments to Advertising Rules Applicable to Money Market Funds**

The amendments to the Commission's advertising rules and forms applicable to money market funds are designed to clarify the formula used by money market funds to calculate yield and reduce the potential for investors being misled or confused by the presentation of a money market fund's short-term total return. They benefit funds and fund investors by clarifying the yield formula and codifying accepted practices under the current rules. The amendments are intended to preserve the consistency of advertised yield and to maintain the ability of investors to compare yields quoted by various funds.

The Commission anticipates that the costs of these amendments to funds and investors are likely to be minimal. No commenters responded to the Commission's request for specific estimates of costs or benefits associated with the proposed rule amendments. One commenter stated that the proposal to clarify that only investment income may be included in a fund's yield would benefit neither funds nor investors, because it would discourage funds from identifying sources of safe, non-investment income, encourage funds to increase yield through riskier investments, and deprive investors of information regarding consistent sources of non-investment income.<sup>109</sup> The Commission believes, however, that the rule will benefit investors by ensuring that a money market fund's yield is consistently advertised and represents only income that reflects the performance of the fund's investment portfolio.<sup>110</sup>

### **V. Paperwork Reduction Act**

As set forth in the Proposing Release, certain provisions of the amendments adopted in this Release contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>111</sup> The collection of information requirements contained in these amendments were submitted to the Office of Management and Budget ("OMB") for review in accordance with Section 3507(d) of the PRA. The title for the collection of information is "Rules Regulating Money Market Funds." The collection of information requirements are in accordance with Section 3507 of the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the agency displays a valid OMB control number. OMB approved the PRA submission with respect to these amendments and assigned OMB control numbers with respect to the rules amended by this Release.<sup>112</sup>

Responses to the collection of information requirements for the rules and forms amended by this Release are mandatory. The collection of information requirements under Rule 2a-7 are designed to enable the Commission staff to ascertain a money market funds' compliance with the rule and ensure that funds have in place procedures for collecting information necessary to make the required determinations regarding portfolio securities. Most responses required by Rule 2a-7 and requested by or submitted to the Commission will be kept confidential to the extent permitted by relevant statutory and

<sup>108</sup> 15 USC 80a-2(c).

<sup>109</sup> According to this commenter, the inability to advertise non-investment income also would have an adverse effect on competition in the industry.

<sup>110</sup> The Commission believes that it is not relevant to consider the costs to funds identified by the commenter in connection with these amendments. The amendments are intended to clarify the existing money market fund yield formula, and as noted in the Proposing Release, the existing yield formula does not permit the inclusion of non-investment income in yield. *See* Proposing Release, *supra* note 6, at n.83 and accompanying text. In addition, the Commission believes that any such costs are in fact quite limited, since it is aware of only one fund that has sought to include non-investment income in its calculation of yield.

<sup>111</sup> 44 USC 3501 - 3520.

<sup>112</sup> OMB control numbers are as follows: Rule 2a-7 (3235-0268, expires, Mar. 31, 2000); Rule 34b-1 (3235-0346, expires Mar. 31, 2000); Rule 482 (3235-0074, expires Mar, 31, 2000); Form N-1A (3235-0307, expires May 31, 2000); Form N-3 (3235-0316, expires Mar. 31, 2000); and Form N-4 (3235-0318, expires Apr. 30, 2000).

regulatory provisions.<sup>113</sup> The collection of information required by Rule 34b-1, Rule 482, Form N-1A, Form N-3 and Form N-4, and which is disclosed in fund prospectuses, registration statements and advertisements, is public and is not kept confidential by the Commission.

The Supporting Statement to this Paperwork Reduction Act submission notes that, because the technical amendments to Rule 2a-7 clarify existing reporting and recordkeeping obligations, it is estimated that they will have no effect on the annual reporting burden of money market funds. The amendments to the advertising rules and forms applicable to money market funds are estimated to impose no substantive additional paperwork burdens on funds. The Commission is aware of only one money market fund that has sought to include income other than investment income in its yield calculation and very few money market funds that quote any type of total return in their advertisements. If total return is quoted, however, an insignificant additional burden is required only if the quoted yield differs materially from quoted total return, which the Commission believes occurs infrequently.

## VI. Summary of Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis (“IRFA”) regarding the proposed amendments, which was prepared in accordance with 5 USC 603, was published in the Proposing Release. No comments were received on the IRFA. The Commission has prepared a Final Regulatory Flexibility Analysis (“FRFA”) in accordance with 5 USC 604 regarding the adoption of technical amendments to Rule 2a-7 and the adoption of amendments to the Commission’s advertising rules applicable to money market funds.

The FRFA discusses the need for, and objectives of, the rule amendments. The FRFA explains that the technical amendments to Rule 2a-7 address many of the questions and issues raised by industry participants after the adoption of the 1996 Amendments. The objective of the technical amendments is to refine and correct the 1996 Amendments, and thereby permit money market funds the maximum amount of flexibility in selecting their investments consistent with the objective of maintaining a stable net asset value. The FRFA explains that the amendments to the advertising rules applicable to money market funds clarify that only investment income may be included in the yield of a money market fund and reduce the potential for investors being misled or confused by the presentation of a money market fund’s short-term total return.

The FRFA estimates that out of the approximately 650 investment companies registered with the Commission that have one or more portfolios that are money market funds, a total of 130 would be considered small entities. The FRFA indicates that the technical amendments to Rule 2a-7 and the amendments to the advertising rules and forms applicable to money market funds would effect small entities in the same manner as other funds subject to these rules.

The FRFA explains that neither the technical amendments to Rule 2a-7 nor the amendments to the advertising rules applicable to money market funds impose any substantive additional reporting, recordkeeping or other compliance burdens. Finally, the FRFA states that in adopting the amendments the Commission considered (a) the establishment of differing compliance requirements that take into account the resources available to small entities; (b) simplification of the requirements for small entities; (c) the use of performance rather than design standards; and (d) an exemption from the rules for small entities. The FRFA states that the Commission concluded that different requirements for small entities with respect to either the technical amendments to Rule 2a-7 or the amendments to the advertising rules applicable to money market funds are unnecessary and would be inconsistent with investor protection, and that the adopted amendments are not design standards.

Cost/benefit information reflected in the “Cost/Benefit Analysis” section of this Release also is reflected in the FRFA. A copy of the FRFA may be obtained by contacting David P. Mathews, Senior Counsel, Mail Stop 10-2, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

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<sup>113</sup> If the board of directors takes action with respect to defaulted securities, events of insolvency or deviations in share price, however, funds must file an exhibit to Form N-SAR describing the action. This collection of information under Rule 2a-7 is public and is not kept confidential by the Commission. See paragraph (c)(10)(vii) of Rule 2a-7, as amended.



## VII. Statutory Authority

The Commission is amending Rule 2a-7 and the advertising rules and forms applicable to money market funds under the exemptive and rulemaking authority set forth in Sections 6(c) [15 USC 80a-6(c)], 8(b) [15 USC 80a-8(b)], 22(c) [15 USC 80a-22(c)], 34(b) [15 USC 80a-33(b)], 35(d) [15 USC 80a-34(d)] and 38(a) [15 USC 80a-37(a)] of the Investment Company Act of 1940. The authority citations for the amendments to the rules and forms precede the text of the amendments.

## VII. Text of Rule and Form Amendments

List of Subjects in 17 CFR Parts 230, 239, 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Commission is amending chapter II, title 17 of the Code of Federal Regulations as follows:

### Part 230—General Rules and Regulations, Securities Act of 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77b, 77j, 77s, 77sss, 78c, 78d, 78l, 78m, 78n, 78o, 78w, 79ll(d), 79t, 80a-8, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

\* \* \* \*

2. Section 230.482 is amended by revising paragraph (d) to read as follows:

§ 230.482 Advertising by an investment company as satisfying requirements of section 10.

\* \* \* \*

(d) In the case of a money market fund:

(1) Any quotation of the money market fund's yield in an advertisement shall be based on the methods of computation prescribed in Form N-1A §§ 239.15A and 274.11A of this chapter), Form N-3 (§§ 239.17a and 274.11b of this chapter), or Form N-4 (§§ 239.17b and 274.11c of this chapter) and may include:

(i) A quotation of current yield that identifies the length of and the date of the last day in the base period used in computing that quotation; or

(ii) A quotation of effective yield if it appears in the same advertisement as a quotation of current yield and each quotation relates to an identical base period and is presented with equal prominence.

(2) Accompany any quotation of the money market fund's total return in an advertisement with a quotation of the money market fund's current yield under paragraph (d)(1)(i) of this section. Place the quotations of total return and current yield next to each other, in the same size print, and if there is a material difference between the quoted total return and the quoted current yield, include a statement that the yield quotation more closely reflects the current earnings of the money market fund than the total return quotation.

### Part 270—Rules and Regulations, Investment Company Act of 1940

3. The general authority citation for Part 270 is revised to read as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(b), 80a-37, 80a-39 unless otherwise noted;

\* \* \* \*

4. Section 270.2a-7 is revised to read as follows:

## § 270.2a-7 Money market funds.

## (a) Definitions.

(1) Acquisition (or Acquire) means any purchase or subsequent rollover (but does not include the failure to exercise a Demand Feature).

(2) Amortized Cost Method of valuation means the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(3) Asset Backed Security means a fixed income security (other than a Government security) issued by a Special Purpose Entity (as defined in this paragraph), substantially all of the assets of which consist of Qualifying Assets (as defined in this paragraph). Special Purpose Entity means a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from Qualifying Assets, but does not include a registered investment company. Qualifying Assets means financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(4) Business Day means any day, other than Saturday, Sunday, or any customary business holiday.

(5) Collateralized Fully in the case of a repurchase agreement means that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the money market fund reasonably could expect to incur if the seller defaults is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price (as defined in paragraph (a)(5)(v)) provided in the agreement;

(ii) The money market fund or its custodian either has actual physical possession of the collateral or, in the case of a security registered on a book entry system, the book entry is maintained in the name of the money market fund or its custodian;

(iii) The collateral consists entirely of cash items, Government Securities or other securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the Requisite NRSROs; and

(iv) Upon and Event of Insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller.

(v) Resale Price means the Acquisition price paid to the seller of the securities plus the accrued resale premium on such Acquisition price. The accrued resale premium shall be the amount specified in the repurchase agreement or the daily amortization of the difference between the Acquisition price and the resale price specified in the repurchase agreement.

(6) Conditional Demand Feature means a Demand Feature that is not an Unconditional Demand Feature. A Conditional Demand Feature is not a Guarantee.

(7) Conduit Security means a security issued by a Municipal Issuer (as defined in this paragraph) involving an arrangement or agreement entered into, directly or indirectly, with a person other than a Municipal Issuer, which arrangement or agreement provides for or secures repayment of the security. Municipal Issuer means a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality of a state or territory of the United States. A Conduit Security does not include a security that is:

(i) Fully and unconditionally guaranteed by a Municipal Issuer; or

(ii) Payable from the general revenues of the Municipal Issuer or other Municipal Issuers (other than those revenues derived from an agreement or arrangement with a person who is not a Municipal Issuer that provides for or secures repayment of the security issued by the Municipal Issuer); or

(iii) Related to a project owned and operated by a Municipal Issuer; or

(iv) Related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a Municipal Issuer.

(8) Demand Feature means:

(i) A feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise. A Demand Feature must be exercisable either:

(A) At any time on no more than 30 calendar days' notice; or

(B) At specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice; or

(ii) A feature permitting the holder of an Asset Backed Security unconditionally to receive principal and interest within 397 calendar days of making demand.

(9) Demand Feature Issued By A Non-Controlled Person means a Demand Feature issued by:

(i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature (control means "control" as defined in Section 2(a)(9) of the Act (*15 U.S.C. 80a-2(a)(9)*)); or

(ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.

(10) Eligible Security means:

(i) A Rated Security with a remaining maturity of 397 calendar days or less that has received a rating from the Requisite NRSROs in one of the two highest short-term rating categories (within which there may be sub-categories or gradations indicating relative standing); or

(ii) An Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(10)(i) of this section, as determined by the money market fund's board of directors; Provided, however, that:

(A) A security that at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less and that is an Unrated Security is not an Eligible Security if the security has received a long-term rating from any NRSRO that is not within the NRSRO's three highest long-term ratings categories (within which there may be sub-categories or gradations indicating relative standing), unless the security has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories;

(B) An Asset Backed Security (other than an Asset Backed Security substantially all of whose Qualifying Assets consist of obligations of one or more Municipal Issuers, as that term is defined in paragraph (a)(7) of this section) shall not be an Eligible Security unless it has received a rating from an NRSRO.

(iii) In addition, in the case of a security that is subject to a Demand Feature or Guarantee:

(A) The Guarantee has received a rating from an NRSRO or the Guarantee is issued by a guarantor that has received a rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee, unless:

(1) The Guarantee is issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the Guarantee (other than a sponsor of a Special Purpose Entity with respect to an Asset Backed Security);

(2) The security subject to the Guarantee is a repurchase agreement that is Collateralized Fully; or

(3) The Guarantee is itself a Government Security; and

(B) The issuer of the Demand Feature or Guarantee, or another institution, has undertaken promptly to notify the holder of the security in the event the Demand Feature or Guarantee is substituted with another Demand Feature or Guarantee (if such substitution is permissible under the terms of the Demand Feature or Guarantee).

(11) Event of Insolvency means, with respect to a person:

(i) An admission of insolvency, the application by the person for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; or

(ii) The institution of similar proceedings by another person which proceedings are not contested by the person; or

(iii) The institution of similar proceedings by a government agency responsible for regulating the activities of the person, whether or not contested by the person.

(12) First Tier Security means any Eligible Security that:

(i) Is a Rated Security that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(ii) Is an Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(12)(i) of this section, as determined by the fund's board of directors; or

(iii) Is a security issued by a registered investment company that is a money market fund; or

(iv) Is a Government Security.

(13) Floating Rate Security means a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and that, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(14) Government Security means any "Government security" as defined in Section 2(a)(16) of the Act (*15 U.S.C. 80a-2(a)(16)*).

(15) Guarantee means an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the Guarantee (if required), the principal amount of the underlying security plus accrued interest when due or upon default, or, in the case of an Unconditional Demand Feature, an obligation that entitles the holder to receive upon exercise the approximate amortized cost of the underlying security or securities, plus accrued interest, if any. A Guarantee includes a letter of credit, financial guaranty (bond) insurance, and an Unconditional Demand Feature (other than an Unconditional Demand Feature provided by the issuer of the security).

(16) Guarantee Issued By A Non-Controlled Person means a Guarantee issued by:

(i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Guarantee (control means "control" as defined in Section 2(a)(9) of the Act (*15 U.S.C. 80a-2(a)(9)*)); or

(ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.

(17) NRSRO means any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi) (E), (F) and (H) of § 240.15c3-1 of this Chapter, that is not an "affiliated person," as defined in Section 2(a)(3)(C) of the Act (*15 U.S.C. 80a-2(a)(3)(C)*), of the issuer of, or any insurer or provider of credit support for, the security.

(18) Penny-Rounding Method of pricing means the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(19) Rated Security means a security that meets the requirements of paragraphs (a)(19)(i) or (ii) of this section, in each case subject to paragraph (a)(19)(iii) of this section:

(i) The security has received a short-term rating from an NRSRO, or has been issued by an issuer that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security; or

(ii) The security is subject to a Guarantee that has received a short-term rating from an NRSRO, or a Guarantee issued by a guarantor that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the Guarantee; but

(iii) A security is not a Rated Security if it is subject to an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement as provided in paragraph (a)(19)(i) of this section, or the credit support agreement with respect to the security has received a short-term rating as provided in paragraph (a)(19)(ii) of this section.

(20) Refunded Security means a debt security the principal and interest payments of which are to be paid by Government Securities ("deposited securities") that have been irrevocably placed in an escrow account pursuant to agreement between the issuer of the debt security and an escrow agent that is not an "affiliated person," as defined in Section 2(a)(3)(C) of the Act (15 U.S.C. 80a-2(a)(3)(C)), of the issuer of the debt security, and, in accordance with such escrow agreement, are pledged only to the payment of the debt security and, to the extent that excess proceeds are available after all payments of principal, interest, and applicable premiums on the Refunded Securities, the expenses of the escrow agent and, thereafter, to the issuer or another party; provided that:

(i) The deposited securities shall not be redeemable prior to their final maturity;

(ii) The escrow agreement shall prohibit the substitution of the deposited securities unless the substituted securities are Government Securities; and

(iii) At the time the deposited securities are placed in the escrow account, or at the time a substitution of the deposited securities is made, an independent certified public accountant shall have certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities; Provided, however, an independent public accountant need not have provided the certification described in this paragraph (a)(20)(iii) if the security, as a Refunded Security, has received a rating from an NRSRO in the highest category for debt obligations (within which there may be sub-categories or gradations including relative standing).

(21) Requisite NRSROs means:

(i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or

(ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund Acquires the security, that NRSRO.

(22) Second Tier Security means any Eligible Security that is not a First Tier Security. Second Tier Conduit Security means any Conduit Security that is an Eligible Security that is not a First Tier Security.

(23) Single State Fund means a Tax Exempt Fund that holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and where applicable, subdivisions thereof.

- (24) Tax Exempt Fund means any money market fund that holds itself out as distributing income exempt from regular federal income tax.
- (25) Total Assets means, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.
- (26) Unconditional Demand Feature means a Demand Feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.
- (27) United States Dollar-Denominated means, with reference to a security, that all principal and interest payments on such security are payable to security holders in United States dollars under all circumstances and that the interest rate of, the principal amount to be repaid, and the timing of payments related to such security do not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars.
- (28) Unrated Security means a security that is not a Rated Security.
- (29) Variable Rate Security means a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.
- (b) Holding Out and Use of Names and Titles.
- (1) It shall be an untrue statement of material fact within the meaning of Section 34(b) of the Act (*15 U.S.C. 80a-33(b)*) for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Act (*15 U.S.C. 80a-24(b)*), to hold itself out to investors as a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of this section.
- (2) It shall constitute the use of a materially deceptive or misleading name or title within the meaning of Section 35(d) of the Act (*15 U.S.C. 80a-34(d)*) for a registered investment company to adopt the term “money market” as part of its name or title or the name or title of any redeemable securities of which it is the issuer, or to adopt a name that suggests that it is a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this section.
- (3) For purposes of this paragraph, a name that suggests that a registered investment company is a money market fund or the equivalent thereof shall include one that uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.
- (c) Share Price Calculations. The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund” or “fund”), notwithstanding the requirements of Section 2(a)(41) of the Act (*15 U.S.C. 80a-2(a)(41)*) and of §§ 270.2a-4 and 270.22c-1 thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; Provided, however, that:
- (1) Board Findings. The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.
- (2) Portfolio Maturity. The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; Provided, however, that the money market fund will not:

(i) Except as provided in paragraph (c)(2)(ii) of this section, Acquire any instrument with a remaining maturity of greater than 397 calendar days; or

(ii) In the case of a money market fund not using the Amortized Cost Method, Acquire a Government Security with a remaining maturity of greater than 762 calendar days; or

(iii) Maintain a dollar-weighted average portfolio maturity that exceeds ninety days.

(3) Portfolio Quality.

(i) General. The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO) and that are at the time of Acquisition Eligible Securities.

(ii) Second Tier Securities. Immediately after the Acquisition of any Second Tier Security:

(A) Taxable Funds. A money market fund that is not a Tax Exempt Fund shall not have invested more than five percent of its Total Assets in securities that are Second Tier Securities; and

(B) Tax Exempt Funds. A money market fund that is a Tax Exempt Fund shall not have invested more than five percent of its Total Assets in Conduit Securities that are Second Tier Conduit Securities.

(iii) Securities Subject to Guarantees. A security that is subject to a Guarantee may be determined to be an Eligible Security or a First Tier Security based solely on whether the Guarantee is an Eligible Security or First Tier Security, as the case may be.

(iv) Securities Subject to Conditional Demand Features. A security that is subject to a Conditional Demand Feature ("Underlying Security") may be determined to be an Eligible Security or a First Tier Security only if:

(A) The Conditional Demand Feature is an Eligible Security or First Tier Security, as the case may be;

(B) At the time of the Acquisition of the Underlying Security, the money market fund's board of directors has determined that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur; and

(1) The conditions limiting exercise either 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

(2) The terms of the Conditional Demand Feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand Feature in accordance with its terms; and

(C) The Underlying Security or any Guarantee of such security (or the debt securities of the issuer of the Underlying Security or Guarantee that are comparable in priority and security with the Underlying Security or Guarantee) has received either a short-term rating or a long-term rating, as the case may be, from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund's board of directors to a security that has received a rating from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories, as the case may be.

(4) Portfolio Diversification.

(i) Issuer Diversification. The money market fund shall be diversified with respect to issuers of securities Acquired by the fund as provided in paragraphs (c)(4)(i) and (c)(4)(ii) of this section, other than with respect to Government Securities and securities subject to a Guarantee Issued By A Non-Controlled Person.

(A) Taxable and National Funds. Immediately after the Acquisition of any security, a money market fund other than a Single State Fund shall not have invested more than five percent of its Total Assets in Securities issued by the issuer of the security; Provided, however, that such a fund may invest up to twenty-five percent of its Total Assets in the First Tier Securities of a single issuer for a period of up to three Business Days after the Acquisition thereof; Provided, further, that the fund may not invest in the securities of more than one issuer in accordance with the foregoing proviso in this paragraph at any time.

(B) Single State Funds. With respect to seventy-five percent of its Total Assets, immediately after the Acquisition of any security, a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security; Provided, however, that a Single State Fund shall not invest more than five percent of its Total Assets in securities issued by the issuer of the security unless the securities are First Tier Securities.

(C) Second Tier Securities.

(1) Taxable Funds. Immediately after the Acquisition of any Second Tier Security, a money market fund that is not a Tax Exempt Fund shall not have invested more than the greater of one percent of its Total Assets or one million dollars in securities issued by that issuer that are Second Tier Securities.

(2) Tax Exempt Funds. Immediately after the Acquisition of any Second Tier Conduit Security, a money market fund that is a Tax Exempt Fund shall not have invested more than the greater of one percent of its Total Assets or one million dollars in securities issued by that issuer that are Second Tier Conduit Securities.

(ii) Issuer Diversification Calculations. For purposes of making calculations under paragraph (c)(4)(i) of this section:

(A) Repurchase Agreements. The Acquisition of a repurchase agreement may be deemed to be an Acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully.

(B) Refunded Securities. The Acquisition of a Refunded Security shall be deemed to be an Acquisition of the escrowed Government Securities.

(C) Conduit Securities. A Conduit Security shall be deemed to be issued by the person (other than the Municipal Issuer) ultimately responsible for payments of interest and principal on the security.

(D) Asset Backed Securities.

(1) General. An Asset Backed Security Acquired by a fund ("Primary ABS") shall be deemed to be issued by the Special Purpose Entity that issued the Asset Backed Security, Provided, however:

(i) Holdings of Primary ABS. Any person whose obligations constitute ten percent or more of the principal amount of the Qualifying Assets of the Primary ABS ("Ten Percent Obligor") shall be deemed to be an issuer of the portion of the Primary ABS such obligations represent; and

(ii) Holdings of Secondary ABS. If a Ten Percent Obligor of a Primary ABS is itself a Special Purpose Entity issuing Asset Backed Securities ("Secondary ABS"), any Ten Percent Obligor of such Secondary ABS also shall be deemed to be an issuer of the portion of the Primary ABS that such Ten Percent Obligor represents.

(2) Restricted Special Purpose Entities. A Ten Percent Obligor with respect to a Primary or Secondary ABS shall not be deemed to have issued any portion of the assets of a Primary ABS as provided in paragraph (c)(4)(ii)(D)(1) of this section if that Ten Percent Obligor is itself a Special Purpose Entity issuing Asset Backed Securities ("Restricted Special Purpose Entity"), and the securities that it issues (other than securities issued to a company that controls, or is controlled by or under common control with, the Restricted Special Purpose Entity and which is not itself a Special Purpose Entity issuing Asset Backed Securities) are held by only one other Special Purpose Entity.



(3) Demand Features and Guarantees. In the case of a Ten Percent Obligor deemed to be an issuer, the fund shall satisfy the diversification requirements of paragraph (c)(4)(iii) of this section with respect to any Demand Feature or Guarantee to which the Ten Percent Obligor's obligations are subject.

(E) Shares of Other Money Market Funds. A money market fund that Acquires shares issued by another money market fund in an amount that would otherwise be prohibited by paragraph (c)(4)(i) of this section shall nonetheless be deemed in compliance with this section if the board of directors of the Acquiring money market fund reasonably believes that the fund in which it has invested is in compliance with this section.

(iii) Diversification Rules for Demand Features and Guarantees. The money market fund shall be diversified with respect to Demand Features and Guarantees Acquired by the fund as provided in paragraphs (c)(4)(iii) and (c)(4)(iv) of this section, other than with respect to a Demand Feature issued by the same institution that issued the underlying security, or with respect to a Guarantee or Demand Feature that is itself a Government Security.

(A) General. Immediately after the Acquisition of any Demand Feature or Guarantee or security subject to a Demand Feature or Guarantee, a money market fund, with respect to seventy-five percent of its Total Assets, shall not have invested more than ten percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, subject to paragraphs (c)(4)(iii)(B) and (C) of this section.

(B) Second Tier Demand Features or Guarantees.

Immediately after the Acquisition of any Demand Feature or Guarantee (or a security after giving effect to the Demand Feature or Guarantee) that is a Second Tier Security, a money market fund shall not have invested more than five percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee.

(C) Demand Features or Guarantees Issued by Non-Controlled Persons. Immediately after the Acquisition of any security subject to a Demand Feature or Guarantee, a money market fund shall not have invested more than ten percent of its Total Assets in securities issued by, or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, unless, with respect to any security subject to Demand Features or Guarantees from that institution (other than securities issued by such institution), the Demand Feature or Guarantee is a Demand Feature or Guarantee Issued By A Non-Controlled Person.

(iv) Demand Feature and Guarantee Diversification Calculations.

(A) Fractional Demand Features or Guarantees. In the case of a security subject to a Demand Feature or Guarantee from an institution by which the institution guarantees a specified portion of the value of the security, the institution shall be deemed to guarantee the specified portion thereof.

(B) Layered Demand Features or Guarantees. In the case of a security subject to Demand Features or Guarantees from multiple institutions that have not limited the extent of their obligations as described in paragraph (c)(4)(iv)(A) of this section, each institution shall be deemed to have provided the Demand Feature or Guarantee with respect to the entire principal amount of the security.

(v) Diversification Safe Harbor. A money market fund that satisfies the applicable diversification requirements of paragraphs (c)(4) and (c)(5) of this section shall be deemed to have satisfied the diversification requirements of Section 5(b)(1) of the Act (*15 U.S.C. 80a-5(b)(1)*) and the rules adopted thereunder.

(5) Demand Features and Guarantees Not Relied Upon. If the fund's board of directors has determined that the fund is not relying on a Demand Feature or Guarantee to determine the quality (pursuant to paragraph (c)(3) of this section), or maturity (pursuant to paragraph (d) of this section), or liquidity of a portfolio security, and maintains a record of this determination (pursuant to paragraphs (c)(9)(ii) and (c)(10)(vi) of this section), then the fund may disregard such Demand Feature or Guarantee for all purposes of this section.

(6) Downgrades, Defaults and Other Events.

## (i) Downgrades.

(A) General. Upon the occurrence of either of the events specified in paragraphs (c)(6)(i)(A)(1) and (2) of this section with respect to a portfolio security, the board of directors of the money market fund shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders:

(1) A portfolio security of a money market fund ceases to be a First Tier Security (either because it no longer has the highest rating from the Requisite NRSROs or, in the case of an Unrated Security the board of directors of the money market fund determines that it is no longer of comparable quality to a First Tier Security); and

(2) The money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated Security or Second Tier Security held by the money market fund has, since the security was Acquired by the fund, been given a rating by any NRSRO below the NRSRO's second highest short-term rating category.

(B) Securities to Be Disposed Of. The reassessments required by paragraph (c)(6)(i)(A) of this section shall not be required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five Business Days of the specified event and, in the case of events specified in paragraph (c)(6)(i)(A)(2) of this section, the board is subsequently notified of the adviser's actions.

(C) Special Rule for Certain Securities Subject to Demand Features. In the event that after giving effect to a rating downgrade, more than five percent of the fund's Total Assets are invested in securities issued by or subject to Demand Features from a single institution that are Second Tier Securities, the fund shall reduce its investment in securities issued by or subject to Demand Features from that institution to no more than five percent of its Total Assets by exercising the Demand Features at the next succeeding exercise date(s), absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund.

(ii) Defaults and Other Events. Upon the occurrence of any of the events specified in paragraphs (c)(6)(ii)(A) through (D) of this section with respect to a portfolio security, the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security):

(A) The default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(B) A portfolio security ceases to be an Eligible Security;

(C) A portfolio security has been determined to no longer present minimal credit risks; or

(D) An Event of Insolvency occurs with respect to the issuer of a portfolio security or the provider of any Demand Feature or Guarantee.

(iii) Notice to the Commission. In the event of a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Demand Feature or Guarantee to which it is subject, where immediately before default the securities (or the securities subject to the Demand Feature or Guarantee) accounted for  $\frac{1}{2}$  of 1 percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically, or by means of a facsimile transmission or electronic mail, followed by letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management.

(iv) Defaults for Purposes of Paragraphs (c)(6)(ii) and (iii). For purposes of paragraphs (c)(6)(ii) and (iii) of this section, an instrument subject to a Demand Feature or Guarantee shall not be deemed to be in default (and an Event of Insolvency with respect to the security shall not be deemed to have occurred) if:

(A) In the case of an instrument subject to a Demand Feature, the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest; or

(B) The provider of the Guarantee is continuing, without protest, to make payments as due on the instrument.

(7) Required Procedures: Amortized Cost Method. In the case of a money market fund using the Amortized Cost Method:

(i) General. In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) Specific Procedures. Included within the procedures adopted by the board of directors shall be the following:

(A) Shadow Pricing. Written procedures shall provide:

(1) That the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions;

(2) For the periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and

(3) For the maintenance of records of the determination of deviation and the board's review thereof.

(B) Prompt Consideration of Deviation. In the event such deviation from the money market fund's amortized cost price per share exceeds  $\frac{1}{2}$  of 1 percent, the board of directors shall promptly consider what action, if any, should be initiated by the board of directors.

(C) Material Dilution or Unfair Results. Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(8) Required Procedures: Penny-Rounding Method. In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.

(9) Specific Procedures: Amortized Cost and Penny-Rounding Methods. Included within the procedures adopted by the board of directors for money market funds using either the Amortized Cost or Penny-Rounding Methods shall be the following:

(i) Securities for Which Maturity is Determined by Reference to Demand Features. In the case of a security for which maturity is determined by reference to a Demand Feature, written procedures shall require ongoing review of the

security's continued minimal credit risks, and that review must be based on, among other things, financial data for the most recent fiscal year of the issuer of the Demand Feature and, in the case of a security subject to a Conditional Demand Feature the issuer of the security whose financial condition must be monitored under paragraph (c)(3)(iv) of this section, whether such data is publicly available or provided under the terms of the security's governing documentation.

(ii) Securities Subject to Demand Features or Guarantees. In the case of a security subject to one or more Demand Features or Guarantees that the fund's board of directors has determined that the fund is not relying on to determine the quality (pursuant to paragraph (c)(3) of this section), maturity (pursuant to paragraph (d) of this section) or liquidity of the security subject to the Demand Feature or Guarantee, written procedures shall require periodic evaluation of such determination.

(iii) Adjustable Rate Securities Without Demand Features. In the case of a Variable Rate or Floating Rate Security that is not subject to a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section, written procedures shall require periodic review of whether the interest rate formula, upon readjustment of its interest rate, can reasonably be expected to cause the security to have a market value that approximates its amortized cost value.

(iv) Asset Backed Securities. In the case of an Asset Backed Security, written procedures shall require the fund to periodically determine the number of Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section; Provided, however, written procedures need not require periodic determinations with respect to any Asset Backed Security that a fund's board of directors has determined, at the time of Acquisition, will not have, or is unlikely to have, Ten Percent Obligors that are deemed to be issuers of all or a portion of that Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section, and maintains a record of this determination.

#### (10) Record Keeping and Reporting.

(i) Written Procedures. For a period of not less than six years following the replacement of such procedures with new procedures (the first two years in an easily accessible place), a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(6) through (c)(9) and (e) of this section shall be maintained and preserved.

(ii) Board Considerations and Actions. For a period of not less than six years (the first two years in an easily accessible place) a written record shall be maintained and preserved of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth in this section, to be included in the minutes of the board of directors' meetings.

(iii) Credit Risk Analysis. For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks and the NRSRO ratings (if any) used to determine the status of the security as an Eligible Security, First Tier Security or Second Tier Security shall be maintained and preserved in an easily accessible place.

(iv) Determinations with Respect to Adjustable Rate Securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(9)(iii) of this section (that a Variable Rate or Floating Rate Security that is not subject to a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section can reasonably be expected, upon readjustment of its interest rate at all times during the life of the instrument, to have a market value that approximates its amortized cost).

(v) Determinations with Respect to Asset Backed Securities. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determinations required by paragraph (c)(9)(iv) of this section (the number of Ten Percent Obligors (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section). The written record shall include:

(A) The identities of the Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section), the percentage of the Qualifying Assets constituted by the securities of each Ten Percent Obligor and the percentage of the fund's Total Assets that are invested in securities of each Ten Percent Obligor; and

(B) Any determination that an Asset Backed Security will not have, or is unlikely to have, Ten Percent Obligor deemed to be issuers of all or a portion of that Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section.

(vi) Evaluations with Respect to Securities Subject to Demand Features or Guarantees. For a period of not less than three years from the date when the evaluation was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the evaluation required by paragraph (c)(9)(ii) (regarding securities subject to one or more Demand Features or Guarantees) of this section.

(vii) Inspection of Records. The documents preserved pursuant to this paragraph (c)(10) shall be subject to inspection by the Commission in accordance with Section 31(b) of the Act (*15 U.S.C. 80a-30(b)*) as if such documents were records required to be maintained pursuant to rules adopted under Section 31(a) of the Act (*15 U.S.C. 80a-30(a)*). If any action was taken under paragraphs (c)(6)(ii) (with respect to defaulted securities and events of insolvency) or (c)(7)(ii) (with respect to a deviation from the fund's share price of more than ½ of 1 percent) of this section, the money market fund will file an exhibit to the Form N-SAR (*17 CFR 274.101*) filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

(d) Maturity of Portfolio Securities. For purposes of this section, the maturity of a portfolio security shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, except as provided in paragraphs (d)(1) through (d)(8) of this section:

(1) Adjustable Rate Government Securities. A Government Security that is a Variable Rate Security where the variable rate of interest is readjusted no less frequently than every 762 calendar days shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate. A Government Security that is a Floating Rate Security shall be deemed to have a remaining maturity of one day.

(2) Short-Term Variable Rate Securities. A Variable Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity equal to the earlier of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(3) Long-Term Variable Rate Securities. A Variable Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) Short-Term Floating Rate Securities. A Floating Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity of one day.

(5) Long-Term Floating Rate Securities. A Floating Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(6) Repurchase Agreements. A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.

(7) Portfolio Lending Agreements. A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(8) Money Market Fund Securities. An investment in a money market fund shall be treated as having a maturity equal to the period of time within which the Acquired money market fund is required to make payment upon redemption, unless the Acquired money market fund has agreed in writing to provide redemption proceeds to the investing money market fund within a shorter time period, in which case the maturity of such investment shall be deemed to be the shorter period.

(e) Delegation. The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (c)(1) (board findings); (c)(6)(i)(C) (rule for certain securities subject to second tier Demand Features); (c)(6)(ii) (defaults and other events); (c)(7)(i) (general required procedures: Amortized Cost Method); (c)(7)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), and (C) (material dilution or unfair results); and (c)(8) (required procedures: Penny Rounding Method) of this section) provided:

(1) Written Guidelines. The Board shall establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this section) and procedures under which the delegate makes such determinations:

(2) Oversight. The Board shall take any measures reasonably necessary (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security or Event of Insolvency with respect to the issuer of the security or any Guarantee to which it is subject that requires notification of the Commission under paragraph (c)(6)(iii) of this section) to assure that the guidelines and procedures are being followed.

5. Section 270.2a41-1 is amended by revising the introductory text of paragraph (a) to read as follows:

§ 270.2a41-1 Valuation of standby commitments by registered investment companies.

(a) A standby commitment means a right to sell a specified underlying security or securities within a specified period of time and at an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise, that may be sold, transferred or assigned only with the underlying security or securities. A standby commitment entitles the holder to receive same day settlement, and will be considered to be from the party to whom the investment company will look for payment of the exercise price. A standby commitment may be assigned a fair value of zero, Provided, That:

\* \* \* \*

6. Section 270.12d3-1 is amended by revising paragraph (d)(7)(v) to read as follows:

§ 270.12d3-1 Exemption of acquisitions of securities issued by persons engaged in securities related businesses.

\* \* \* \*

(d) \* \* \*

(7) \* \* \*

(v) Acquisition of Demand Features or Guarantees, as these terms are defined in § 270.2a-7(a)(8) and § 270.2a-7(a)(15) respectively, provided that, immediately after the acquisition of any Demand Feature or Guarantee, the company will not, with respect to 75 percent of the total value of its assets, have invested more than ten percent of the total value of its assets in securities underlying Demand Features or Guarantees from the same institution. For the purposes of this section, a Demand Feature or Guarantee will be considered to be from the party to whom the company will look for payment of the exercise price.

## Releases

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7. Section 270.17a-9 is amended by revising the cite to “paragraph (a)(9)” in the introductory paragraph to read “paragraph (a)(10)”.

8. Section 270.31a-1 is amended by revising the last sentence of paragraph (b)(1) to read as follows:

§ 270.31a-1 Records to be maintained by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.

\* \* \* \*

(b) \* \* \*

(1) \* \* \* In the case of a money market fund, also identify the provider of any Demand Feature or Guarantee (as defined in § 270.2a-7(a)(8) or § 270.2a-7(a)(15) respectively) and give a brief description of the nature of the Demand Feature or Guarantee (e.g., unconditional demand feature, conditional demand feature, letter of credit, or bond insurance) and, in a subsidiary portfolio investment record, provide the complete legal name and accounting and other information (including sufficient information to calculate coupons, accruals, maturities, puts, and calls) necessary to identify, value, and account for each investment.

\* \* \* \*

9. Section 270.34b-1 is amended by revising paragraph (b) (the Note remains unchanged) to read as follows:

§ 270.34b-1 Sales literature deemed to be misleading.

\* \* \* \*

(b)(1) Except as provided in paragraph (b)(3) of this section:

(i) In any sales literature that contains performance data for an investment company, include the disclosure required by paragraph (a)(6) of § 230.482 of this chapter.

(ii) In any sales literature for a money market fund:

(A) Accompany any quotation of yield or similar quotation purporting to demonstrate the income earned or distributions made by the money market fund with a quotation of current yield specified by paragraph (d)(1)(i) of § 230.482 of this chapter;

(B) Accompany any quotation of tax equivalent yield or other similar quotation purporting to demonstrate the tax equivalent yield earned or distributions made by the money market fund with a quotation of current yield specified in paragraph (d)(1)(i) of § 230.482 of this chapter; and

(C) Accompany any quotation of the money market fund’s total return with a quotation of the money market fund’s current yield specified in paragraph (d)(1)(i) of § 230.482 of this chapter. Place the quotations of total return and current yield next to each other, in the same size print, and if there is a material difference between the quoted total return and the quoted current yield, include a statement that the yield quotation more closely reflects the current earnings of the money market fund than the total return quotation.

(iii) In any sales literature for an investment company other than a money market fund that contains performance data:

(A) Include the total return information required by paragraph (e)(3) of § 230.482 of this chapter;

(B) Accompany any quotation of yield or similar quotation purporting to demonstrate the income earned or distributions made by the company with a quotation of current yield specified by paragraph (e)(1) of § 230.482 of this chapter; and

(C) Accompany any quotation of tax equivalent yield or other similar quotation purporting to demonstrate the tax equivalent yield earned or distributions made by the company with a quotation of tax equivalent yield specified in paragraph (e)(2) and current yield specified by paragraph (e)(1) of § 230.482 of this chapter.

(2) Any performance data included in sales literature under paragraphs (b)(1)(ii) or (iii) of this section must meet the currentness requirements of paragraph (f) of § 230.482 of this chapter.

(3) The requirements specified in paragraph (b)(1) of this section shall not apply to any quarterly, semi-annual, or annual report to shareholders under Section 30 of the Act (*15 U.S.C. 80a-29*), containing performance data for a period commencing no earlier than the first day of the period covered by the report; nor shall the requirements of paragraphs (e)(3)(ii) and (f) of § 230.482 of this chapter apply to any such periodic report containing any other performance data.

## **Part 239—Forms Prescribed Under the Securities Act of 1933**

### **Part 274—Forms Prescribed Under the Investment Company Act of 1940**

10. The authority citation for part 239 continues to read, in part, as follows:

Authority: *15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-29, 80a-30 and 80a-37*, unless otherwise noted.

\* \* \* \*

11. The authority citation for Part 274 continues to read as follows:

Authority: *15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, and 80a-29*, unless otherwise noted.

12. Part B, Item 22(a) of Form N-1A (reference in §§ 239.15A and 274.11A) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase “and income other than investment income” after the phrase “exclusive of capital changes” in each paragraph.

(b) Adding at the end of Instruction 2 the following: “Exclude income other than investment income.”

NOTE: Form N-1A does not and the amendments will not appear in the Code of Federal Regulations.

13. Item 25(a) of Form N-3 (referenced in §§ 239.17a and 274.11b) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase “and income other than investment income” after the phrase “exclusive of capital changes” in each paragraph.

(b) Adding at the end of Instruction 3 the following: “Exclude income other than investment income.”

NOTE: Form N-3 does not and the amendments will not appear in the Code of Federal Regulations.

14. Guide 38 to Form N-3 (Money Market Fund Investments in Other Money Market Funds) (referenced in §§ 239.17a and 274.11b) is amended by revising the last sentence to read as follows:

\* \* \* Paragraph (c)(4)(ii)(E) of Rule 2a-7 describes the obligations of a fund that invests its assets in another money market fund.

NOTE: Guide 38 to Form N-3 does not and the amendments will not appear in the Code of Federal Regulations.

15. Part B, Item 21(a) of Form N-4 (referenced in §§ 239.17b and 274.11c) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase “and income other than investment income” after the phrase “exclusive of capital changes” in each paragraph.



(b) Adding at the end of Instruction 3 the following: “Exclude income other than investment income.”

NOTE: Form N-4 does not and the amendments will not appear in the Code of Federal Regulations.

By the Commission.

NOTE: The Appendix to the preamble will not appear in the Code of Federal Regulations.

## APPENDIX

Illustration: Guarantee and Demand Feature Diversification Calculations For Securities Subject to Multiple Demand Features and Guarantees<sup>114</sup>

With respect to securities subject to multiple demand features or guarantees upon which a fund is relying, a fund must first analyze each credit enhancement provider individually to determine whether securities issued by or subject to demand features or guarantees from the same provider exceed ten percent of total assets. If so, then those securities are placed in the twenty-five percent basket. Once placed in the basket, however, the value of each security is counted only once for purposes of calculating the amount of the twenty-five percent basket available for additional investments.

FACTS: A fund invests 9% of its total assets in Security A, which is guaranteed by a letter of credit (“LOC”) issued by ABC Bank and subject to a conditional demand feature issued by XYZ Bank. The fund invests 5% of its total assets in Security B, which is guaranteed by a LOC issued by ABC Bank. The fund invests 5% of its total assets in Security C, which is subject to a conditional demand feature issued by XYZ Bank. Assume that the fund holds no other securities subject to guarantees or demand features provided by ABC Bank or XYZ Bank and that no other entity has guaranteed, or issued conditional demand features with respect to, over 10% percent of the fund’s assets.

ANALYSIS: For purposes of the demand feature and guarantee diversification standards:

- » 14% percent of the fund’s total assets (Securities A and B) are subject to guarantees or demand features from ABC Bank. 14% of the fund’s total assets (Securities A and C) are subject to guarantees or demand features from XYZ Bank.
- » The fund must include Securities A, B and C in its twenty-five percent basket. The amount of investments in the twenty-five percent basket is calculated to be 19% of the fund’s total assets (9% + 5% + 5%). This represents the aggregate value of all of the fund’s securities subject to guarantees and demand features issued by ABC Bank and XYZ Bank.

Illustration: “Look-Through” to Secondary ABSs Under the Rule’s ABS Issuer Diversification Standards<sup>115</sup>

Any ten percent obligor of a primary or secondary ABS is deemed to have issued a portion of the assets of the primary ABS that such ten percent obligor represents. To prevent double counting, obligations of each ten percent obligor are netted against the obligations of the special purpose entity (“SPE”) for which it is a ten percent obligor. All netted obligations issued by the same direct or indirect ten percent obligor are aggregated when calculating a fund’s total investment in any particular security.

## FACTS

A fund invests 10% of its assets directly in an ABS (“Primary ABS”) issued by an SPE. The fund also invests 4% of its assets directly in securities issued by Obligor C. Obligor C is not an SPE issuing ABSs. 25% of the Primary ABS’s qualifying assets is invested in Obligor A and 50% of the Primary ABS’s qualifying assets is invested in Obligor B.

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<sup>114</sup> See Section I.B.3.b.iv. of the Release (discussing the twenty-five percent basket with respect to the demand feature and guarantee diversification standards).

<sup>115</sup> See Section I.B.3.b.i. of the Release.

Obligor A is an SPE with 30% of its qualifying assets invested in securities issued by Obligor C. Obligor B is an SPE with 20% of its qualifying assets invested in securities issued by Obligor C.<sup>1</sup>

## ANALYSIS

For issuer diversification purposes, the fund has invested as follows:

- » 1.75% of fund assets in Obligor A ( $[25\% \times 10\%] - [30\% \times 25\% \times 10\%]$ ). The portion indirectly invested in Obligor C through Obligor A (.75%) is netted against the portion indirectly invested in Obligor A (2.5%).
- » 4% of fund assets in Obligor B ( $[50\% \times 10\%] - [20\% \times 50\% \times 10\%]$ ). The portion indirectly invested in Obligor C through Obligor B (1%) is netted against the portion indirectly invested in Obligor B (5%).
- » 5.75% of fund assets in Obligor C ( $[[30\% \times 25\% \times 10\%] + [20\% \times 50\% \times 10\%]] + 4\%$ ). The portion indirectly invested in Obligor C (1.75%) (i.e., .75% through Obligor A + 1% through Obligor B) is added to the amount directly invested in Obligor C (4%).<sup>2</sup> In this example, the fund's investment in Obligor C would exceed the 5% limit on investments in securities of a single issuer.<sup>3</sup>
- » 2.5% of fund assets in the Primary ABS ( $10\% - [1.75\% + 4\% + 1.75\%]$ ). The portion deemed indirectly invested in Obligors A, B and C through the Primary ABS is netted against the amount directly invested in the Primary ABS.

By the Commission.  
Jonathan G. Katz  
Secretary  
December 2, 1997

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<sup>1</sup> Reference to "Diversified Pool" in this illustration means that no other obligor's obligations constitute 10% or more of the pool of qualifying assets of the special purpose entity issuing ABSs.

<sup>2</sup> If Obligors A or B (i.e., secondary ABSs) had, in addition to Obligor C, another ten percent obligor that was an SPE issuing ABSs (i.e., a "tertiary ABS"), the amended rule would not require the fund to "look through" to the qualifying assets of any ten percent obligors of such "tertiary ABS" for purposes of compliance with the issuer diversification standards.

<sup>3</sup> See paragraph (c)(4)(i)(A) of Rule 2a-7, as amended.

## PROPOSAL REGARDING TREATMENT OF REPURCHASE AGREEMENTS AND REFUNDED SECURITIES AS AN ACQUISITION OF THE UNDERLYING SECURITIES

Release No. IC-24050

September 23, 1999

ACTION: Proposed rule

SUMMARY: The Commission is proposing for public comment a new rule and related rule amendments under the Investment Company Act of 1940 that would affect the ability of investment companies to invest in repurchase agreements and pre-refunded bonds under the Act. The proposed rule would generally codify and update staff positions that have permitted investment companies to “look through” counterparties to certain repurchase agreements and issuers of municipal bonds that have been “refunded” with U.S. government securities and treat the securities comprising the collateral as investments for certain purposes under the Act.

DATES: Comments must be received on or before November 23, 1999.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0609. Comments also may be submitted electronically at the following E-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-21-99; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission’s Public Reference Room, 450 5th Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission’s Internet web site (<http://www.sec.gov>).

FOR FURTHER INFORMATION CONTACT: Marilyn Mann, Senior Counsel, Office of Regulatory Policy, at (202) 942-0690, or Alison M. Fuller, Assistant Chief Counsel, Office of Chief Counsel, (202) 942-0660, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0506.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed Rule 5b-3 [17 *CFR* 270.5b-3] and conforming amendments to Rules 2a-7 [17 *CFR* 270.2a-7] and 12d3-1 [17 *CFR* 270.12d3-1] under the Investment Company Act of 1940 [15 *U.S.C.* 80a] (the “Act”).<sup>4</sup>

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<sup>4</sup> Unless otherwise noted, all references to Rule 2a-7 or Rule 12d3-1, or to any paragraph of those rules, will be to 17 *CFR* 270.2a-7 and 17 *CFR* 270.12d3-1, respectively.

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### Executive Summary

Repurchase agreements provide investment companies (“funds”) with a convenient means to invest excess cash on a secured basis, generally for short periods of time. In a typical fund repurchase agreement, a fund enters into a contract with a broker, dealer or bank (the “counterparty” to the transaction) for the purchase of securities. The counterparty agrees to repurchase the securities at a specified future date or on demand for a price that is sufficient to return to the fund its original purchase price, plus an additional amount representing the return on the fund’s investment.

The Commission is proposing a rule that would permit funds to “look through” certain repurchase agreements to the securities collateralizing the agreements for various purposes under the Act. Because a fund looks to the collateral as the ultimate source of repayment for its loan, the Commission staff has taken a “no-action” position in order to allow funds to treat certain repurchase agreements as investments in the securities making up the collateral rather than as a loan to the counterparty. Proposed Rule 5b-3 would codify these positions and allow a fund to treat a repurchase agreement as an acquisition of the underlying collateral in determining whether it is in compliance with the investment criteria for diversified funds set forth in Section 5(b)(1) of the Act.<sup>5</sup> The proposed rule also would codify staff no-action positions that allow a fund that enters into a repurchase agreement with a counterparty that is a broker-dealer to “look through” the repurchase agreement to the underlying collateral for purposes of Section 12(d)(3) of the Act, which prohibits a fund from acquiring an interest in a broker-dealer.<sup>6</sup> The proposed rule would require the value of the collateral at all times to be sufficient to fully cover the amount payable under the repurchase agreement (that is, the amount that the counterparty would repay the fund to repurchase the securities). In addition, the fund must evaluate whether the counterparty is creditworthy and the repurchase agreement must qualify for an exclusion from any automatic stay of creditors’ rights under the federal Bankruptcy Code or other insolvency laws.

Proposed Rule 5b-3 would provide similar “look-through” treatment for purposes of Section 5(b)(1) of the Act in the case of investments in pre-refunded bonds, the repayment of which has been fully funded by escrowed U.S. government securities. As in the case of repurchase agreements, a fund may view its investment in pre-refunded bonds as an investment in the escrowed government securities rather than in the original bonds.

The conditions proposed for the treatment of repurchase agreements and pre-refunded bonds under the proposed rule would be substantially the same as those required by Rule 2a-7, the rule governing money market funds, and would codify and update long-standing staff no-action positions.

<sup>5</sup> 15 U.S.C. 80a-5(b)(1).

<sup>6</sup> 15 U.S.C. 80a-12(d)(3).

## I. Background

### A. Repurchase Agreements

Repurchase agreements provide funds with a means to invest idle cash at competitive rates for periods as short as overnight. Economically, they may be viewed as loans from the fund to the counterparty in which the securities that the fund purchases serve as collateral for the loan and are placed in the possession or under the control of the fund's custodian during the term of the agreement.<sup>7</sup> By investing in repurchase agreements, funds can expand their available options for the productive investment of short-term cash. At the same time, fund participation in the market for repurchase agreements benefits other market participants by enhancing their ability to borrow to meet their short-term needs.

Two provisions of the Act may affect a fund's ability to invest in repurchase agreements. Section 12(d)(3) of the Act generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter.<sup>8</sup> Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty,<sup>9</sup> Section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as counterparties.<sup>10</sup> Section 5(b)(1) of the Act limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. government).<sup>11</sup> This provision may limit the amount of repurchase agreements that a diversified fund may enter into with any one counterparty.

A fund investing in a properly structured repurchase agreement looks primarily to the value and liquidity of the collateral rather than the credit of the counterparty for satisfaction of the repurchase agreement.<sup>12</sup> In two separate no-action positions issued in 1979 and 1980, the staff stated that, for purposes of Sections 12(d)(3) and 5(b)(1) of the Act, a fund may treat a repurchase agreement as an acquisition of the underlying collateral if the repurchase agreement is "collateralized fully."<sup>13</sup> Because most repurchase agreements are collateralized fully by highly liquid U.S. government securities, this "look-through" treatment allowed funds to treat repurchase agreements as investments in government securities. As a result, a fund could invest in repurchase agreements with the same counterparty without the limitations of Sections 12(d)(3) or 5(b)(1).<sup>14</sup>

<sup>7</sup> See *The Handbook of Fixed Income Securities* 198 (Frank J. Fabozzi ed., 5th ed. 1997). Most repurchase transactions involve Treasury bills and other U.S. government securities, but bank certificates of deposit and bankers' acceptances, as well as commercial paper from major corporations, are used as well. See Jeanne L. Schroeder, *Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C.*, 46 *Syracuse L. Rev.* 999, 1005 (1996). When the counterparty lends to, rather than borrows from, the fund, the transaction is termed a "reverse repurchase agreement." Reverse repurchase agreements raise issues under Section 18 of the Act [15 U.S.C. 80a-18] because they can be viewed as the issuance by the fund of a senior security. These issues were addressed in Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)] ("Release 10666").

<sup>8</sup> With minor exceptions, Section 12(d)(3) prohibits an investment company from purchasing or otherwise acquiring "any security issued by or any other interest in the business of any person who is a broker, a dealer, [or] is engaged in the business of underwriting." The staff has taken the position that fund repurchase agreements with banks that are engaged in a securities-related business, including dealing in government securities, may be subject to the prohibitions of Section 12(d)(3). See Letter from Gerald Osheroff, Associate Director, Division of Investment Management, to Matthew Fink, General Counsel, Investment Company Institute (May 7, 1985) ("May 7, 1985 Letter").

<sup>9</sup> See American Medical Ass'n Tax-Exempt Income Fund, Inc., SEC No-Action Letter (Apr. 23, 1978); May 7, 1985 Letter, *supra* note 5.

<sup>10</sup> Brokers and dealers (as well as banks that are engaged in securities related activities) often act as counterparties in repurchase transactions. See Schroeder, *supra* note 4, at 1004. If funds are unable to enter into repurchase agreements with these counterparties, they effectively may be unable to participate in this market.

<sup>11</sup> To be classified as a "diversified" fund under Section 5(b)(1) of the Act, a fund is required, with respect to 75 percent of its assets, to invest no more than 5 percent of its assets in the securities of any one issuer (excluding cash and cash items, government securities, and securities of other investment companies). The remaining 25 percent of the fund's assets may be invested in any manner. Section 13(a)(1) of the Act [15 U.S.C. 80a-13(a)(1)] prohibits a fund that is classified as a diversified company from changing to a non-diversified company without shareholder authorization.

<sup>12</sup> See *infra* note 16 and accompanying text.

<sup>13</sup> In 1979, the staff announced that it would not recommend enforcement action under Section 12(d)(3) if the repurchase agreement was "structured in a manner reasonably designed to collateralize fully the investment company loan." Release 10666, *supra* note 4. The following year, the staff applied this no-action position to a fund's compliance with the diversification requirements of Section 5(b)(1) of the Act. MoneyMart Assets, Inc., SEC No-Action Letter (Sept. 3, 1980).

<sup>14</sup> Repurchase agreements with broker-dealers affiliated with the fund would, of course, continue to raise serious questions under Sections 17(a) and 17(d) of the Act [15 U.S.C. 80a-17(a), 15 U.S.C. 80a-17(d)]. See Release 10666, *supra* note 4, at n.24.

The assumptions underlying the 1979 and 1980 no-action positions were challenged in the early 1980s as a result of the bankruptcy of Lombard-Wall, Inc., a large issuer of repurchase agreements, and the insolvency of several others.<sup>15</sup> The court in the Lombard-Wall case held that the purchaser of securities in a repurchase agreement was subject to the automatic stay of the Bankruptcy Code,<sup>16</sup> and could not close out its position without the approval of the bankruptcy court.<sup>17</sup> This decision created uncertainty regarding the status of repurchase agreements under the Bankruptcy Code and exposed a fund to the risk that it might be unable to liquidate the collateral securities immediately upon the insolvency of the counterparty.<sup>18</sup> Because of the possible adverse effect of counterparty insolvency on a fund's liquidity, the Commission issued a staff release that added a condition to the staff's earlier no-action position. In addition to requiring the repurchase agreement to be fully collateralized, the staff now required the fund to evaluate the creditworthiness of the counterparty.<sup>19</sup>

Congress later amended the Bankruptcy Code to resolve this uncertainty.<sup>20</sup> As amended, the Bankruptcy Code now protects participants in repurchase agreements from the Code's automatic stay and preference avoidance provisions when the collateral consists of U.S. government and agency obligations, certificates of deposit, and eligible bankers' acceptances.<sup>21</sup> In 1996, when we amended the money market fund rule (Rule 2a-7, which had codified the staff's position on repurchase agreements in connection with that rule's diversification requirements),<sup>22</sup> we tied the availability of the "look-through" more directly to the preferred treatment given to repurchase agreements under the Bankruptcy Code and related insolvency statutes.<sup>23</sup> We noted that if the collateral did not qualify for special treatment under these statutes,

<sup>15</sup> See *In re Lombard-Wall Inc.*, No. 82 B 11556, bench op. (Bankr. S.D.N.Y. Sept. 16, 1982).

<sup>16</sup> *11 U.S.C. 101 et seq.*

<sup>17</sup> See Omnibus Bankruptcy Improvements Act of 1983, S. Rep. No. 98-65, at 47 (1983) (discussing *In re Lombard-Wall Inc.*).

<sup>18</sup> As a consequence, the repurchase agreement might be an illiquid investment subject to restrictions on the amount of these investments in a fund's portfolio.

<sup>19</sup> Investment Company Act Release No. 13005 (Feb. 2, 1983) [*48 FR 5894* (Feb. 9, 1983)] ("Release 13005"). Release 13005 called for the evaluation of the counterparty's creditworthiness to be made by the fund's board of directors. In a recent letter to the Investment Company Institute, the staff revised this position to permit a fund's investment adviser, rather than the fund's board, to evaluate the creditworthiness of counterparties and otherwise assume primary responsibility for monitoring and evaluating the fund's use of repurchase agreements. Investment Company Institute, SEC No-Action Letter (June 15, 1999).

<sup>20</sup> Before the passage of the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984) ("BAFJA"), the treatment of a repurchase agreement under the Bankruptcy Code depended upon whether it was characterized as a secured loan or a purchase and sale transaction. If the transaction was characterized as a secured loan, the borrower-counterparty would retain at least an equitable interest in the securities, and the securities would be subject to the automatic stay provisions of the Bankruptcy Code, preventing the lender from taking any action against the borrower's property. If the transaction was characterized as a purchase and sale, the repurchase obligation would be viewed as an executory contract, which the bankruptcy trustee could accept or reject. Until acceptance or rejection, the fund would be exposed to the market risk of the securities. Regardless of the transaction's characterization, it was unclear whether "mark-to-market" payments (the payments required to keep the repurchase agreement fully collateralized) could be voided by the trustee as preferential transfers. The BAFJA amendments removed qualifying repurchase agreements from the operation of the Bankruptcy Code's automatic stay and preference avoidance provisions. See *11 U.S.C. 101(47)* (defining repurchase agreement); *11 U.S.C. 559* (protecting repurchase agreement participants from the Bankruptcy Code's automatic stay provisions).

<sup>21</sup> See *11 U.S.C. 101(47)*; *11 U.S.C. 559*. The Federal Deposit Insurance Act also provides preferred treatment to repurchase agreements in which a bank is the counterparty. See *12 U.S.C. 1821(e)(8)(A), (C)* (affording preferred treatment to "qualified financial contracts"); *12 U.S.C. 1821(e)(8)(D)(i)* (defining qualified financial contracts to include repurchase agreements); *12 U.S.C. 1821(e)(8)(D)(v)* (defining repurchase agreement).

In broker-dealer insolvencies, the buyer's ability to liquidate the repurchase agreement collateral is subject to the possible imposition of a judicial stay obtained by the Securities Investor Protection Corporation ("SIPC"). Representatives of SIPC, however, have indicated that SIPC would consent, and urge the trustee to consent, to the liquidation of repurchase agreement collateral upon SIPC's receipt of certain documentation, including an affidavit from the buyer that it has a perfected security interest in the collateral. See Letter from Michael E. Don, President, SIPC, to Seth Grosshandler, Cleary, Gottlieb, Steen & Hamilton (Feb. 14, 1996); Letter from Michael E. Don, Deputy General Counsel, Office of the General Counsel, SIPC, to Eugene Marans, Cleary, Gottlieb, Steen & Hamilton (Aug. 29, 1988).

<sup>22</sup> See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991) [*56 FR 8113* (Feb. 27, 1991)], at nn.30-33 and accompanying text.

<sup>23</sup> See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [*58 FR 68585* (Dec. 28, 1993)] ("1996 Amendments Proposing Release"), at nn.168-74 and accompanying text; Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [*61 FR 13956* (Mar. 28, 1996)] ("1996 Amendments Adopting Release"), at nn.116-19.

a fund could encounter significant liquidity problems if a large percentage of its assets were invested in a repurchase agreement with a bankrupt counterparty. In that case, the credit risks assumed by the fund would be directly tied to the counterparty rather than the issuers of the underlying collateral.<sup>24</sup>

The Commission is proposing a new Rule 5b-3 that would codify the staff's positions that a fund may look through a fully collateralized repurchase agreement to the underlying securities for purposes of Sections 5(b)(1) and 12(d)(3) of the Act,<sup>25</sup> supplemented by the requirement of Rule 2a-7 that the repurchase agreement qualify for an exclusion from any automatic stay of creditors' rights under applicable insolvency law. Because the conditions for looking through a repurchase agreement for purposes of Sections 5(b)(1) and 12(d)(3) are substantially the same as the conditions under Rule 2a-7, the Commission is proposing to codify the same standard for all three purposes.

## B. Pre-Refunded Bonds

Pre-refunded bonds are municipal bonds the repayment of which has been fully funded by a deposit into escrow of U.S. government securities. From time to time, a municipality may choose to refund previously issued bonds prior to their call date by issuing a second bond, the proceeds of which are used to purchase U.S. government securities. These securities are placed in escrow, and the principal and interest on the escrowed securities are used to pay off the original bonds.<sup>26</sup> The holders of the original bonds no longer look to the municipal issuer for repayment, but rather to the escrowed securities.

In 1993, the staff issued a no-action position permitting funds, under certain conditions, to look through pre-refunded bonds to the escrowed government securities for purposes of the section 5(b)(1) diversification requirements.<sup>27</sup> When the Commission amended Rule 2a-7 in 1996, it codified this position for purposes of the money market fund diversification requirements, but omitted the condition that the pre-refunded bonds of any one issuer could account for no more than 25 percent of the fund's assets.<sup>28</sup> The Commission proposes to codify this revised treatment of pre-refunded bonds for purposes of Section 5(b)(1).<sup>29</sup>

## II. DISCUSSION

### A. Proposed Rule 5b-3(a): Treatment of Repurchase Agreements

Proposed Rule 5b-3 would permit a fund to treat the acquisition of a repurchase agreement as an acquisition of the underlying securities for purposes of Sections 5(b)(1) and 12(d)(3) of the Act, if the obligation of the seller to repurchase the securities from the fund is "collateralized fully," as defined in the proposed rule.<sup>30</sup> Consistent with the staff's no-

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<sup>24</sup> 1996 Amendments Proposing Release, *supra* note 20, at n.172.

<sup>25</sup> The Commission expects to withdraw the staff positions if we adopt the proposed rule.

<sup>26</sup> *See, e.g.*, Robert Zipf, *How Municipal Bonds Work* 44-47 (1995).

<sup>27</sup> T. Rowe Price Tax-Free Funds, SEC No-Action Letter (June 24, 1993). In the letter, the Division of Investment Management agreed not to recommend any enforcement action if a fund treated an investment in municipal bonds refunded with escrowed government securities as an investment in the government securities for purposes of Section 5(b)(1). This no-action position was based on certain representations, including that (1) the deposit of the government securities was irrevocable and pledged only to the debt service on the original bonds, (2) payments from the escrow would not be subject to the preference provisions or automatic stay provisions of the Bankruptcy Code, and (3) no fund would invest more than 25 percent of its assets in the pre-refunded bonds of any single municipal issuer.

<sup>28</sup> The Commission also eliminated the 25 percent limitation for funds other than money market funds that rely on the staff no-action position set forth in T. Rowe Price Tax-Free Funds. 1996 Amendments Adopting Release, *supra* note 20, at n.122.

<sup>29</sup> The Commission expects to withdraw the staff position if we adopt the proposed rule.

<sup>30</sup> Proposed Rule 5b-3(a). A fund would be permitted to look through only that portion of the repurchase agreement that is collateralized fully. Any agreement or portion of an agreement that is not collateralized fully would be treated as a loan by the fund to the counterparty. Even if a repurchase agreement is collateralized fully, a fund may elect to look to the counterparty rather than the underlying securities in meeting the diversification requirements of Section 5(b)(1).

action positions, the proposed rule also would require the board of directors or its delegate to evaluate the counterparty's creditworthiness.<sup>31</sup> A similar requirement would be added to Rule 2a-7.<sup>32</sup>

The proposed rule generally would incorporate the definition of "collateralized fully" currently employed in Rule 2a-7.<sup>33</sup> A repurchase agreement would be collateralized fully if:

(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;<sup>34</sup> (ii) the collateral for the repurchase agreement consists entirely of cash items, U.S. government securities, or other securities of a high quality;<sup>35</sup> and (iii) the repurchase agreement 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.<sup>36</sup>

The Rule 2a-7 definition of "collateralized fully" also requires either the fund or its custodian to have physical possession of the collateral or a book entry to be maintained in the name of the fund or its custodian.<sup>37</sup> This provision derived from a Commission staff position requiring funds to acquire actual or constructive possession of repurchase agreement collateral.<sup>38</sup> In lieu of this requirement, the proposed rule would require the fund to perfect its security interest in the repurchase agreement collateral and maintain the collateral in an account with the fund's custodian or a third party that qualifies as a custodian under the Act.<sup>39</sup> This proposal, which we believe generally would not require a change from current practice, is intended to update the definition of "collateralized fully" in light of the 1994 revisions to the Uniform

<sup>31</sup> *Id.* See Release 13005, *supra* note 16; Investment Company Institute, *supra* note 16.

<sup>32</sup> Proposed Rule 2a-7(c)(4)(ii)(A). This requirement is not new. In Investment Company Act Release No. 22383 (Dec. 10, 1996) [61 FR 66621 (Dec. 18, 1996)] (proposing technical amendments to Rule 2a-7), at note 32, the Commission stated that a money market fund must continue to evaluate the counterparty's creditworthiness in order to minimize the risk of becoming involved in bankruptcy proceedings, consistent with the no-action position stated in Release 13005.

<sup>33</sup> Rule 2a-7(a)(5).

<sup>34</sup> Proposed Rule 5b-3(c)(1)(i) requires the value of the securities collateralizing the repurchase agreement to be, and during the entire term of the agreement to remain, at least equal to the resale price. The term "resale price" is defined in paragraph (c)(7) of the proposed rule as the acquisition price paid to the seller plus the accrued resale premium, i.e., the return on investment specified in the agreement. Consistent with prior staff positions, the market value of the securities held as collateral must be marked to market daily during the entire term of the agreement to ensure that the collateral is at all times at least equal to the resale price, and the repurchase agreement should provide for the delivery of additional collateral if the market value of the securities falls below the resale price. See Letter from Gerald Osheroff, *supra* note 5. Under the proposed rule, the fund's expected return on its investment may be either the full amount specified in the agreement or the daily amortization of the difference between the purchase price and the resale price specified in the agreement. This allows the counterparty to add to the collateral as interest on the loan accrues. See 1996 Amendments Proposing Release, *supra* note 20, at n.176 and accompanying text.

<sup>35</sup> Proposed Rule 5b-3(c)(1)(iv). Any securities other than government securities must be rated in the highest rating category by the "requisite NRSROs." *Id.* See also *infra* text accompanying notes 41-43 (describing this proposed quality requirement and requesting comment). "Requisite NRSROs" are defined in paragraph (c)(6) of the proposed rule as any two NRSROs, or, if only one NRSRO has issued a rating at the time the fund acquires the security, that NRSRO. "NRSRO" is defined in paragraph (c)(5) as any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi)(E), (F) and (H) of Rule 15c3-1 [17 CFR 240.15c3-1] under the Securities Exchange Act of 1934 [15 U.S.C. 78a-mm], that is not an "affiliated person," as defined in Section 2(a)(3)(C) of the Act [15 U.S.C. 80a-2(a)(3)(C)], of the issuer of, or any insurer or provider of credit support for, the security.

<sup>36</sup> Proposed Rule 5b-3(c)(1)(v).

<sup>37</sup> Rule 2a-7(a)(5)(ii).

<sup>38</sup> See Release 13005, *supra* note 16, at n.2 and accompanying text. In Release 13005, the Division stated that the requirement of actual or constructive possession was intended to ensure that the fund would be able to liquidate the collateral immediately upon any default or insolvency of the seller. Constructive possession included the transfer of book-entry securities. See *id.* The staff also provided guidance with respect to the custody requirements in a letter from Kathryn McGrath, Director, Division of Investment Management, to Matthew Fink, General Counsel, Investment Company Institute (June 19, 1985). Among other things, the letter noted the staff's position that "a repurchase agreement is fully collateralized only if the collateral is in the actual or constructive possession of the investment company." The letter also noted that the staff would consider a fund to have constructive possession of collateral when the collateral has been transferred to the fund's custodian or to the care of a third party to the repurchase agreement that would qualify as a custodian for fund assets under Section 17(f) of the Act [15 U.S.C. 80a-17(f)].

<sup>39</sup> Proposed Rule 5b-3(c)(1)(ii), (iii).



Commercial Code, which address the evolution of the indirect system for holding securities.<sup>40</sup> The updated requirement would, we believe, more accurately reflect the steps that a fund should take to protect its interests in repurchase agreement collateral. The Commission requests comment on this proposal. Should the definition of collateralized fully specifically require funds to perfect their security interests in repurchase agreement collateral by obtaining “control” of the collateral?<sup>41</sup>

We understand that some funds engage in “hold-in-custody” repurchase agreements (“HIC repos”)<sup>42</sup> with their custodians as a means of investing cash that they receive late in the business day. Some commentators have suggested that these transactions entail the risk that the fund would not be able to liquidate the collateral promptly if the custodian were to become insolvent.<sup>43</sup> The Commission requests comment on risks posed by these transactions and whether HIC repos should be considered “collateralized fully” under Rule 5b-3.

Most repurchase agreements are collateralized with U.S. government securities, and the staff positions with respect to Section 5(b)(1) have limited the collateral to those securities.<sup>44</sup> Under the proposed rule, cash collateral also could be used, as well as other high quality securities. The Commission is proposing to limit the high quality securities that may be used as collateral based on the same standards currently contained in Rule 2a-7 for money market funds.<sup>45</sup> The high quality requirement is designed to limit a fund’s exposure to the ability of the counterparty to maintain sufficient collateral.<sup>46</sup> In addition, use of this Rule 2a-7 standard would permit a fund complex to establish uniform criteria for repurchase agreements among funds. Comment is requested whether the rule should include these minimum quality standards for collateral. Are there any other criteria that would be preferable?

As discussed above, the proposed rule also requires the fund to evaluate the counterparty’s creditworthiness.<sup>47</sup> This evaluation, which currently is required under staff no-action positions, is designed to require the fund to determine whether the counterparty presents a serious risk of becoming involved in bankruptcy proceedings.<sup>48</sup> The Commission requests comment on the need for this evaluation of the counterparty’s creditworthiness in light of the proposed

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<sup>40</sup> See generally UCC, Revised Article 8—Investment Securities (With Conforming and Miscellaneous Amendments to Articles 1,4, 5, 9, and 10) (1994 Official Text with Comments), 2C Uniform Laws Annotated (West Supp. 1997), Prefatory Note at I.D., II.B., II.C., II.D. As of April 1, 1999, the 1994 amendments to UCC Article 8 had been adopted by 48 states, the District of Columbia, and Puerto Rico. The most recent information regarding the status of proposed UCC revisions in the state legislatures can be obtained by contacting the National Conference of Commissioners on Uniform State Laws at (312) 915-0195.

<sup>41</sup> Under the 1994 revisions to the UCC, the primary means to perfect a security interest in investment securities is by obtaining “control” of the securities. See UCC, Revised Article 8, §§ 8-106, 9-115(4). In general, obtaining “control” means taking the steps necessary to place a secured lender in a position where it can have the collateral sold off without the further cooperation of the debtor. See UCC, Revised Article 8, Prefatory Note at II.D.

<sup>42</sup> In a HIC repo, the seller merely segregates the collateral during the term of the agreement, rather than transferring it to the buyer or to a third party. Ellen Taylor, *Trader’s Guide To The Repo Market* 25-26 (1995).

<sup>43</sup> See Seth Grosshandler, Lech Kalembka & Daniel Feit, *Securities, Forward and Commodity Contracts and Repurchase And Swap Agreements Under U.S. Insolvency Laws* (1995), 721 PLI/Comm 401, 434 (qualified financial contract provisions do not protect the right of a purchaser of securities under a HIC repo to compel delivery of the securities from the FDIC as conservator or receiver); see also *id.* at 416 (Bankruptcy Code does not appear to protect the right of a purchaser of securities under a HIC repo to compel delivery of the securities from the bankrupt).

<sup>44</sup> See *MoneyMart Assets*, *supra* note 10. The staff’s no-action positions with respect to the treatment of repurchase agreements for purposes of section 12(d)(3) did not expressly limit the type of eligible collateral. See Release 10666, *supra* note 4; Release 13005, *supra* note 16.

<sup>45</sup> Rule 2a-7(a)(5)(iii); see also *supra* note 32.

<sup>46</sup> Securities of lower quality may be subject to greater price fluctuation. In the event of a steep drop in the market value of the collateral, it may be difficult for the counterparty to deliver additional securities sufficient to ensure that the repurchase agreement remains fully collateralized. If the counterparty does not deliver sufficient additional securities and thus defaults, the fund may be unable to realize the full value of the repurchase agreement upon liquidation of the collateral. In addition, high quality securities are generally more liquid than lower quality securities. A fund could more readily liquidate high quality securities in the event of a counterparty default.

<sup>47</sup> See *supra* note 28 and accompanying text.

<sup>48</sup> See Release 13005, *supra* note 16, at n.6.

requirement that repurchase agreements qualify for the preferred treatment now given to certain repurchase agreements under the Bankruptcy Code.<sup>49</sup>

### **B. Proposed Rule 5b-3(b): Treatment of Pre-Refunded Bonds**

Proposed Rule 5b-3 would codify for purposes of Section 5(b)(1) the conditions specified in the staff's no-action position permitting a fund to treat an investment in a "refunded security" as an investment in the escrowed U.S. government securities for purposes of Section 5(b)(1).<sup>50</sup> The rule, however, would not limit the amount of pre-refunded bonds of any one issuer that a fund could acquire.<sup>51</sup>

Under the proposed rule, a "refunded security" would be defined 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 pledged only to the payment of the debt security.<sup>52</sup> 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.<sup>53</sup> 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.<sup>54</sup> This treatment corresponds to the treatment given to pre-refunded bonds in Rule 2a-7.<sup>55</sup>

### **C. Availability of Rule 12d3-1 for Repurchase Agreements**

The Commission also proposes to amend Rule 12d3-1, which provides an exemption from the prohibition in Section 12(d)(3) on acquiring an interest in a broker-dealer or a bank engaged in a securities-related business.<sup>56</sup> The amendment would affect only repurchase agreements that do not meet the conditions for looking through the agreements to the underlying collateral. As discussed above, if a fund enters into a repurchase agreement with a broker-dealer or other counterparty that is engaged in securities related activities, and the fund is unable to look through the agreement to the underlying collateral, the fund may be in violation of Section 12(d)(3) of the Act.<sup>57</sup> Rule 12d3-1 provides an exemption from Section 12(d)(3) under certain conditions, but a note appended to Rule 12d3-1 currently makes the rule unavailable for repurchase agreements that fail to meet the requirements for look-through treatment set forth in Investment Company Act Release No. 13005 ("Release 13005").<sup>58</sup> We are proposing to eliminate that note, and thus allow funds to rely on Rule 12d3-1 even if the repurchase agreement does not meet the requirements of Release 13005. The Commission requests comment whether it is appropriate to permit funds to enter into repurchase agreements with broker-dealers when the transaction does not meet all of the requirements of proposed Rule 5b-3, but does meet the requirements of Rule 12d3-1.<sup>59</sup>

<sup>49</sup> When we proposed amendments to Rule 2a-7 in 1993, we requested comment on the need for a credit risk determination in light of the amendments to the Bankruptcy Code. 1996 Amendments Proposing Release, *supra* note 20, at n.173 and accompanying text. Most commenters urged that the determination be retained.

<sup>50</sup> Proposed Rule 5b-3(b).

<sup>51</sup> See T. Rowe Price Tax-Free Funds, *supra* note 24.

<sup>52</sup> Proposed Rule 5b-3(c)(4).

<sup>53</sup> Proposed Rule 5b-3(c)(4)(i), (ii).

<sup>54</sup> Proposed Rule 5b-3(c)(4)(iii). The proposed rule makes an exception to the certification requirement if the refunded security has received the highest rating from an NRSRO. *Id.*

<sup>55</sup> See Rule 2a-7(a)(20), (c)(4)(ii)(B); see also 1996 Amendments Proposing Release, *supra* note 20, at Section II.A.3

<sup>56</sup> See *supra* note 5.

<sup>57</sup> See *supra* notes 5-7 and accompanying text.

<sup>58</sup> See Release 13005, *supra* note 16. Rule 12d3-1 provides an exemption for purchases of securities of any entity that derived fifteen percent or less of its gross revenues from securities related activities in its most recent fiscal year, unless the acquiring company would control the entity after the purchase. If the entity derived more than fifteen percent of its gross revenues from securities related activities, the rule provides a limited exemption based on the amount and value of the securities purchased. The note to the rule states: "Note: It is not intended that this rule should supersede the requirements prescribed in Investment Company Act Release No. 13005 (Feb. 2, 1983) with respect to repurchase agreements with brokers or dealers."

<sup>59</sup> A fund investing in a repurchase agreement that does not meet the requirements of the proposed rule would not be able to "look through" the agreement and must instead treat the counterparty to the agreement as the issuer.

#### D. Conforming Amendments to Rule 2a-7

We are also proposing conforming amendments to Rule 2a-7. These amendments would add to Rule 2a-7 the requirement that a money market fund must evaluate the counterparty's creditworthiness in order to treat the acquisition of a repurchase agreement as an acquisition of the underlying securities.<sup>60</sup> In addition, the proposed amendments would replace the definitions of "collateralized fully," "event of insolvency," and "refunded security," currently set forth in Rule 2a-7 with cross references to the corresponding definitions set forth in proposed Rule 5b-3.<sup>61</sup>

#### E. Request for Comments

Any interested persons wishing to submit written comments on the proposed rule and rule amendments that are the subject of this Release, to suggest additional provisions or changes to the rules, or to submit comments on other matters that might have an effect on the proposals contained in this Release, are requested to do so. The Commission specifically requests comment whether a fund should be allowed to look through any other types of investments to underlying securities for purposes of diversification, the prohibition of Section 12(d)(3), or any other provision of the Investment Company Act. Commenters suggesting alternative approaches are encouraged to submit suggested rule text.

The Commission also requests comment whether the proposals, if adopted, would promote efficiency, competition, and capital formation. We will consider these comments pursuant to our responsibilities under Section 2(c) of the Investment Company Act.<sup>62</sup> The Commission encourages commenters to provide empirical data or other facts to support their views. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>63</sup> the Commission also requests information regarding the potential impact of the proposed rule and rule amendments on the economy on an annual basis. Commenters are requested to provide empirical data to support their views.

### III. Cost/Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. For the most part, the proposed rule would codify current staff positions. By codifying a number of staff no-action positions issued over a nearly twenty year period, the proposed rule should make it easier for funds to determine whether, and under what conditions, they are permitted to look through repurchase agreements or pre-refunded bonds to the underlying securities for purposes of Sections 5(b)(1) and 12(d)(3) of the Act. In addition, the proposed rule would use substantially the same standards currently specified in Rule 2a-7 for the treatment of repurchase agreements and pre-refunded bonds by money market funds. With this uniform treatment, fund complexes that include money market funds may be more efficient in monitoring compliance with the requirements of the rules for all types of funds.

As discussed above, the proposed rule would be limited to repurchase agreements in which the underlying collateral consists of cash items, U.S. government securities, or other securities that meet certain quality standards. As proposed, the rule tracks the language of Rule 2a-7, generally requiring any "other securities" to carry the highest rating of two national rating agencies ("NRSROs," as defined in the rule). This proposed requirement is intended to ensure that the market value of the collateral will remain fairly stable and that the fund will be able to liquidate the collateral quickly in the event of a default. This limitation on collateral is more restrictive than the staff's position with respect to the treatment of repurchase agreements for purposes of Section 12(d)(3),<sup>64</sup> but it is less restrictive than the staff's position with respect to Section 5(b)(1).<sup>65</sup> Since most repurchase agreements are collateralized by U.S. government securities, which clearly fall within the proposed rule's limitations, it appears that the limitation will not have any significant impact on funds.

<sup>60</sup> Proposed Rule 2a-7(c)(4)(ii)(A). As noted above, this merely codifies a current staff requirement. *See supra* note 29.

<sup>61</sup> Proposed Rule 2a-7(a)(5), (11) and (20) (cross-referencing proposed Rule 5b-3(c)(1), (2), and (4)).

<sup>62</sup> 15 U.S.C. 80a-2(c).

<sup>63</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

<sup>64</sup> Release 13005, *supra* note 16, did not specify the type of collateral, merely noting that the "securities most frequently used in connection with repurchase agreements are Treasury bills and other United States Government securities."

<sup>65</sup> The staff's no-action position in MoneyMart Assets, *supra* note 10, was conditioned on the collateral consisting entirely of U.S. government securities.

The proposed rule is limited to repurchase agreements that qualify for an exclusion from any automatic stay under applicable insolvency law. Although this requirement is included in Rule 2a-7, it was not a feature of the staff positions, which generally pre-dated the relevant changes in the Bankruptcy Code. Again, because most repurchase agreements qualify for an exclusion, this limitation should not have any significant impact on funds. The limitation will, however, provide important protections for investors by ensuring that a fund can liquidate the collateral quickly in the event of the counterparty's bankruptcy.

The proposed amendment to Rule 12d3-1 would eliminate the "Note" to the rule that renders the rule unavailable to repurchase agreements. The Commission believes that funds should be allowed to rely on Rule 12d3-1 in cases in which a repurchase agreement does not meet all of the conditions of proposed Rule 5b-3. This amendment will provide additional flexibility for funds without impairing investor interests.

The Commission requests comment on the costs and benefits of the proposed rule and rule amendments. To the extent possible, please quantify any significant costs or benefits.

#### **IV. Summary of Initial Regulatory Flexibility Analysis**

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA") in accordance with 5 U.S.C. 603 regarding proposed Rule 5b-3, and the conforming amendments to Rules 2a-7 and 12d3-1. The IRFA indicates that the new rule would codify the staff's position that a fund may look through a fully collateralized repurchase agreement to the underlying securities for purposes of Sections 5(b)(1) and 12(d)(3) of the Act, and add the requirement of Rule 2a-7 that the repurchase agreement qualify for an exclusion from any automatic stay of creditors' rights under applicable insolvency law. The IRFA indicates that proposed Rule 5b-3 also would permit a fund to treat the acquisition of certain pre-refunded bonds as an acquisition of the escrowed securities for purposes of Section 5(b)(1) of the Act. In addition, the IRFA explains that the proposed amendment to Rule 12d3-1 would eliminate the "Note" appended to the rule in order to allow funds to rely on Rule 12d3-1 even if the repurchase agreement is not collateralized fully. Finally, the IRFA states that the conforming amendments to Rule 2a-7 are intended to simplify and update the provisions of that rule that address repurchase agreements and refunded securities.

The IRFA sets forth the statutory authority for the proposed rule and rule amendments. The IRFA also discusses the effect of the proposed rule and rule amendments on small entities. For purposes of the Investment Company Act and the Regulatory Flexibility Act, a fund is a small entity if the fund, together with other funds in the same group of related funds, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>66</sup>

The IRFA states that proposed Rule 5b-3 will affect (i) any fund that invests in a repurchase agreement with a broker, dealer, underwriter, or bank that is engaged in a securities-related business, when the investment may otherwise be prohibited by Section 12(d)(3) of the Act, and (ii) any fund that holds itself out as a diversified investment company under Section 5(b)(1) of the Act and that invests in repurchase agreements or pre-refunded bonds.

As of December 31, 1998, there were approximately 4,300 registered funds. Of this number, the Commission staff estimates that there are approximately 269 funds that are small entities. These funds could be affected by the proposed rule's treatment of investments in repurchase agreements for purposes of Section 12(d)(3) of the Act. As of December 31, 1998, there were approximately 2,500 registered funds with one or more portfolios that hold themselves out to be diversified companies. Of this number, the Commission staff estimates that there are approximately 73 funds that are small entities. These funds could be affected by proposed rule's treatment of investments in repurchase agreements and pre-refunded bonds for purposes of Section 5(b)(1) of the Act.

The IRFA explains that the proposed rule should not have a significant economic impact on these funds, including those that are small entities. It would not effect significant changes to the current treatment of repurchase agreements and pre-refunded bonds, but instead would codify and update a number of no-action positions that have been taken by the Commission staff.

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<sup>66</sup> 17 CFR 270.0-10.

The IRFA states that the proposed amendment to Rule 2a-7 would affect money market funds. As of December 31, 1998, there were approximately 300 registered funds with one or more portfolios that are money market funds. Of this number, it is estimated that approximately 3 were small entities. The proposed amendment, however, would only update one aspect of Rule 2a-7, and it appears that the updated provision would not require a change from current practice. The proposal thus should not have a significant economic impact on a substantial number of small entities.

The IRFA states that the proposed amendment to Rule 12d3-1 will affect any fund that invests in a repurchase agreement with a broker, dealer, underwriter, or bank that is engaged in a securities-related business, when the investment may otherwise be prohibited by Section 12(d)(3) of the Act. As stated above, there were approximately 4,300 registered funds as of December 31, 1998, of which approximately 269 funds were small entities. These funds would benefit from the proposed amendment to Rule 12d3-1, which would allow funds to rely on that rule even if the repurchase agreement does not meet the requirements of the Commission staff positions.

The IRFA explains that the proposed rule and rule amendments would not impose any new reporting or recordkeeping requirements. The proposals do not involve major changes in compliance requirements because they mainly codify existing Commission staff positions. The IRFA states that the definition of “collateralized fully” in proposed Rule 5b-3 supplements prior staff positions by requiring that the repurchase agreement qualify for an exclusion from any automatic stay of creditors’ rights under applicable insolvency law. The definition also has been updated to reflect the 1994 revisions to the UCC. It appears, however, that this change generally would not require a change from current practice. There are no rules that duplicate, overlap or conflict with the proposed rule and rule amendments.

The IRFA discusses the various alternatives considered by the Commission that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed rule and rule amendments, the Commission considered the following alternatives: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities. The IRFA notes that the proposed rule and rule amendments are not intended to effect major substantive changes to the current treatment of repurchase agreements and pre-refunded bonds, but would essentially codify a number of no-action positions taken by the Commission staff. Because the proposed rule and rule amendments are designed to clarify the appropriate treatment of investments by funds in repurchase agreements and pre-refunded bonds for various purposes of the Act, and to provide investment flexibility for funds of all sizes, it would be inconsistent with the purposes of the Regulatory Flexibility Act to propose to exempt small entities from their coverage. Further clarification, consolidation, or simplification of the proposals, or specification of different compliance standards for small entities, would not be appropriate, because the proposals set forth the minimum standards consistent with investor protection. For the same reasons, the use of performance standards would be inappropriate. Overall, it appears that the proposed rule and rule amendments would not have an adverse effect on small entities.

The IRFA states that the Commission encourages the solicitation of comments with respect to any aspect of the IRFA. Comment is specifically requested on the number of small entities that would be affected by the proposed rule and rule amendments, and the likely impact of the proposals on small entities. A copy of the IRFA may be obtained by contacting Marilyn Mann, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0506.

## **V. Statutory Authority**

The Commission is proposing new Rule 5b-3, and is proposing amendments to Rule 2a-7 and to Rule 12d3-1, pursuant to the authority set forth in Sections 6(c) and 38(a) of the Act [15 U.S.C. 80a-6(c) and 80a-37(a)].

List of Subjects

17 CFR Part 270

Investment Companies, Reporting and recordkeeping requirements, Securities.

## Text of Proposed Rule and Rule Amendments

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

### Part 270—Rules and Regulations, Investment Company Act of 1940

1. The authority citation for Part 270 continues to read, in part, as follows:

Authority: *15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, 80a-39* unless otherwise noted:

\* \* \* \*

2. Section 270.2a-7 is amended by revising paragraphs (a)(5), (a)(11), (a)(20) and (c)(4)(ii)(A) to read as follows:

§ 270.2a-7 Money market funds.

(a) Definitions.

\* \* \*

(5) Collateralized Fully means “Collateralized Fully” as defined in § 270.5b-3(c)(1).

\* \* \*

(11) Event of Insolvency means “Event of Insolvency” as defined in § 270.5b-3(c)(2).

\* \* \*

(20) Refunded Security means “Refunded Security” as defined in § 270.5b-3(c)(4).

\* \* \* \*

(c) Share Price Calculations. \* \* \*

\* \* \*

(4) Portfolio Diversification.

\* \* \*

(ii) Issuer Diversification Calculations. \* \* \*

(A) Repurchase Agreements. The Acquisition of a repurchase agreement may be deemed to be an Acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully and the fund’s board of directors (or the person delegated by the board under paragraph (e) of this section) has evaluated the seller’s creditworthiness.

\* \* \* \*

3. Section 270.5b-3 is added to read as follows:

§ 270.5b-3 Acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities.

(a) Repurchase Agreements. For purposes of Sections 5 and 12(d)(3) of the Act (*15 U.S.C. 80a-5, 80a-12(d)(3)*), the acquisition of a repurchase agreement may be deemed to be an acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the investment company is Collateralized Fully and the board of directors or its delegate has evaluated the seller’s creditworthiness.

(b) Refunded Securities. For purposes of Section 5 of the Act (*15 U.S.C. 80a-5*), the acquisition of a Refunded Security shall be deemed to be an acquisition of the escrowed Government Securities.

(c) Definitions. As used in this section:

(1) Collateralized Fully in the case of a repurchase agreement means that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the investment company reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price provided in the agreement;

(ii) The investment company has perfected its security interest in the collateral;

(iii) The collateral is maintained with the investment company's custodian or a third party that qualifies as a custodian under the Act;

(iv) The collateral consists entirely of cash items, Government Securities or other securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the Requisite NRSROs; and

(v) Upon an Event of Insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller.

(2) Event of Insolvency means, with respect to a person:

(i) An admission of insolvency, the application by the person for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; or

(ii) The institution of similar proceedings by another person which proceedings are not contested by the person; or

(iii) The institution of similar proceedings by a government agency responsible for regulating the activities of the person, whether or not contested by the person.

(3) Government Security means any "Government Security" as defined in Section 2(a)(16) of the Act (*15 U.S.C. 80a-2(a)(16)*).

(4) Refunded Security means a debt security the principal and interest payments of which are to be paid by Government Securities ("deposited securities") that have been irrevocably placed in an escrow account pursuant to an agreement between the issuer of the debt security and an escrow agent that is not an "affiliated person," as defined in Section 2(a)(3)(C) of the Act (*15 U.S.C. 80a-2(a)(3)(C)*), of the issuer of the debt security, and, in accordance with such escrow agreement, are pledged only to the payment of the debt security and, to the extent that excess proceeds are available after all payments of principal, interest, and applicable premiums on the Refunded Securities, the expenses of the escrow agent and, thereafter, to the issuer or another party; provided that:

(i) The deposited securities shall not be redeemable prior to their final maturity;

(ii) The escrow agreement shall prohibit the substitution of the deposited securities unless the substituted securities are Government Securities; and

(iii) At the time the deposited securities are placed in the escrow account, or at the time a substitution of the deposited securities is made, an independent certified public accountant shall have certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities; provided however, an independent public accountant need not have provided the certification described in this paragraph (c)(4)(iii) if the security, as a Refunded Security, has received a rating from an NRSRO in the highest category for debt obligations (within which there may be sub-categories or gradations indicating relative standing).

(5) NRSRO means any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi) (E), (F) and (H) of § 240.15c3-1 of this chapter, that is not an “affiliated person,” as defined in Section 2(a)(3)(C) of the Act (15 U.S.C. 80a-2(a)(3)(C)), of the issuer of, or any insurer or provider of credit support for, the security.

(6) Requisite NRSROs means:

(i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or

(ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO.

(7) Resale Price means the acquisition price paid to the seller of the securities plus the accrued resale premium on such acquisition price. The accrued resale premium shall be the amount specified in the repurchase agreement or the daily amortization of the difference between the acquisition price and the resale price specified in the repurchase agreement.

4. Section 270.12d3-1 is amended by removing the appended Note.

By the Commission.

Jonathan G. Katz

Secretary

September 23, 1999



## **ADOPTION OF REQUIREMENTS REGARDING TREATMENT OF REPURCHASE AGREEMENTS AND REFUNDED SECURITIES AS AN ACQUISITION OF THE UNDERLYING SECURITIES**

Release No. IC-25058

July 5, 2001

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission is adopting a new rule and related rule amendments under the Investment Company Act of 1940 that affect the ability of investment companies to invest in repurchase agreements and pre-refunded bonds under the Act. The final rule codifies and updates staff positions that have permitted investment companies to “look through” counterparties to certain repurchase agreements and issuers of municipal bonds that have been “refunded” with U.S. government securities and treat the securities comprising the collateral as investments for certain purposes under the Act.

**EFFECTIVE DATE:** August 15, 2001.

**FOR FURTHER INFORMATION CONTACT:** Hugh Lutz, Attorney, or Martha B. Peterson, Special Counsel, Office of Regulatory Policy, at (202) 942-0690, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0506.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission today is adopting new Rule 5b-3 [*17 CFR 270.5b-3*] and conforming amendments to Rules 2a-7 [*17 CFR 270.2a-7*] and 12d3-1 [*17 CFR 270.12d3-1*] under the Investment Company Act of 1940 [*15 U.S.C. 80a*] (“Investment Company Act” or “Act”).<sup>1</sup>

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<sup>1</sup> Unless otherwise noted, all references to Rule 2a-7 or Rule 12d3-1, or to any paragraph of those rules, will be to *17 CFR 270.2a-7* and *17 CFR 270.12d3-1*, respectively.

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### Executive Summary

Repurchase agreements provide investment companies (“funds”) with a convenient means to invest excess cash on a secured basis, generally for short periods of time. In a typical fund repurchase agreement, a fund enters into a contract with a broker, dealer, or bank (the “counterparty” to the transaction) for the purchase of securities. The counterparty agrees to repurchase the securities at a specified future date, or on demand, for a price that is sufficient to return to the fund its original purchase price, plus an additional amount representing the return on the fund’s investment.

The Commission is adopting Rule 5b-3, which permits a fund, subject to certain conditions, to treat a repurchase agreement as an acquisition of the underlying collateral in determining whether it is in compliance with (i) the investment criteria for diversified funds set forth in Section 5(b)(1) of the Act<sup>2</sup> and (ii) the prohibition on fund acquisition of an interest in a broker-dealer in Section 12(d)(3) of the Act.<sup>3</sup> Rule 5b-3 also provides for similar “look-through” treatment for purposes of Section 5(b)(1) of the Act in the case of an investment in state or municipal bonds, the payment of which has been fully funded by escrowed U.S. government securities.

The new rule codifies and updates staff interpretive and no-action letters. It is intended to adapt the Act to economic realities of repurchase agreements and pre-refunded bonds and reflects recent developments in bankruptcy law protecting parties to repurchase agreements.

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<sup>2</sup> 15 U.S.C. 80a-5(b)(1).

<sup>3</sup> 15 U.S.C. 80a-12(d)(3).

## I. Background

Repurchase agreements provide funds with a means to invest idle cash at competitive rates for short periods. While a repurchase agreement has legal characteristics of both a sale and a secured transaction, economically it functions as a loan from the fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan and are placed in the possession or under the control of the fund's custodian during the term of the agreement.<sup>4</sup>

Two provisions of the Act may affect a fund's ability to invest in repurchase agreements. Section 12(d)(3) of the Act generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter. Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty, Section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as counterparties.<sup>5</sup> Section 5(b)(1) of the Act limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. Government). This provision may limit the amount of repurchase agreements that a diversified fund may enter into with any one counterparty.

A fund investing in a properly structured repurchase agreement looks primarily to the value and liquidity of the collateral rather than the credit of the counterparty for satisfaction of the repurchase agreement. In two separate no-action positions issued in 1979 and 1980, the staff stated that, for purposes of Sections 12(d)(3) and 5(b)(1) of the Act, a fund may treat a repurchase agreement as an acquisition of the underlying collateral if the repurchase agreement is "collateralized fully."<sup>6</sup> Because most repurchase agreements are collateralized fully by highly liquid U.S. government securities, this "look-through" treatment allowed funds to treat repurchase agreements as investments in government securities. As a result, a fund could invest in repurchase agreements with the same counterparty without the limitations of Section 12(d)(3) or 5(b)(1).<sup>7</sup>

On September 23, 1999, the Commission issued a release proposing to codify and update these staff no-action positions.<sup>8</sup> We proposed new Rule 5b-3 that would permit a fund, under certain circumstances, to look through repurchase agreements to the underlying securities for purposes of Sections 5(b)(1) and 12(d)(3) of the Act. The proposed rule included conditions for looking through a repurchase agreement that were substantially similar to the conditions governing "look-through" treatment for money market funds under Rule 2a-7 for purposes of complying with the rule's diversification requirements.<sup>9</sup> We also proposed to codify a 1993 staff no-action position that permits funds, under certain conditions, to look through pre-refunded bonds to the escrowed government securities for purposes of the Section

<sup>4</sup> See Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 24050 (Sept. 23, 1999) [64 FR 52476 (Sept. 29, 1999)] ("Proposing Release"), at n.4 and accompanying text.

<sup>5</sup> With minor exceptions, Section 12(d)(3) prohibits an investment company from purchasing or otherwise acquiring "any security issued by or any other interest in the business of any person who is a broker, a dealer, [or] is engaged in the business of underwriting." The staff has taken the position that fund repurchase agreements with banks that are engaged in a securities-related business, including dealing in government securities, may be subject to the prohibitions of section 12(d)(3). See Letter from Gerald Osheroff, Associate Director, Division of Investment Management, to Matthew Fink, General Counsel, Investment Company Institute (May 7, 1985).

<sup>6</sup> In 1979, the staff announced that it would not recommend enforcement action under Section 12(d)(3) if the repurchase agreement was "structured in a manner reasonably designed to collateralize fully the investment company loan." Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)] ("Release 10666"). The following year, the staff applied this no-action position to a fund's compliance with the diversification requirements of Section 5(b)(1) of the Act. MoneyMart Assets, Inc., SEC No-Action Letter (Sept. 3, 1980).

<sup>7</sup> Repurchase agreements with broker-dealers affiliated with the fund would, of course, continue to raise serious questions under Sections 17(a) and 17(d) of the Act [15 U.S.C. 80a-17(a), 15 U.S.C. 80a-17(d)]. See Release 10666, *supra* note 6, at n.24.

<sup>8</sup> See Proposing Release, *supra* note 4.

<sup>9</sup> In 1996, when the Commission amended Rule 2a-7, we tied the availability of "look-through" treatment to the preferred treatment given to repurchase agreements under the Bankruptcy Code and related insolvency statutes. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)]. Proposed Rule 5b-3 included similar requirements. In addition, we proposed conforming amendments to Rule 2a-7 so that it would be consistent with Rule 5b-3.

5(b)(1) diversification requirements.<sup>10</sup> Finally, we proposed to eliminate a note to Rule 12d3-1, which makes the rule's limited exemption from Section 12(d)(3) of the Act unavailable for repurchase agreements, including those that were not collateralized fully.

The Commission received letters from four commenters on the Proposing Release, including the Investment Company Institute, which supported adoption of the rule.<sup>11</sup> We are adopting Rule 5b-3, amendments to rule 2a-7, and amendments to Rule 12d3-1, with certain changes suggested by these commenters.

## II. Discussion

### A. Qualifying Repurchase Agreements

New Rule 5b-3(a) allows funds to treat the acquisition of a repurchase agreement as an acquisition of the underlying securities for purposes of Sections 5(b)(1) and 12(d)(3) of the Act if the obligation of the seller to repurchase the securities from the fund is “collateralized fully.”<sup>12</sup> A repurchase agreement is “collateralized fully” if: (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;<sup>13</sup> (ii) the fund has perfected its security interest in the collateral; (iii) the collateral is maintained in an account of the fund with its custodian or a third party that qualifies as a custodian under the Act;<sup>14</sup> (iv) the collateral for the repurchase agreement consists entirely of: (A) cash items; (B) U.S. government securities; (C) securities that at the time the repurchase agreement is entered into are rated in the highest category by the “Requisite NRSROs”;<sup>15</sup> or (D) unrated securities that are of comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the fund's board of directors or its delegate; and (v) the repurchase agreement 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.

#### 1. Acceptable Types of Collateral

New Rule 5b-3 specifies the types of collateral that may be used to “collateralize fully” a repurchase agreement eligible for “look-through” treatment under the rule. We have expanded acceptable collateral to include unrated securities that are of comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the investment company's board of directors or its delegate.<sup>16</sup> We are not, however, adopting a recommendation by two commenters that we altogether eliminate the rule's requirements regarding the credit quality of the collateral. A requirement that the underlying collateral be of highest quality limits a fund's exposure to the ability of the counterparty

<sup>10</sup> T. Rowe Price Tax-Free Funds, SEC No-Action Letter (June 24, 1993). In the letter, the Division of Investment Management agreed not to recommend any enforcement action if a fund treated an investment in municipal bonds refunded with escrowed government securities as an investment in the government securities for purposes of Section 5(b)(1). This no-action position was based on certain representations, including that (1) the deposit of the government securities was irrevocable and pledged only to the debt service on the original bonds, (2) payments from the escrow would not be subject to the preference provisions or automatic stay provisions of the Bankruptcy Code, and (3) no fund would invest more than 25 percent of its assets in the pre-refunded bonds of any single municipal issuer.

<sup>11</sup> The commenters included two trade associations, one investment adviser, and a bank. The comment letters are available in the Commission's Public Reference Room, 450 5th Street, N.W., Washington, D.C. (File No. S7-21-99).

<sup>12</sup> Rule 5b-3(a). A fund may only look through only that portion of the repurchase agreement that is collateralized fully. Any agreement or portion of an agreement that is not collateralized fully would be treated as a loan by the fund to the counterparty. Use of Rule 5b-3(a) is optional: even if a fund can look through the repurchase agreement, it may choose to look to the counterparty rather than the underlying securities in meeting the diversification requirements of Section 5(b)(1).

<sup>13</sup> The term “resale price” is defined in Rule 5b-3(c)(7) as the acquisition price paid to the seller plus the accrued resale premium, i.e., the return on investment specified in the agreement.

<sup>14</sup> We have revised this element of the rule to clarify that the collateral would have to be held by a custodian, or third party, in an account of the fund.

<sup>15</sup> The term “Requisite NRSROs” is defined in Rule 5b-3(c)(6) as any two NRSROs, or, if only one NRSRO has issued a rating at the time the fund acquires the security, that NRSRO. “NRSRO” is defined in Rule 5b-3(c)(5) as any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi)(E), (F) and (H) of Rule 15c3-1 [17 CFR 240.15c3-1] under the Securities Exchange Act of 1934 [15 U.S.C. 78a-mm], that is not an “affiliated person,” as defined in Section 2(a)(3)(C) of the Act [15 U.S.C. 80a-2(a)(3)(C)], of the issuer of, or any insurer or provider of credit support for, the security.

<sup>16</sup> Rule 5b-3(c)(1)(iv)(D).

to maintain sufficient collateral. As we noted in the Proposing Release, securities of lower quality may be subject to greater price fluctuation. In the event of a steep drop in the market value of the collateral, the counterparty would have to deliver additional securities sufficient to ensure that the repurchase agreement remains fully collateralized. If the counterparty does not deliver sufficient additional securities and thus defaults, the fund may be unable to realize the full value of the repurchase agreement upon liquidation of the collateral. In addition, high quality securities are more readily liquidated than lower quality securities, in the event of a counterparty default.

## 2. Bankruptcy Treatment

Rule 5b-3 extends “look-through” treatment only to repurchase agreements that qualify for an exclusion from any automatic stay of creditors’ rights under applicable bankruptcy laws.<sup>17</sup> Most comments supported this provision, which we are adopting as proposed. Failure of a repurchase agreement to qualify for an exclusion from an automatic stay would make “look-through” treatment inappropriate because the credit and liquidity risks assumed by the fund would be tied directly to the counterparty rather than the issuer of the underlying collateral.

## 3. Evaluating the Creditworthiness of Counterparties

We are eliminating the requirement, included in the staff no-action positions, and our proposal, that the fund’s board of directors or its delegate evaluate the creditworthiness of the counterparty to a repurchase agreement. As one commenter observed, the creditworthiness assessment was required under the staff no-action letters because, at the time the letters were written, it was not clear whether a repurchase agreement would be subject to the automatic stay provision in the Bankruptcy Code, in the event that the counterparty became insolvent.<sup>18</sup> In light of subsequent amendments to the Code protecting the parties to repurchase agreements and our requirement that funds relying on the rule qualify for Bankruptcy Code protection,<sup>19</sup> we conclude that it is not necessary for the rule to contain a specific requirement that the fund’s directors or their delegate assess the creditworthiness of the counterparty.<sup>20</sup>

### B. Treatment of Pre-Refunded Bonds

We are adopting, as proposed, new Rule 5b-3(b) which codifies, for purposes of Section 5(b)(1), the conditions specified in the staff’s no-action position permitting a fund to treat an investment in a “refunded security” as an investment in the escrowed U.S. government securities.<sup>21</sup> Under the rule, a “refunded security” is defined 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 pledged only to the payment of the debt security.<sup>22</sup> 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.<sup>23</sup> Finally, an independent certified public accountant must have certified to the escrow agent that the escrowed securities will satisfy all scheduled payments of

<sup>17</sup> Rule 5b-3(c)(1)(v). See Sections 101(47) of the Federal Bankruptcy Code (“Bankruptcy Code”) (defining “repurchase agreement”) and 559 (protecting repurchase agreement participants from the Bankruptcy Code’s automatic stay provisions). The Bankruptcy Code currently defines a repurchase agreement as:

An agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers’ acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptances, or securities as described above, at a date certain no later than one year after such transfer or on demand, against the transfer of funds. As a result, funds are limited in the collateral they can accept by both paragraph (c)(1)(iv)(D) of the rule and the provisions of the Bankruptcy Code (and other applicable insolvency laws) providing preferred treatment to qualifying repurchase agreements.

<sup>18</sup> See Proposing Release *supra* note 4 at nn. 12-16 and accompanying text.

<sup>19</sup> Rule 5b-3(c)(1)(v).

<sup>20</sup> By omitting this requirement, we are not suggesting that it might not be prudent for an adviser to a fund to take precautions, including evaluating the creditworthiness of the counterparty, when entering into repurchase agreements on behalf of the fund.

<sup>21</sup> Rule 5b-3(b). Unlike the no-action position, the rule does not limit the amount of pre-refunded bonds of any one issuer that a fund can acquire. See T. Rowe Price Tax-Free Funds, *supra* note 10.

<sup>22</sup> Rule 5b-3(c)(4).

<sup>23</sup> Rule 5b-3(c)(4)(i), (ii).

principal, interest and applicable premiums on the refunded securities.<sup>24</sup> This treatment corresponds to the treatment that has been given to pre-refunded bonds in Rule 2a-7.<sup>25</sup>

Commenters expressed support for the changes made by Rule 5b-3(b), and we are adopting this provision as proposed.

### C. Availability of Rule 12d3-1 for Repurchase Agreements

We are adopting, as proposed, an amendment to Rule 12d3-1 that eliminates a note appended to the rule. Rule 12d3-1 provides limited exemptive relief from the prohibition in Section 12(d)(3) of the Act against a fund acquiring an interest in a broker-dealer or a bank engaged in a securities-related business.<sup>26</sup> As discussed above, a fund that enters into a repurchase agreement with a broker-dealer or other counterparty that is engaged in securities related activities may be in violation of Section 12(d)(3) of the Act, unless it is permitted to look through the agreement to the underlying collateral. The note appended to Rule 12d3-1 has made the rule unavailable for repurchase agreements. With the elimination of this note, funds may rely on Rule 12d3-1 even if the repurchase agreement does not meet the requirements for “look-through” treatment in Rule 5b-3.<sup>27</sup>

### D. Conforming Amendments to Rule 2a-7

We are also adopting conforming amendments to Rule 2a-7. These amendments replace the definitions of “collateralized fully,” “event of insolvency,” and “refunded security,” currently set forth in Rule 2a-7, with cross-references to the corresponding definitions in Rule 5b-3.<sup>28</sup>

## III. Effective Date

The new rule and rule amendments will be effective August 15, 2001.<sup>29</sup>

## IV. Cost/Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. For the most part, Rule 5b-3 codifies current staff positions, and therefore will result in few marginal costs or benefits.<sup>30</sup> By codifying a number of staff no-action positions issued over a nearly twenty year period, the rule will give greater transparency to the Commission’s rules in this area. In addition, the rule uses standards that are similar to those currently specified in Rule 2a-7 for the treatment of repurchase agreements and pre-refunded bonds by money market funds. With this similar treatment, fund complexes that include money market funds may be more efficient in monitoring compliance with the requirements of the rules for all types of funds.

<sup>24</sup> Rule 5b-3(c)(4)(iii). The rule makes an exception to the certification requirement if the refunded security has received the highest rating from an NRSRO. *Id.*

<sup>25</sup> See Rule 2a-7(c)(4)(ii)(B). Technical amendments that we are adopting today will replace the definition of “refunded security” in Rule 2a-7(a)(20) with a reference incorporating the definition that we are adopting in Rule 5b-3(c)(4).

<sup>26</sup> Rule 12d3-1 provides an exemption for purchases of securities of any entity that derived fifteen percent or less of its gross revenues from securities related activities in its most recent fiscal year, unless the acquiring company would control the entity after the purchase. If the entity derived more than fifteen percent of its gross revenues from securities related activities, the rule provides a limited exemption based on the amount and value of the securities purchased. The note to the rule stated: “NOTE: It is not intended that this rule should supersede the requirements prescribed in Investment Company Act Release No. 13005 (Feb. 2, 1983) with respect to repurchase agreements with brokers or dealers.”

<sup>27</sup> By eliminating this note, we do not intend in any way to alter an adviser’s duty of care with respect to the advice it provides a mutual fund, including the advice to enter into a repurchase agreement.

<sup>28</sup> Rule 2a-7(a)(5), (11), and (20) (cross-referencing Rule 5b-3(c)(1), (2), and (4)). Rule 5b-3(c)(1) expands the types of collateral that may be used to collateralize fully a repurchase agreement to include certain high-quality, unrated securities. See *supra* note 16 and accompanying text. This expansion of acceptable collateral also applies to Rule 2a-7.

<sup>29</sup> As we indicated in the Proposing Release, we are withdrawing all prior Commission and staff no-action and interpretive positions that are inconsistent with Rule 5b-3. This withdrawal is effective [60 days after publication of the release in the federal register]. After this date, funds may “look through” repurchase agreements and pre-refunded bonds to the underlying collateral, for purposes of the Act, only if all of the requirements of Rule 5b-3 are met.

<sup>30</sup> We received no response to the request for comment on the preliminary cost-benefit analysis that was included in the Proposing Release.

The rule is more restrictive than current requirements in two respects. First, as discussed above, Rule 5b-3 is limited to repurchase agreements in which the underlying collateral consists of cash items, U.S. government securities, securities that are rated in the highest rating category by the Requisite NRSROs and unrated securities that are of comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by an investment company's board of directors or its delegate. This requirement is intended to ensure that the market value of the collateral will remain fairly stable and that the fund will be able to liquidate the collateral quickly in the event of a default. This limitation on collateral is more restrictive than the staff's position with respect to the treatment of repurchase agreements for purposes of Section 12(d)(3),<sup>31</sup> but less restrictive than the staff's position with respect to Section 5(b)(1).<sup>32</sup> Since most repurchase agreements are collateralized by U.S. government securities, which clearly fall within the rule's limitations, it appears that the limitation will not have any significant impact on funds.

Second, the rule is limited to repurchase agreements that qualify for an exclusion from any automatic stay under applicable insolvency law. Although this requirement is included in Rule 2a-7, it was not a feature of the staff positions, which generally pre-dated the relevant changes in the Bankruptcy Code. Again, because most repurchase agreements qualify for an exclusion, this limitation should not have any significant impact on funds. The limitation will, however, provide important protections for investors by ensuring that a fund can liquidate the collateral quickly in the event of the counterparty's bankruptcy.

The use of Rule 5b-3 is optional: even if a fund can look through a repurchase agreement, it may choose to look to the counterparty rather than the underlying securities in meeting the diversification requirements in Section 5(b)(1). Thus, a fund may choose not to use Rule 5b-3 if it determines that the costs of complying with the rule's requirements outweigh the benefits of being able to look through the repurchase agreement to the underlying securities.

The amendment to Rule 12d3-1 eliminates the "Note" to the rule that renders the rule unavailable for repurchase agreements. This amendment will provide additional flexibility for funds without impairing investor protection.

## V. Effects on Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>33</sup> Rule 5b-3 and the amendments to Rules 2a-7 and 12d-3 are being adopted pursuant to the authority in Section 6(c) and 38(a) of the Act.<sup>34</sup> Section 6(c) conditions rulemaking authority on the requirement that the rule be "necessary or appropriate in the public interest"; therefore, the requirements of Section 2(c) apply to Rule 5b-3 and the rule amendments.

The Commission has considered whether this rulemaking will promote efficiency, competition, and capital formation. The rule and rule amendments generally codify the requirements for looking through repurchase agreements and pre-refunded bonds to the underlying securities for purposes of complying with Sections 5(b)(1) and 12(d)(3) of the Act. Consistent with staff no-action positions, funds have been looking through repurchase agreements and pre-refunded bonds for a number of years. The few changes made by the rule and rule amendments generally are intended to reflect recent developments in bankruptcy law protecting parties to repurchase agreements and to adapt the Act to economic realities of repurchase agreements and pre-refunded bonds. These changes should not have a significant impact on funds. In addition, since the use of Rule 5b-3 is optional, funds may choose to look to the repurchase agreement counterparty rather than the underlying securities in meeting the diversification requirements in Section 5(b)(1). Given these factors, we believe that the rule and rule amendments will have no significant impact on efficiency, competition, and capital formation.

<sup>31</sup> Investment Company Act Release No. 13005 (Feb. 2, 1983) [48 FR 5894 (Feb. 9, 1983)] did not specify the type of collateral, merely noting that the "securities most frequently used in connection with repurchase agreements are Treasury bills and other United States Government securities."

<sup>32</sup> The staff's no-action position in MoneyMart Assets, *supra* note 6, was conditioned on the collateral consisting entirely of U.S. government securities.

<sup>33</sup> 15 U.S.C. 80a-2(c).

<sup>34</sup> 15 U.S.C. 80a-6(c) and 80a-38(a).

## VI. Summary of Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis (“FRFA”) in accordance with 5 U.S.C. 604 regarding Rule 5b-3, and the amendments to Rules 2a-7 and 12d3-1. A summary of the Initial Regulatory Flexibility Analysis (“IRFA”), which was prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release. The following is a summary of the FRFA.

### A. Need for and Objectives of the Rule Amendments

Rule 5b-3 generally codifies the staff’s position that a fund may look through a fully collateralized repurchase agreement to the underlying securities for purposes of Sections 5(b)(1) and 12(d)(3) of the Act. The rule also permits a fund to treat the acquisition of certain pre-refunded bonds as an acquisition of the escrowed securities for purposes of Section 5(b)(1) of the Act. In addition, the amendment to Rule 12d3-1 eliminates the “Note” appended to the rule in order to allow funds to rely on Rule 12d3-1 even if the repurchase agreement is not collateralized fully. Finally, the amendments to Rule 2a-7 are intended to simplify and update the provisions of that rule that address repurchase agreements and refunded securities.

### B. Significant Issues Raised by Public Comments

The Commission received no comments on the IRFA.

### C. Small Entities Subject to the Rules

For purposes of the Investment Company Act and the Regulatory Flexibility Act, a fund is a small entity if the fund, together with other funds in the same group of related funds, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>35</sup>

Rule 5b-3 and the amendment to Rule 12d3-1 will affect any fund that invests in a repurchase agreement with a broker, dealer, underwriter, or bank that is engaged in a securities-related business, when the investment may otherwise be prohibited by Section 12(d)(3) of the Act. In addition, Rule 5b-3 will affect any fund that holds itself out as a diversified investment company under Section 5(b)(1) of the Act and that invests in repurchase agreements or pre-refunded bonds.

As of December 31, 2000, there were approximately 4,145 registered funds that were not money market funds. The Commission staff estimates that 196 of these funds are small entities. We assume that all funds enter into repurchase agreements, and that many of these agreements are with broker-dealers or other counterparties that are engaged in a securities-related business. Therefore, we anticipate that all of the estimated 196 small entities will be affected by the rule’s treatment of investments in repurchase agreements for purposes of Section 5(b)(1) and 12(d)(3) of the Act, and the amendment to Rule 12d3-1.

The FRFA explains that Rule 5b-3 should not have a significant economic impact on these funds. The rule would not effect significant changes to the current treatment of repurchase agreements and pre-refunded bonds, but instead would generally codify and update a number of no-action positions that have been taken by the Commission staff. In addition, the amendment to Rule 12d3-1 would benefit these funds by allowing them to rely on the rule even if the repurchase agreement does not meet the requirements for “look-through” treatment.

The amendments to Rule 2a-7 affect money market funds. As of December 31, 2000, there were approximately 300 registered funds with one or more portfolios that are money market funds. The Commission staff estimates that approximately six of these funds are small entities. The amendments replace the definitions of “collateralized fully,” “event of insolvency,” and “refunded security” in Rule 2a-7 with cross-references to the corresponding definitions in Rule 5b-3. The cross-reference to the definition of “collateralized fully” in rule 5b-3 will allow money market funds to use unrated securities that are of comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs to collateralize fully their repurchase agreements. This change will not have a significant impact on small entities because most repurchase agreements are collateralized fully by U.S. government securities. In addition, the cross-references to the definitions of “event of insolvency” and “refunded security” in Rule 5b-3 will not have a significant impact on small entities because the cross-references do not involve any change in substantive requirements.

<sup>35</sup> 17 CFR 270.0-10.



#### D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Rule 5b-3 and the amendments to Rule 2a-7 and 12d-3 will not impose any new reporting or recordkeeping requirements. These provisions do not involve major changes in compliance requirements because they mainly codify existing Commission staff positions. There are no rules that duplicate, overlap or conflict with the rule and rule amendments.

#### E. Agency Action to Minimize Effects on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant economic impact on small entities. In connection with Rule 5b-3 and the rule amendments, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for small entities. The FRFA notes that Rule 5b-3 and the rule amendments are not intended to effect major substantive changes to the current treatment of repurchase agreements and pre-refunded bonds, but would essentially codify a number of no-action positions taken by the Commission staff. Because Rule 5b-3 and the rule amendments are designed to clarify the appropriate treatment of investments by funds in repurchase agreements and pre-refunded bonds for various purposes of the Act, and to provide investment flexibility for funds of all sizes, it would be inconsistent with the purposes of the Regulatory Flexibility Act to propose to exempt small entities from their coverage. Further clarification, consolidation, or simplification of the rules, or specification of different compliance standards for small entities, would not be appropriate, because the rules set forth the minimum standards consistent with investor protection. For the same reasons, the use of performance standards would be inappropriate. Overall, Rule 5b-3 and the rule amendments will not have an adverse effect on small entities.

The FRFA is available for public inspection in File No. S7-21-99, and a copy may be obtained by contacting Hugh Lutz, Attorney, at (202-942-0690), Office of Regulatory Policy, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0506.

### VII. Statutory Authority

The Commission is adopting new Rule 5b-3, and amending Rule 2a-7 and Rule 12d3-1, pursuant to the authority set forth in Sections 6(c) and 38(a) of the Act [*15 U.S.C. 80a-6(e) and 80a-37(a)*]. The Commission is amending Form N-SAR pursuant to authority set forth in Sections 13, 15(d) and 23(a) of the Securities Exchange Act of 1934 [*15 U.S.C. 78m, 78o(d), and 78w(a)*] and Sections 8, 30 and 38 of the Investment Company Act of 1940 [*15 U.S.C. 80a-8, 80a-29 and 80a-37*].

#### List of Subjects

17 CFR Parts 270 and Part 274

Investment companies, Reporting and recordkeeping requirements, Securities.

#### Text of Rule and Form Amendments

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

#### Part 270—Rules and Regulations, Investment Company Act of 1940

1. The authority citation for Part 270 continues to read, in part, as follows:

Authority: *15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, 80a-39*, unless otherwise noted;

\* \* \* \*

2. Section 270.2a-7 is amended by revising paragraphs (a)(5), (a)(11), and (a)(20) to read as follows:

§ 270.2a-7 Money market funds.

(a) Definitions.

\* \* \* \*

(5) Collateralized Fully means “Collateralized Fully” as defined in § 270.5b-3(c)(1).

\* \* \* \*

(11) Event of Insolvency means “Event of Insolvency” as defined in § 270.5b-3(c)(2).

\* \* \* \*

(20) Refunded Security means “Refunded Security” as defined in § 270.5b-3(c)(4).

\* \* \* \*

3. Section 270.5b-3 is added to read as follows:

§ 270.5b-3 Acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities.

(a) Repurchase Agreements. For purposes of Sections 5 and 12(d)(3) of the Act (*15 U.S.C. 80a-5 and 80a-12(d)(3)*), the acquisition of a repurchase agreement may be deemed to be an acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the investment company is Collateralized Fully.

(b) Refunded Securities. For purposes of Section 5 of the Act (*15 U.S.C. 80a-5*), the acquisition of a Refunded Security is deemed to be an acquisition of the escrowed Government Securities.

(c) Definitions. As used in this section:

(1) Collateralized Fully in the case of a repurchase agreement means that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the investment company reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price provided in the agreement;

(ii) The investment company has perfected its security interest in the collateral;

(iii) The collateral is maintained in an account of the investment company with its custodian or a third party that qualifies as a custodian under the Act;

(iv) The collateral consists entirely of:

(A) Cash items;

(B) Government Securities;

(C) Securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the Requisite NRSROs; or

(D) Unrated Securities that are of comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the investment company’s board of directors or its delegate; and

(v) Upon an Event of Insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors’ rights against the seller.

(2) Event of Insolvency means, with respect to a person:

- (i) An admission of insolvency, the application by the person for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; or
- (ii) The institution of similar proceedings by another person which proceedings are not contested by the person; or
- (iii) The institution of similar proceedings by a government agency responsible for regulating the activities of the person, whether or not contested by the person.

(3) Government Security means any “Government Security” as defined in Section 2(a)(16) of the Act (*15 U.S.C. 80a-2(a)(16)*).

(4) Refunded Security means a debt security the principal and interest payments of which are to be paid by Government Securities (“deposited securities”) that have been irrevocably placed in an escrow account pursuant to an agreement between the issuer of the debt security and an escrow agent that is not an “affiliated person,” as defined in Section 2(a)(3)(C) of the Act (*15 U.S.C. 80a-2(a)(3)(C)*), of the issuer of the debt security, and, in accordance with such escrow agreement, are pledged only to the payment of the debt security and, to the extent that excess proceeds are available after all payments of principal, interest, and applicable premiums on the Refunded Securities, the expenses of the escrow agent and, thereafter, to the issuer or another party; provided that:

- (i) The deposited securities are not redeemable prior to their final maturity;
- (ii) The escrow agreement prohibits the substitution of the deposited securities unless the substituted securities are Government Securities; and
- (iii) At the time the deposited securities are placed in the escrow account, or at the time a substitution of the deposited securities is made, an independent certified public accountant has certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities; provided, however, an independent public accountant need not have provided the certification described in this paragraph (c)(4)(iii) if the security, as a Refunded Security, has received a rating from an NRSRO in the highest category for debt obligations (within which there may be sub-categories or gradations indicating relative standing).

(5) NRSRO means any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi) (E), (F) and (H) of § 240.15c3-1 of this chapter, that is not an “affiliated person,” as defined in Section 2(a)(3)(C) of the Act (*15 U.S.C. 80a-2(a)(3)(C)*), of the issuer of, or any insurer or provider of credit support for, the security.

(6) Requisite NRSROs means:

- (i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or
- (ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO.

(7) Resale Price means the acquisition price paid to the seller of the securities plus the accrued resale premium on such acquisition price. The accrued resale premium is the amount specified in the repurchase agreement or the daily amortization of the difference between the acquisition price and the resale price specified in the repurchase agreement.

(8) Unrated Securities means securities that have not received a rating from the Requisite NRSROs.

4. Section 270.12d3-1 is amended by removing the note following paragraph (d)(8).

## **Part 274—Forms Prescribed Under the Investment Company Act of 1940**

5. The authority citation for Part 274 continues to read as follows:

Authority: *15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, and 80a-29*, unless otherwise noted.

## 2009 PROPOSAL REGARDING MONEY MARKET FUND REFORM

Release No. IC-28807

June 30, 2009

AGENCY: Securities and Exchange Commission

ACTION: Proposed rule

**SUMMARY:** The Securities and Exchange Commission (“Commission” or “SEC”) is proposing amendments to certain rules that govern money market funds under the Investment Company Act. The amendments would: (i) tighten the risk-limiting conditions of rule 2a-7 by, among other things, requiring funds to maintain a portion of their portfolios in instruments that can be readily converted to cash, reducing the weighted average maturity of portfolio holdings, and limiting funds to investing in the highest quality portfolio securities; (ii) require money market funds to report their portfolio holdings monthly to the Commission; and (iii) permit a money market fund that has “broken the buck” (i.e., re-priced its securities below \$1.00 per share) to suspend redemptions to allow for the orderly liquidation of fund assets. In addition, the Commission is seeking comment on other potential changes in our regulation of money market funds, including whether money market funds should, like other types of mutual funds, effect shareholder transactions at the market-based net asset value, i.e., whether they should have “floating” rather than stabilized net asset values. The proposed amendments are designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share.

**DATES:** Comments should be received on or before September 8, 2009.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic Comments:*

- » Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- » Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-11-09 on the subject line; or
- » Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

*Paper Comments:*

- » Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-11-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet website (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission’s Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Office of Regulatory Policy, at (202) 551-6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is proposing for public comment amendments to rules 2a-7 [17 CFR 270.2a-7], 17a-9 [17 CFR 270.17a-9], and 30b1-5 [17 CFR 270.30b1-5], new rules 22e-3 [17 CFR 270.22e-3] and 30b1-6 [17 CFR 270.30b1-6], and new Form N-MFP under the Investment Company Act of 1940 (“Investment Company Act” or “Act”).<sup>1</sup>

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<sup>1</sup> 15 U.S.C. 80a. Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act, including rule 2a-7, are to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270].

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### I. BACKGROUND

#### A. Money Market Funds

Money market funds are open-end management investment companies that are registered under the Investment Company Act and regulated under rule 2a-7 under the Act. They invest in high-quality, short-term debt instruments such as commercial paper, Treasury bills and repurchase agreements.<sup>2</sup> Money market funds pay dividends that reflect prevailing short-term interest rates and, unlike other investment companies, seek to maintain a stable net asset value per share, typically \$1.00 per share.<sup>3</sup>

This combination of stability of principal and payment of short-term yields has made money market funds one of the most popular investment vehicles for many different types of investors. Commonly offered features, such as check-writing privileges, exchange privileges, and near-immediate liquidity, have contributed to the popularity of money market funds. More than 750 money market funds are registered with the Commission, and collectively they hold approximately \$3.8 trillion of assets.<sup>4</sup> Money market funds account for approximately 39 percent of all investment company assets.<sup>5</sup>

Individual (or “retail”) investors use money market funds for a variety of reasons. For example, they may invest in money market funds to hold cash temporarily or to take a temporary “defensive position” in anticipation of declining equity markets. Money market funds also play an important role in cash management accounts for banks, broker-dealers, variable insurance products, and retirement accounts. As of December 2008, about one-fifth of U.S. households’ cash balances were held in money market funds.<sup>6</sup>

Different types of money market funds have been introduced to meet the differing needs of retail money market fund investors. Historically, most retail investors have invested in “prime money market funds,” which hold a variety of taxable short-term obligations issued by corporations and banks, as well as repurchase agreements and asset backed commercial paper secured by pools of assets.<sup>7</sup> Prime money market funds typically have paid higher yields than other types of money

<sup>2</sup> Money market funds are also sometimes called “money market mutual funds” or “money funds.”

<sup>3</sup> See generally Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] (“1983 Adopting Release”). Most money market funds *Seek* to maintain a stable net asset value per share of \$1.00, but a few *Seek* to maintain a stable net asset value per share of a different amount, e.g., \$10.00. For convenience, throughout this release, the discussion will simply refer to the stable net asset value of \$1.00 per share.

<sup>4</sup> See Investment Company Institute, *Trends in Mutual Fund Investing*, Apr. 2009, available at [http://www.ici.org/highlights/trends\\_04\\_09](http://www.ici.org/highlights/trends_04_09) (“ICI Trends”).

<sup>5</sup> See *id.*

<sup>6</sup> See Investment Company Institute, Report of The Money Market Working Group, at 21 (Mar. 17, 2009), available at [http://www.ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://www.ici.org/pdf/ppr_09_mmwg.pdf) (“ICI Report”).

<sup>7</sup> See Investment Company Institute, 2009 Investment Company Institute Fact Book, at 147, Table 38 (May 2009), available at [http://www.ici.org/pdf/2009\\_factbook.pdf](http://www.ici.org/pdf/2009_factbook.pdf) (“2009 Fact Book”).

market funds available to retail investors.<sup>8</sup> “Government money market funds” principally hold obligations of the U.S. Government, including obligations of the U.S. Treasury and federal agencies and instrumentalities, as well as repurchase agreements collateralized by Government securities. Some government money market funds limit themselves to holding only Treasury obligations. Compared to prime funds, government funds generally offer greater safety of principal but historically have paid lower yields. “Tax exempt money market funds” primarily hold obligations of state and local governments and their instrumentalities, and pay interest that is generally exempt from federal income taxes.

Institutional investors account for a growing portion of investments in money market funds. These investors include corporations, bank trust departments, securities lending operations of brokerage firms, state and local governments, hedge funds and other private funds. Many corporate treasurers of large businesses have essentially “outsourced” cash management operations to money market funds, which may be able to manage cash more efficiently due both to the scale of their operations and their expertise. As of January 2008, approximately 80 percent of U.S. companies used money market funds to manage at least a portion of their cash balances.<sup>9</sup> At year-end 2008, U.S. non-financial businesses held approximately 32 percent of their cash balances in money market funds.<sup>10</sup> According to the Investment Company Institute, about 66 percent of money market fund assets are held in money market funds or share classes intended to be sold to institutional investors (“institutional money market funds”).<sup>11</sup>

Institutional money market funds hold securities similar to those held by prime funds and government funds. They typically have large minimum investment amounts (e.g., \$1 million), and offer lower expenses and higher yields due to the large account balances, large transaction values, and smaller number of accounts associated with these funds. As we will discuss in more detail below, institutional money market funds also tend to have greater investment inflows and outflows than retail money market funds.

## B. Market Significance

Due in large part to the growth of institutional funds, money market funds have grown substantially over the last decade, from approximately \$1.4 trillion in assets under management at the end of 1998 to approximately \$3.8 trillion in assets under management at the end of 2008.<sup>12</sup> During this same period, retail taxable money market fund assets grew from approximately \$835 billion to \$1.36 trillion, or 63 percent, while institutional taxable money market fund assets grew from approximately \$516 billion to \$2.48 trillion, or 380 percent.<sup>13</sup>

One implication of the growth of money market funds is the increased role they play in the capital markets. They are by far the largest holders of commercial paper, owning almost 40 percent of the outstanding paper.<sup>14</sup> The growth of the commercial paper market has generally followed the growth of money market funds over the last three decades.<sup>15</sup> Today, money market funds provide a substantial portion of short-term credit extended to U.S. businesses.

<sup>8</sup> See, e.g., *iMoneyNet Money Fund Report* (Mar. 20, 2009), available at [http://www.imoney.net/files/Publication\\_News/mfr.pdf](http://www.imoney.net/files/Publication_News/mfr.pdf).

<sup>9</sup> See ICI Report, *supra* note 6, at 28–29, Figure 3.7.

<sup>10</sup> See *id.* at 28–29, Figure 3.6.

<sup>11</sup> See Investment Company Institute, *Money Market Mutual Fund Assets*, June 11, 2009, available at [http://www.ici.org/highlights/mm\\_06\\_11\\_09](http://www.ici.org/highlights/mm_06_11_09).

<sup>12</sup> See Investment Company Institute, 1999 *Mutual Fund Fact Book*, at 4 (May 1999), available at [http://www.ici.org/pdf/1999\\_factbook.pdf](http://www.ici.org/pdf/1999_factbook.pdf); Investment Company Institute, *Trends in Mutual Fund Investing*, May 28, 2009, available at [http://www.ici.org/highlights/trends\\_04\\_2009](http://www.ici.org/highlights/trends_04_2009).

<sup>13</sup> See Investment Company Institute, 2008 *Investment Company Institute Fact Book*, at 144, Table 35 (May 2008) (“2008 Fact Book”); 2009 *Fact Book*, *supra* note 7, at 147, Table 38.

<sup>14</sup> Federal Reserve Board, Statistical Release Z.1: Flow of Funds Accounts of the United States: Flows and Outstandings Fourth Quarter 2008, at 86, Table L.208 (Mar. 12, 2009), available at <http://www.federalreserve.gov/releases/z1/Current/z1.pdf> (“*Fed. Flow of Funds Report*”).

<sup>15</sup> See *Instruments of the Money Market*, at 121, Table 2 (Timothy Q. Cook & Robert K. Laroche eds., 1993), available at [http://www.richmondfed.org/publications/research/special\\_reports/instruments\\_of\\_the\\_money\\_market/pdf/full\\_publication.pdf](http://www.richmondfed.org/publications/research/special_reports/instruments_of_the_money_market/pdf/full_publication.pdf); *Fed. Flow of Funds Report*, *supra* note 14, at Tables L.206 and L.208. One commenter has called the growth of these two markets “inextricably linked.” See Leland Crabbe & Mitchell A. Post, *The Effect of SEC Amendments to Rule 2a-7 on the Commercial Paper Market*, at 4 (Federal Reserve Board, Finance and Economics Discussion Series #199, May 1992) (“Crabbe & Post”).

Money market funds also play a large role in other parts of the short-term market. They hold approximately 23 percent of all repurchase agreements, 65 percent of state and local government short-term debt, 24 percent of short-term Treasury securities, and 44 percent of short-term agency securities.<sup>16</sup> They serve as a substantial source of financing in the broader capital markets, holding approximately 22 percent of all state and local government debt, approximately nine percent of U.S. Treasury securities and 15 percent of agency securities.<sup>17</sup>

As a consequence, the health of money market funds is important not only to their investors, but also to a large number of businesses and state and local governments that finance current operations through the issuance of short-term debt. A “break in the link [between borrowers and money market funds] can lead to reduced business activity and pose risks to economic growth.”<sup>18</sup> The regulation of money market funds, therefore, is important not only to fund investors, but to a wide variety of operating companies as well as state and local governments that rely on these funds to purchase their short-term securities.

### C. Regulation of Money Market Funds

The Commission regulates money market funds under the Investment Company Act and pursuant to rule 2a-7 under the Act. We adopted rule 2a-7 as an exemptive rule in 1983 and amended it in 1986 to facilitate the development of tax exempt money market funds.<sup>19</sup> We also amended it substantially in 1991 (taxable funds) and 1996 (tax exempt funds) to provide for a more robust set of regulatory conditions and to expand the rule to apply it to any investment company holding itself out as a money market fund.<sup>20</sup>

The Investment Company Act and applicable rules generally require that mutual funds price their securities at the current net asset value per share by valuing portfolio instruments at market value or, if market quotations are not readily available, at fair value determined in good faith by the board of directors.<sup>21</sup> As a consequence, the price at which funds will sell and redeem shares ordinarily fluctuates daily with changes in the value of the fund’s portfolio securities. These valuation and pricing requirements are designed to prevent investors’ interests from being diluted or otherwise adversely affected if fund shares are not priced fairly.<sup>22</sup>

Rule 2a-7, however, permits money market funds to use the amortized cost method of valuation and penny-rounding method of pricing instead, which facilitate money market funds’ ability to maintain a stable net asset value.<sup>23</sup> Under the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or

<sup>16</sup> These securities include securities issued or guaranteed by the Federal National Mortgage Association (“Fannie Mae”), the Federal Home Loan Mortgage Corporation (“Freddie Mac”) and the Federal Home Loan Banks. See ICI Report, *supra* note 6, at 19, Figure 2.3. See generally U.S. Treasury Department, FAQs on Fixed Income Agency Securities, available at <http://www.treas.gov/education/faq/markets/fixedfederal.shtml>.

<sup>17</sup> See Fed. Flow of Funds Report, *supra* note 14 (percentages derived from flow of funds data). Foreign banks also have relied substantially on U.S. money market funds for dollar-denominated funding. See Naohiko Baba, Robert N. McCauley, & Srichander Ramaswamy, *U.S. Dollar Money Market Funds and non-U.S. Banks*, BIS Quarterly Review, Mar. 2009, available at [http://www.bis.org/publ/qtrpdf/r\\_qt0903g.htm](http://www.bis.org/publ/qtrpdf/r_qt0903g.htm) (“U.S. Dollar Money Market Funds”).

<sup>18</sup> See Mike Hammill & Andrew Flowers, *MMMF, and AMLF, and MMIFF*, Macroblog (Federal Reserve Bank of Atlanta), Oct. 30, 2008, available at <http://www.macroblog.typepad.com/macroblog/2008/10/index.html>.

<sup>19</sup> See 1983 Adopting Release, *supra* note 3; Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (“1986 Adopting Release”).

<sup>20</sup> See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)] (“1991 Adopting Release”); Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] (“1996 Adopting Release”).

<sup>21</sup> See section 2(a)(41) of the Act (defining “value” of fund assets); rule 2a-4 (defining “current net asset value” for use in computing the current price of a redeemable security); and rule 22c-1 (generally requiring open-end funds to sell and redeem their shares at a price based on the funds’ current net asset value as next computed after receipt of a redemption, purchase, or sale order).

<sup>22</sup> See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 17589 at n.7 and accompanying text (July 17, 1990) [55 FR 30239 (July 25, 1990)] (“1990 Proposing Release”).

<sup>23</sup> The penny-rounding method of pricing means the method of computing a fund’s price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent. See rule 2a-7(a)(18).



accumulation of discount (“amortized cost”).<sup>24</sup> The basic premise underlying money market funds’ use of the amortized cost method of valuation is that high-quality, short-term debt securities held until maturity will eventually return to the amortized cost value, regardless of any current disparity between the amortized cost value and market value, and would not ordinarily be expected to fluctuate significantly in value.<sup>25</sup> Therefore, the rule permits money market funds to value portfolio securities at their amortized cost so long as the deviation between the amortized cost and current market value *remains* minimal and results in the computation of a share price that represents fairly the current net asset value per share of the fund.<sup>26</sup>

To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, the rule contains several conditions (which we refer to as “risk-limiting conditions”) that limit the fund’s exposure to certain risks, such as credit, currency, and interest rate risks.<sup>27</sup> In addition, the rule includes certain procedural requirements overseen by the fund’s board of directors. One of the most important is the requirement that the fund periodically “shadow price” the amortized cost net asset value of the fund’s portfolio against the mark-to-market net asset value of the portfolio.<sup>28</sup> If there is a difference of more than ½ of 1 percent (or \$0.005 per share), the fund’s board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) \$1.00 per share, an event colloquially known as “breaking the buck.”<sup>29</sup>

#### D. Recent Developments

Money market funds have had a record of stability during their more than 30 years of operation. Before last fall, only one money market fund had ever broken the buck.<sup>30</sup> This record appears to be due primarily to three factors. First, the short-term debt markets generally were relatively stable during this period. Second, many fund advisers (and their portfolio managers and credit analysts) were skillful in analyzing the risks of portfolio securities and thereby largely avoiding significant losses that could force a fund to break the buck.<sup>31</sup> Finally, fund managers and their affiliated persons have had significant sources of private capital that they were willing to make available to support the stable net asset value of a money market fund when it experienced losses in one or more of its portfolio securities.

Since the late 1980s, fund managers from time to time have sought to prevent a money market fund from breaking the buck by voluntarily purchasing distressed portfolio securities from the fund, directly or through an affiliated person,

<sup>24</sup> See rule 2a-7(a)(2) (defining the amortized cost method as calculating an investment company’s net asset value whereby portfolio securities are valued at the fund’s acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors).

<sup>25</sup> See 1983 Adopting Release, *supra* note 3, at nn.3–7 and accompanying text; Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies, Investment Company Act Release No. 12206, at nn.3–4 and accompanying text (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] (“1982 Proposing Release”).

<sup>26</sup> See rule 2a-7(c)(1), (c)(7)(ii)(C).

<sup>27</sup> For example, the rule requires, among other things, that a money market fund’s portfolio securities meet certain credit quality requirements, such as being rated in the top one or two rating categories by nationally recognized statistical rating organizations (“NRSROs”), and by limiting the portion of the fund’s portfolio that may be invested in securities rated in the second highest rating category. See rule 2a-7(c)(3). The rule also places limits on the remaining maturity of securities in the fund’s portfolio. A fund generally may not acquire, for example, any securities with a remaining maturity greater than 397 days, and the dollar-weighted average maturity of the securities owned by the fund may not exceed 90 days. See rule 2a-7(c)(2).

<sup>28</sup> See rule 2a-7(c)(7); See also *supra* note 21 and accompanying text.

<sup>29</sup> See rule 2a-7(c)(7)(ii)(B). Regardless of the extent of the deviation, rule 2a-7 imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Rule 2a-7(c)(7)(ii)(C). See 1983 Adopting Release, *supra* note 3, at nn.51–52 and accompanying text.

<sup>30</sup> In September 1994, a series of a small institutional money market fund re-priced its shares below \$1.00 as a result of loss in value of certain floating rate securities. The fund promptly announced that it would liquidate and distribute its assets to its shareholders. See 1996 Adopting Release, *supra* note 20, at n.162.

<sup>31</sup> We made similar observations last year. See Temporary Exemption for Liquidation of Certain Money Market Funds, Investment Company Act Release No. 28487, at text accompanying nn.6–7 (Nov. 20, 2008) [73 FR 71919 (Nov. 26, 2008)] (“Rule 22e-3T Adopting Release”).

at the higher of market price or amortized cost.<sup>32</sup> These events occurred irregularly and involved a limited number of funds.<sup>33</sup> In response to these events, the Commission tightened the risk-limiting conditions of the rule for taxable funds in 1991 and for tax exempt funds in 1996.<sup>34</sup> Among other things, we added diversification requirements to the rule, which limited the exposure of a fund to any one issuer of securities, thus reducing the consequences of a credit event affecting the value of a portfolio holding.<sup>35</sup> We repeatedly emphasized the responsibility of fund managers to manage, and fund boards to oversee that the fund is managed, in a manner consistent with the investment objective of maintaining a stable net asset value.<sup>36</sup>

In 2007, however, losses in the subprime mortgage markets adversely affected a significant number of money market funds. These money market funds had invested in asset backed commercial paper issued by structured investment vehicles (“SIVs”), which were off-balance sheet conduits sponsored mostly by certain large banks and money managers.<sup>37</sup> Although we understand that most SIVs had little exposure to sub-prime mortgages, they suffered severe liquidity problems and significant losses when risk-averse short-term investors (including money market funds), fearing increased exposure to liquidity risk and residential mortgages, began to avoid the commercial paper the SIVs issued.<sup>38</sup> Unable to roll over their short-term debt, SIVs were forced to liquidate assets to pay off maturing obligations and began to wind down operations.<sup>39</sup> In addition, NRSROs rapidly downgraded SIV securities, increasing downward price pressures already generated by these securities’ lack of liquidity. The value of the commercial paper fell, which threatened to force several money market funds to break the buck.

Money market funds weathered this storm. In some cases, bank sponsors of SIVs provided support for the SIVs.<sup>40</sup> In other cases, money market fund affiliates voluntarily provided support to the funds by purchasing the SIV investments at their amortized cost or providing some form of credit support.<sup>41</sup> Money market funds also benefited from strong cash flows into money market funds, as investors fled from riskier markets. During the period from July 2007 to August 2008, more than \$800 billion in new cash was invested in money market funds, increasing aggregate fund assets by one-third.<sup>42</sup> Eighty percent of these investments came from institutional investors.<sup>43</sup>

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<sup>32</sup> These transactions implicate section 17(a) of the Investment Company Act, which prohibits an affiliated person of a fund or an affiliated person of such a person from knowingly purchasing a security from the fund, except in limited circumstances. Under section 17(b) of the Act, such persons can apply to the Commission for an exemption from these prohibitions. In 1996, the Commission adopted rule 17a-9, which permits affiliated persons of funds and affiliated persons of such persons to purchase distressed securities in funds’ portfolios subject to certain conditions, without the need to first obtain an individual exemption. We are proposing certain amendments to rule 17a-9 in this release, as well as an amendment to rule 2a-7 that would require money market funds to notify us of any transactions under rule 17a-9. See *infra* Section II.H.

<sup>33</sup> See 1990 Proposing Release, *supra* note 22, at nn.16–18 and accompanying text; 1996 Adopting Release, *supra* note 20, at nn.22–23 and accompanying text.

<sup>34</sup> See 1991 Adopting Release, *supra* note 20; 1996 Adopting Release, *supra* note 20.

<sup>35</sup> See rule 2a-7(c)(4).

<sup>36</sup> See 1983 Adopting Release, *supra* note 3, at nn.41–42 and accompanying text; 1996 Adopting Release, *supra* note 20, at nn.22–29 and accompanying text.

<sup>37</sup> See Neil Shah, *Money Market Funds Cut Exposure to Risky SIV Debt—S&P*, Reuters, Nov. 21, 2007, available at <http://www.reuters.com/article/bondsNews/idUSN2146813220071121>.

<sup>38</sup> We know of at least 44 money market funds that were supported by affiliates because of SIV investments. In many of these cases the affiliate support was provided in reliance on no-action assurances provided by Commission staff. Many of these no-action letters are available on our website. See <http://www.sec.gov/divisions/investment/im-noaction.shtml#money>. Unlike other asset backed commercial paper, SIV debt was not backed by an external liquidity provider.

<sup>39</sup> See, e.g., Alistair Barr, *HSBC’s Bailout Puts Pressure on Citi*, “Superfund,” Marketwatch, Nov. 26, 2007, available at <http://www.marketwatch.com/story/hsbcs-35-blm-siv-bailout-puts-pressure-on-citi-superfund>.

<sup>40</sup> See, e.g., *id.*

<sup>41</sup> See, e.g., Shannon D. Harrington & Christopher Condon, *Bank of America, Legg Mason Prop Up Their Money Funds*, Bloomberg, Nov. 13, 2007, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aWWjLp8m3J1I&refer=home>. Under rule 17a-9, funds are not required to report to us all such transactions. See *infra* Section II.H.

<sup>42</sup> See ICI Report, *supra* note 6, at 49.

<sup>43</sup> *Id.*

As financial markets continued to deteriorate in 2008, however, money market funds came under renewed stress. This pressure culminated the week of September 15, 2008, when the bankruptcy of Lehman Brothers Holdings Inc. (“Lehman Brothers”) led to heavy redemptions from about a dozen money market funds that held Lehman Brothers debt securities. On September 15, 2008, The Reserve Fund, whose Primary Fund series held a \$785 million position in commercial paper issued by Lehman Brothers, began experiencing a run on its Primary Fund, which spread to the other Reserve funds. The Reserve funds rapidly depleted their cash to satisfy redemptions, and began offering to sell the funds’ portfolio securities into the market, further depressing their valuations. Unlike the other money market funds that held Lehman Brothers debt securities (and SIV commercial paper), The Reserve Primary Fund ultimately had no affiliate with sufficient resources to support the \$1.00 net asset value. On September 16, 2008, The Reserve Fund announced that as of that afternoon, its Primary Fund would break the buck and price its securities at \$0.97 per share.<sup>44</sup> On September 22, 2008, in response to a request by The Reserve Fund, the Commission issued an order permitting the suspension of redemptions in certain Reserve funds, to permit their orderly liquidation.<sup>45</sup>

These events led many investors, especially institutional investors, to redeem their holdings in other prime money market funds and move assets to Treasury or government money market funds.<sup>46</sup> This trend was intensified by turbulence in the market for financial sector securities as a result of the bankruptcy of Lehman Brothers and the near failure of American International Group, whose commercial paper was held by many prime money market funds.

During the week of September 15, 2008, investors withdrew approximately \$300 billion from prime (taxable) money market funds, or 14 percent of the assets held in those funds.<sup>47</sup> Most of the heaviest redemptions were from institutional funds, which depleted cash positions and threatened to force a fire sale of portfolio securities that would have placed widespread pressure on fund share prices.<sup>48</sup> Fearing further redemptions, money market fund (and other cash) managers began to retain cash rather than invest in commercial paper, certificates of deposit or other short-term instruments.<sup>49</sup> In the final two weeks of September 2008, money market funds reduced their holdings of top-rated commercial paper by \$200.3 billion, or 29 percent.<sup>50</sup>

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<sup>44</sup> See Press Release, The Reserve Fund, A Statement Regarding The Primary Fund (Sept. 16, 2008). The Reserve Fund subsequently stated that the fund had broken the buck earlier in the day on September 16. See Press Release, The Reserve Fund, Important Notice Regarding Reserve Primary Fund’s Net Asset Value (Nov. 26, 2008) (“The Fund is announcing today that, contrary to previous statements to the public and to investors, the Fund’s net asset value per share was \$0.99 from 11:00 a.m. Eastern time to 4:00 p.m. Eastern time on September 16, 2008, and *not* \$1.00.”).

<sup>45</sup> See In the Matter of The Reserve Fund, Investment Company Act Release No. 28386 (Sept. 22, 2008) [73FR55572 (Sept.25,2008)] (order). Several other Reserve funds also obtained an order from the Commission on October 24, 2008, permitting them to suspend redemptions to allow for their orderly liquidation. See Reserve Municipal Money-Market Trust, et al., Investment Company Act Release No. 28466 (Oct. 24, 2008) [73 FR 64993 (Oct. 31, 2008)] (order).

<sup>46</sup> See U.S. Dollar Money Market Funds, *supra* note 17, at 72; Blackrock, The Credit Crisis: U.S. Government Actions and Implications for Cash Investors (Nov. 2008), available at [https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB\\_INS&ServiceName=PublicServiceView&ContentID=50824](https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&ServiceName=PublicServiceView&ContentID=50824) (“The Credit Crisis”); Standard & Poor’s, *Money Market Funds Tackle ‘Exuberant Irrationality,’* Ratings Direct, Sept. 30, 2008, available at [http://www2.standardandpoors.com/spf/pdf/media/MoneyMarketFunds\\_Irrationality.pdf](http://www2.standardandpoors.com/spf/pdf/media/MoneyMarketFunds_Irrationality.pdf).

<sup>47</sup> See ICI Report, *supra* note 6, at 62 (analyzing data from iMoneyNet); See also Investment Company Institute, *Money Market Mutual Fund Assets Historical Data*, Apr. 30, 2009, available at [http://www.ici.org/pdf/mm\\_data\\_2009.pdf](http://www.ici.org/pdf/mm_data_2009.pdf) (“ICI Mutual Fund Historical Data”).

<sup>48</sup> See ICI Mutual Fund Historical Data, *supra* note 47.

<sup>49</sup> See Philip Swagel, “The Financial Crisis: An Inside View,” Brookings Papers on Economic Activity, at 31 (Spring 2009) (conference draft), available at [http://www.brookings.edu/economics/bpea/-/media/Files/Programs/ES/BPEA/2009\\_spring\\_bpea\\_papers/2009\\_spring\\_bpea\\_swagel.pdf](http://www.brookings.edu/economics/bpea/-/media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009_spring_bpea_swagel.pdf).

<sup>50</sup> See Christopher Condon & Bryan Keogh, *Funds’ Flight from Commercial Paper Forced Fed Move*, Bloomberg, Oct. 7, 2008, available at [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5hvnKFCC\\_pQ](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5hvnKFCC_pQ).

As a consequence, short-term markets seized up, impairing access to credit in short-term private debt markets.<sup>51</sup> Some commercial paper issuers were only able to issue debt with overnight maturities.<sup>52</sup> The interest rate premium (spread) over three-month Treasury bills paid by issuers of three-month commercial paper widened significantly from approximately 25–100 basis points before the September 2008 market events to approximately 200–350 basis points, and issuers were exposed to the costs and risks of having to roll over increasingly large amounts of commercial paper each day.<sup>53</sup> Many money market fund sponsors took extraordinary steps to protect funds' net assets and preserve shareholder liquidity by purchasing large amounts of securities at the higher of market value or amortized cost and by providing capital support to the funds.<sup>54</sup>

On September 19, 2008, the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System ("Federal Reserve Board") announced an unprecedented market intervention by the federal government in order to stabilize and provide liquidity to the short-term markets. The Department of the Treasury announced its Temporary Guarantee Program for Money Market Funds ("Guarantee Program"), which temporarily guaranteed certain investments in money market funds that decided to participate in the program.<sup>55</sup> The Federal Reserve Board announced the creation of its Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"), through which it extended credit to U.S. banks and bank holding companies to finance their purchases of high-quality asset backed commercial paper from money market funds.<sup>56</sup> In addition, the Federal Reserve Board's Commercial Paper Funding Facility ("CPFF") provided support to issuers of commercial paper through a conduit that purchased commercial

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<sup>51</sup> See *Minutes of the Federal Open Market Committee*, Federal Reserve Board, Oct. 28-29, 2008, at 5, available at <http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20081029.pdf> ("*FRB Open Market Committee Oct. 28–29 Minutes*") (stating that following The Reserve Fund's announcement that the Primary Fund would break the buck, "risk spreads on commercial paper rose considerably and were very volatile" and "[c]onditions in short-term funding markets improved somewhat following the announcement of...a number of mutual initiatives by the Federal Reserve and the Treasury to address the pressures on money market funds and the commercial paper market"). See also Press Release, Federal Reserve Board Announces Creation of the Commercial Paper Funding Facility (CPFF) to Help Provide Liquidity to Term Funding Markets (Oct. 7, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm> ("The commercial paper market has been under considerable strain in recent weeks as money market mutual funds and other investors, themselves often facing liquidity pressures, have become increasingly reluctant to purchase commercial paper, especially at longer-dated maturities. As a result, the volume of outstanding commercial paper has shrunk, interest rates on longer term commercial paper have increased significantly, and an increasingly high percentage of outstanding paper must now be refinanced each day. A large share of outstanding commercial paper is issued or sponsored by financial intermediaries, and their difficulties placing commercial paper have made it more difficult for those intermediaries to play their vital role in meeting the credit needs of businesses and households.").

<sup>52</sup> See Matthew Cowley, *Burnt Money Market Funds Stymie Short-Term Debt*, Dow Jones International News, Oct. 1, 2008; Anusha Shrivastava, *Commercial-Paper Market Seizes Up*, *The Wall Street Journal*, Sept. 19, 2008, at C2.

<sup>53</sup> See Federal Reserve Board data, available at [http://www.frbatlanta.org/econ\\_rd/macroblog/102808b.jpg](http://www.frbatlanta.org/econ_rd/macroblog/102808b.jpg) (charting three-month commercial paper spreads over three-month Treasury bill); See also Federal Reserve Board Chairman Ben S. Bernanke, Testimony before the Committee on Financial Services, U.S. House of Representatives (Nov. 18, 2008), available at <http://www.federalreserve.gov/newsevents/testimony/bernanke20081118a.htm>.

<sup>54</sup> Commission staff provided no-action assurances allowing 100 money market funds in 18 different fund complexes to enter into such arrangements during the period from September 16, 2008, to October 1, 2008. See, e.g., <http://www.sec.gov/divisions/investment/im-noaction.shtml#money>.

<sup>55</sup> See Press Release, U.S. Department of the Treasury, Treasury Announces Guaranty Program for Money Market Funds (Sept. 19, 2008), available at <http://www.treas.gov/press/releases/hp1147.htm>. The Program insures investments in money market funds, to the extent of their shareholdings as of September 19, 2008, if the fund has chosen to participate in the Program. The Guarantee Program is due to expire on September 18, 2009. We adopted, on an interim final basis, a temporary rule, rule 22e-3T, to facilitate the ability of money market funds to participate in the Guarantee Program. The rule permits a participating fund to suspend redemptions if it breaks a buck and liquidates under the terms of the Program. See Rule 22e-3T Adopting Release, *supra* note 31. The temporary rule will expire on October 18, 2009. We discuss this rule in more detail in *infra* Section II.I.

<sup>56</sup> See Press Release, Federal Reserve Board, Federal Reserve Board Announces Two Enhancements to Its Programs to Provide Liquidity to Markets (Sept. 19, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20080919a.htm>. The AMLF will expire on February 1, 2010, unless extended. See Press Release, Federal Reserve Board, Federal Reserve Announces Extensions of and Modifications to a Number of Its Liquidity Programs (June 25, 2009), available at <http://www.federalreserve.gov/newsevents/press/monetary/20090625a.htm> ("2009 Federal Reserve Extension and Modification Announcement").

paper from eligible issuers, although the CPFF did not purchase commercial paper from money market funds.<sup>57</sup> The Commission and its staff worked closely with the Treasury Department and the Federal Reserve Board to help design these programs, most of which relied in part on rule 2a-7 to tailor the program and/or condition the terms of a fund's participation in the program, and we also assisted in administering the Guarantee Program.<sup>58</sup> Our staff also worked with sponsors of money market funds to provide regulatory relief they requested to participate fully in these programs.<sup>59</sup>

These steps helped to stanch the tide of redemptions from institutional prime money market funds,<sup>60</sup> and provided liquidity to money market funds that held asset backed commercial paper. Commercial paper markets remained illiquid, however, and, as a result, money market funds experienced significant problems pricing portfolio securities. Institutional as well as retail money market funds with little redemption activity and no distressed securities reported to our staff that they nevertheless faced the prospect of breaking the buck as a consequence of their reliance on independent pricing services that reported prices based on models with few reliable inputs. The Commission's Office of Chief Accountant and the Financial Accounting Standards Board provided funds and others guidance on determining fair value of securities in turbulent markets,<sup>61</sup> but it appeared that fund boards remained reluctant to deviate from the prices received from their vendors. On October 10, 2008, our Division of Investment Management issued a letter agreeing not to recommend enforcement action if money market funds met the "shadow pricing" obligations of rule 2a-7 by pricing certain of their portfolio securities with a remaining final maturity of less than 60 days by reference to their amortized cost.<sup>62</sup>

Over the four weeks after The Reserve Fund's announcement, assets in institutional prime money market funds shrank by 30 percent, or approximately \$418 billion (from \$1.38 trillion to \$962 billion).<sup>63</sup> No money market fund other than The Reserve Primary Fund broke the buck, although money market fund sponsors or their affiliated persons in many cases committed extraordinary amounts of capital to support the \$1.00 net asset value per share. Our staff estimates that

<sup>57</sup> See Press Release, Federal Reserve Board, Board Announces Creation of the Commercial Paper Funding Facility (CPFF) to Help Provide Liquidity to Term Funding Markets (Oct. 7, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm>. At one point the Federal Reserve had purchased about one-fifth of all commercial paper outstanding in the U.S. market. See Bryan Keogh, *GE Leads Commercial Paper "Test" as Fed's Buying Ebbs*, Bloomberg, Jan. 27, 2009, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHWA87Aa2aQQ>. The CPFF will expire on February 1, 2010, unless extended. See 2009 Federal Reserve Extension and Modification Announcement, *supra* note 56. Although the CPFF did not directly benefit money market funds, it did indirectly benefit them by stabilizing the commercial paper market. See, e.g., Richard G. Anderson, *The Success of the CPFF?* (Economic Synopses No. 18, Federal Reserve Bank of St. Louis, 2009), at 2, available at <http://www.research.stlouisfed.org/publications/es/09/ES0918.pdf>.

<sup>58</sup> See, e.g., Guarantee Agreement that money market funds participating in the Treasury's Guarantee Program were required to sign, at 2, 10, available at [http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-docs/Guarantee-Agreement\\_form.pdf](http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-docs/Guarantee-Agreement_form.pdf) (under which money market funds were required to state that they operated in compliance with rule 2a-7 to be eligible to initially participate in the program and must continue to comply with rule 2a-7 to continue to participate in the program); See also <http://www.sec.gov/divisions/investment/mmtempguarantee.htm>.

<sup>59</sup> See Investment Company Institute, SEC Staff No-Action Letter (Sept. 25, 2008) (relating to the AMLF); Investment Company Institute, SEC Staff No-Action Letter (Oct. 8, 2008) (relating to the Guarantee Program). These no-action letters are available on our website at <http://www.sec.gov/divisions/investment/im-noaction.shtml#money>.

<sup>60</sup> During the week ending September 18, 2008, taxable institutional money market funds experienced net outflows of \$165 billion. See *Money Fund Assets Fell to \$3.4T in Latest Week*, Associated Press, Sept. 18, 2008. Almost \$80 billion was withdrawn from prime money market funds even after the announcement of the Guarantee Program on September 19, 2008. See Diana B. Henriques, *As Cash Leaves Money Funds, Financial Firms Sign Up for U.S. Protection*, N.Y. Times, Oct. 2, 2008, at C10. However, by the end of the week following the announcement, net outflows from taxable institutional money market funds had ceased. See *Money Fund Assets Fell to \$3.398T in Latest Week*, Associated Press, Sept. 25, 2008.

<sup>61</sup> See Press Release No. 2008-234, Securities and Exchange Commission, Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008), available at <http://www.sec.gov/news/press/2008/2008-234.htm>.

<sup>62</sup> Investment Company Institute, SEC Staff No-Action Letter (Oct. 10, 2008). This letter is available on our website at <http://www.sec.gov/divisions/investment/noaction/2008/ICI101008.htm>. The letter by its terms did not apply, however, to shadow pricing if particular circumstances (such as the impairment of the creditworthiness of the issuer) suggested that amortized cost was not appropriate. The staff position also was limited to portfolio securities that were "first tier securities" under rule 2a-7 and that the fund reasonably expected to hold to maturity. The letter applied to shadow pricing procedures through January 12, 2009.

<sup>63</sup> On September 10, 2008, six days prior to The Reserve Fund's announcement, approximately \$1.38 trillion was invested in institutional prime (taxable) money market funds. See ICI Mutual Fund Historical Data, *supra* note 47. On October 8, 2008, approximately \$962 billion was invested in those funds. See *id.* In addition, between September 10 and September 17, the assets of these funds fell by approximately \$193 billion. See *id.*

during the period from August 2007 to December 31, 2008, almost 20 percent of all money market funds received some support from their money managers or their affiliates.<sup>64</sup>

During this time period, short-term credit markets became virtually frozen as market participants hoarded cash and generally refused to lend on more than an overnight basis.<sup>65</sup> Interest rate spreads increased dramatically.<sup>66</sup> After shrinking to historically low levels as credit markets boomed in the mid-2000s, interest rate spreads surged upward in the summer of 2007 and peaked after the bankruptcy of Lehman Brothers in September 2008.<sup>67</sup> Money market funds shortened the weighted average maturity of their portfolios to be better positioned in light of increased liquidity risk to the funds.<sup>68</sup>

Although the crisis money markets faced last fall has abated, the problems have not disappeared. Today, while interest rate spreads have recently declined considerably, they remain above levels prior to the crisis,<sup>69</sup> and short-term debt markets remain fragile.<sup>70</sup> Although the average weighted average maturity of taxable money market funds (as a group) had risen to 53 days as of the week ended June 16, 2009,<sup>71</sup> we understand that the long-term securities that account for the longer weighted average maturity are not commercial paper and corporate medium term notes (as they were before the crisis), but instead are predominantly government securities, which suggests that money market funds may still be concerned about credit risk.

The Treasury Guarantee Program has been extended twice, but is set to expire on September 18, 2009.<sup>72</sup> Programs established by the Federal Reserve Board to support liquidity in the short-term market are set to expire early next year.<sup>73</sup> Total money market fund assets have continued to grow and now amount to approximately \$3.8 trillion.<sup>74</sup> However, the composition of those assets has changed dramatically. Between September 10 and October 8, 2008, government money

<sup>64</sup> This estimate is based on no-action requests and other conversations with our staff during this time period.

<sup>65</sup> The Credit Crisis, *supra* note 46, at 1 (“After experiencing more than \$400 billion in outflows over a short period of time, money funds had little appetite for commercial paper; even quality issuers discovered they could not access the commercial paper market....”).

<sup>66</sup> An interest rate spread measures the difference in interest rates of debt instruments with different risk. See Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 J. Econ. Perspectives 77, 85, Winter 2009 (“Brunnermeier”).

<sup>67</sup> See *id.*; David Oakley, *LIBOR Hits Record Low as Credit Fears Ease*, Fin. Times, May 5, 2009. For example, the “TED” spread (the difference between the risk-free U.S. Treasury Bill rate and the riskier London Inter-bank Offering Rate (“LIBOR”)), normally around 50 basis points, reached a high of 463 basis points on October 10, 2008. See David Serchuk, *Banks Led by the TED*, Forbes, Jan. 12, 2009.

<sup>68</sup> Taxable money market fund average weighted average maturities shortened to 40–42 days during October 2008 from 45–46 days shortly prior to this period based on analysis of data from the iMoneyNet Money Fund Analyzer database.

<sup>69</sup> The TED spread was 52 basis points on May 29, 2009. The LIBOR-OIS spread (the difference between three-month dollar London Interbank Offered Rate and the overnight index swap rate) was 45 basis points. See Lukanyo Mnyanda, *Libor Declines for Second Day on Signs Economic Slump Is Easing*, Bloomberg, May 29, 2009, available at <http://www.bloomberg.com/apps/news?pid=20670001&sid=agpZArg2paJE>. Prior to the start of the financial turbulence in the summer of 2007, the TED spread averaged approximately 25–50 basis points and the three-month LIBOR-OIS spread averaged 7–9 basis points. See historical chart of TED spread available at <http://www.bloomberg.com/apps/cbuilder?ticker1=.TEDSP%3AIND>; Simon Kwan, *Behavior of LIBOR in the Current Financial Crisis*, FRBSF Economic Letter (Federal Reserve Bank of San Francisco), Jan. 23, 2009, at 2–3, available at <http://www.frbsf.org/publications/economics/letter/2009/el2009-04.pdf>.

<sup>70</sup> See Bryan Keogh, John Detrixhe & Gabrielle Coppola, *Coca-Cola Flees Commercial Paper for Safety in Bonds*, Bloomberg, Mar. 17, 2009, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=atxKQSJUp6RE> (noting that certain companies are issuing long-term debt to replace commercial paper to avoid the risk of not being able to roll over their commercial paper, given the instability in short-term credit markets); Michael McKee, *Fed Credit Has Stabilized Markets, Not Fixed Them, Study Says*, Bloomberg, Mar. 6, 2008, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRGBZuGYE78Y>.

<sup>71</sup> This information is based on analysis of data from the iMoneyNet Money Fund Analyzer database.

<sup>72</sup> See Press Release, U.S. Department of the Treasury, Treasury Announces Extension of Temporary Guarantee Program for Money Market Funds (Nov. 24, 2008), available at <http://www.treas.gov/press/releases/hp1290.htm>; Press Release, U.S. Department of the Treasury, Treasury Announces Extension of Temporary Guarantee Program for Money Market Funds (Mar. 31, 2009), available at <http://www.treas.gov/press/releases/tg76.htm>.

<sup>73</sup> The AMLF and the CPFF will expire on February 1, 2010. See Press Release, Federal Reserve (June 25, 2009), available at <http://www.federalreserve.gov/newsevents/press/monetary/20090625a.htm>. The use of the AMLF peaked on October 1, 2008, with holdings of \$152.1 billion. See Federal Reserve Board, Statistical Release H.4.1: Factors Affecting Reserve Balances (Oct. 2, 2008), available at <http://www.federalreserve.gov/releases/h41/20081002>. AMLF holdings as of April 29, 2009, stood at \$3.699 billion. See Federal Reserve Board, Statistical Release H.4.1: Factors Affecting Reserve Balances (Apr. 30, 2009), available at <http://www.federalreserve.gov/releases/h41/20090430>.

<sup>74</sup> See ICI Trends, *supra* note 4.

market fund assets *increased* by about 47 percent compared to a *decrease* of about 21 percent in taxable prime money market fund assets.<sup>75</sup> Since that time, prime money market fund assets have begun to grow again, although they remain below pre-September 2008 levels and government money market fund assets remain elevated.<sup>76</sup>

Finally, The Reserve Primary Fund has yet to distribute all of its remaining assets to shareholders, many of whom were placed in financial hardship as a result of losing access to their investments.<sup>77</sup> The dissolution of the fund has been affected by several factors, including operational difficulties and lack of liquidity in the secondary markets, and by legal uncertainties over the disposition of the remaining assets. We recently instituted an action in federal court seeking to ensure that the liquidation is effected on a fair and equitable basis,<sup>78</sup> and propose in this release regulatory changes designed to protect investors in a fund that breaks a dollar in the future.<sup>79</sup>

## II. DISCUSSION

The severe problems experienced by money market funds since the fall of 2007 and culminating in the fall of 2008 have prompted us to review our regulation of money market funds. Based on that review, including our experience with The Reserve Fund, we today are proposing for public comment a number of significant amendments to rule 2a-7 under the Investment Company Act.

In formulating these proposals, Commission staff has consulted extensively with other members of the President's Working Group on Financial Markets, and in particular the Department of Treasury and the Federal Reserve Board, which provided support to money market funds and the short-term debt markets last fall, and which continue to administer programs from which money market funds and their shareholders benefit. We have consulted with managers of money market funds and other experts to develop a deeper understanding of the stresses experienced by funds and the impact of our regulations on the readiness of money market funds to cope with market turbulence and satisfy heavy demand for redemptions. In March, we received an extensive report from a "Money Market Working Group" assembled by the Investment Company Institute ("ICI Report"), which recommended a number of changes to our rule 2a-7 that it believes could improve the safety and oversight of money market funds.<sup>80</sup> We have also drawn from our experience as a regulator of money market funds under rule 2a-7 for more than 25 years and particularly since autumn 2007.

Our proposals, which we discuss in more detail below, are designed to increase the resilience of money market funds to market disruptions such as those that occurred last fall. The proposed rules would reduce the vulnerability of money market funds to breaking the buck by, among other things, improving money market funds' ability to satisfy significant demands for redemptions. If a particular fund does break the buck and determines to liquidate, the proposed rules would facilitate the orderly liquidation of the fund in order to protect the interests of all fund shareholders. These changes together should make money market funds (collectively) less susceptible to a run by diminishing the chance that a money market fund will break a dollar and, if one does, provide a means for the fund to orderly liquidate its assets. Finally, our proposals would improve our ability to oversee money market funds by requiring funds to submit to us current portfolio information.

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<sup>75</sup> See ICI Mutual Fund Historical Data, *supra* note 47.

<sup>76</sup> See *id.*

<sup>77</sup> The Reserve Primary Fund did not make an initial partial pro rata distribution of assets until October 30, 2008. See Press Release, The Reserve Fund, Reserve Primary Fund Makes Initial Distribution of \$26 Billion to Primary Fund Shareholders (Oct. 30, 2008). The fund has distributed approximately 90 percent of its assets. See Press Release, The Reserve Fund, Court Issues Order Setting Objection and Hearing Dates on Securities and Exchange Commission's Proposed Plan for Distribution of Reserve Primary Fund's Assets (June 15, 2009).

<sup>78</sup> See SEC v. Reserve Management Co., Inc., et al., Litigation Release No. 21025 (May 5, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21025.htm>. We note that we also have filed fraud charges against several entities and individuals who operate The Reserve Primary Fund alleging that they failed to provide key material facts to investors and trustees about the fund's vulnerability as Lehman Brothers sought bankruptcy protection. See *id.*

<sup>79</sup> See *infra* Section II.I.

<sup>80</sup> ICI Report, *supra* note 6.

Our proposals represent the first step in addressing issues we believe merit immediate attention.<sup>81</sup> Throughout this release, we ask comment on other possible regulatory changes aimed at further strengthening the stability of money market funds. In addition, we ask comment on some more far-reaching changes that could transform the business and regulatory model on which money market funds have operated for more than 30 years, including whether money market funds should move to a floating net asset value.<sup>82</sup> We expect to benefit from the comments we receive before deciding whether to propose further changes.

### A. Portfolio Quality

To limit the amount of credit risk to which money market funds can be exposed, rule 2a-7 limits them to investing in securities that a fund's board of directors (or its delegate pursuant to written guidelines) determines present minimal credit risks.<sup>83</sup> In addition, securities must at the time of acquisition be "eligible securities," which means in part that they must have received the highest or second highest short-term debt ratings from the "requisite NRSROs."<sup>84</sup> Because of the additional credit risk that generally is represented by securities rated in the second highest, rather than the highest, NRSRO rating category, a taxable money market fund may not invest more than five percent of its total assets in "second tier securities."<sup>85</sup> Tax-exempt money market funds are limited in the same manner only with respect to second tier "conduit securities," i.e., municipal securities backed by a private issuer.<sup>86</sup>

We are also proposing a change to the provisions of rule 2a-7 that limit money market funds to investing in high quality securities. We propose to generally limit money market fund investments to securities rated in the highest NRSRO ratings category. In addition, we are seeking comment on whether to modify provisions of the rule that incorporate minimum ratings by NRSROs to reflect changes made to the federal securities laws by the Credit Rating Agency Reform Act of 2006 ("Rating Agency Reform Act").<sup>87</sup>

#### 1. Second Tier Securities

We propose to amend rule 2a-7 to allow money market funds to invest only in first tier securities. Under the proposed amendments, money market funds could "acquire" only "eligible securities," which would be re-defined to include

<sup>81</sup> We note that we accomplished the reforms of money market fund regulation we initiated in 1990 in two steps. See 1990 Proposing Release, *supra* note 22 (taxable money market funds); Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] (tax exempt money market funds) ("1993 Proposing Release").

<sup>82</sup> See *infra* Section III.A.

<sup>83</sup> Rule 2a-7(c)(3)(i). Although rule 2a-7 refers to determinations to be made by a fund or its board, many of these determinations under the rule may be delegated to the investment adviser or fund officers pursuant to written guidelines that the board establishes and oversees to assure that the applicable procedures are being followed. Rule 2a-7(e).

<sup>84</sup> Rule 2a-7(a)(10)(i) (defining "eligible security"). If the securities are unrated, they must be of comparable quality. Rule 2a-7(a)(10)(ii). The term "requisite NRSROs" is defined in paragraph (a)(21) of the rule to mean "(i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or (ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund Acquires the security, that NRSRO." Thus, a security can satisfy the ratings requirement in one of four ways: (1) it is rated in the same (top two) category by any two NRSROs; (2) if it is rated by at least two NRSROs in either of the top two categories, but no two NRSROs assign the same rating, the lower rating is assigned; (3) it is rated by only one NRSRO, in one of the top two categories; or (4) it is an unrated security that the board or its delegate determines to be of comparable quality to securities satisfying the rating criteria. The terms "rated security" and "unrated security" are defined in paragraphs (a)(19) and (a)(28) of rule 2a-7, respectively.

<sup>85</sup> Rule 2a-7(c)(3)(ii)(A). See also rule 2a-7(a)(10) (defining "eligible security"), (a)(22) (defining "second tier security" as any eligible security that is not a first tier security), and (a)(12) (defining "first tier security" as, among other things, any eligible security that, if rated, has received the highest short-term term debt rating from the requisite NRSROs or, if unrated, has been determined by the fund's board of directors to be of comparable quality). See also 1990 Proposing Release, *supra* note 22, at Section II.1.b.

<sup>86</sup> Rule 2a-7(c)(3)(ii)(B). See also rule 2a-7(a)(7) (defining "conduit security").

<sup>87</sup> Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327.



securities receiving only the highest (rather than the highest two) short-term debt ratings from the “requisite NRSROs.”<sup>88</sup> Funds would not have to immediately dispose of a security that was downgraded by the requisite NRSROs but, under existing provisions of rule 2a-7, the fund would have to dispose of the security “as soon as practicable consistent with achieving an orderly disposition of the security” unless the fund’s board of directors finds that such disposal would not be in the best interest of the fund.<sup>89</sup>

We have considered previously the extent to which money market funds should be permitted to invest in second tier securities. In 1991, following distress at several money market funds that held defaulted commercial paper, the Commission, among other things, limited a taxable money market fund’s total investment in second tier securities to five percent of the fund’s portfolio assets and limited the investment in any particular issuer of second tier securities to no more than the greater of one percent of the fund’s portfolio assets or \$1 million.<sup>90</sup> At that time, commenters in favor of eliminating money market funds’ investment in second tier securities argued that such securities may undergo a rapid deterioration and thus may pose risks to the fund holding such securities as well as to investor confidence in money market funds in general.<sup>91</sup> On the other hand, issuers of second tier securities urged the Commission not to limit money market funds’ holdings of second tier securities, arguing that the Commission’s concerns regarding the creditworthiness of second tier securities were misplaced and that restrictions would raise issuers’ borrowing costs and discourage money market funds from holding any second tier securities.<sup>92</sup> Based principally on the potential risk to money market funds of holding second tier securities, we adopted the five percent and one percent limitations to limit (but not eliminate) exposure of money market funds to second tier securities and any one issuer of second tier securities.<sup>93</sup>

Second tier securities were not directly implicated in the recent strains on money market funds. The ICI’s Money Market Working Group expressed concern to us, however, that these securities may present an “imprudent” risk to the stable value of money market funds because they present “weaker credit profiles, smaller overall market share, and smaller issuer program sizes....”<sup>94</sup> Our examination of the data discussed below suggests support for their recommendation that money market funds no longer be permitted to invest in these securities.<sup>95</sup>

Compared to the market for first tier securities, the market for second tier securities is relatively small. As of June 24, 2009, there was \$1082.5 billion in rule 2a-7–eligible commercial paper outstanding, consisting of

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<sup>88</sup> See rule 2a-7(a)(1) (defining acquisition (or acquire) as any purchase or subsequent rollover, but not including the failure to exercise a demand feature); proposed rule 2a-7(a)(11)(iii) (defining eligible security); proposed rule 2a-7(c)(3) (portfolio quality). Because eligible securities would no longer be divided into first tier and second tier securities, both of those terms would be deleted from the rule, as would provisions relating specifically to second tier securities. See rule 2a-7(a)(12), (a)(22), (c)(3)(ii), (c)(4)(i)(C), (c)(4)(iii)(B), (c)(6)(i)(A), and (c)(6)(i)(C). We would therefore amend the definition of eligible security to require that securities receive “the highest,” as opposed to “one of the two highest” short-term rating categories, as the current definition provides, and delete other references in the rule to the second highest rating category. See proposed rule 2a-7(a)(11)(iii). The definition of eligible security also would be expanded to include two types of securities, securities issued by a money market fund and “Government securities,” that were formerly part of the definition of first tier securities. See proposed rule 2a-7(a)(11)(i) and (ii); See also rule 2a-7(a)(14) (defining Government security). Unrated securities determined by the board of directors of the fund or its delegate to be of comparable quality also would still be eligible securities. See proposed rule 2a-7(a)(11)(iv).

<sup>89</sup> See rule 2a-7(c)(6)(ii); proposed rule 2a-7(c)(7)(ii).

<sup>90</sup> See rule 2a-7(c)(3)(ii)(A), (c)(4)(i)(C)(1). See also 1991 Adopting Release, *supra* note 20.

<sup>91</sup> See 1991 Adopting Release, *supra* note 20, at n.36 and accompanying text. Most commenters representing the mutual fund industry supported or did not oppose the limitations we proposed. *Id.* at n.35 and accompanying text.

<sup>92</sup> See *id.* at text following n.35.

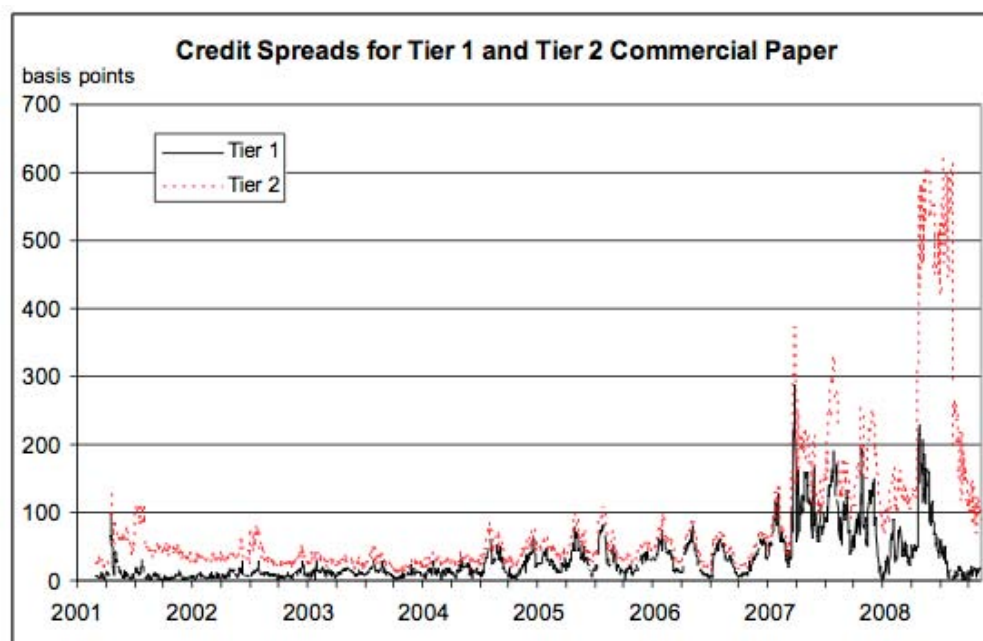
<sup>93</sup> See *id.* at n.35–37 and accompanying text; 1990 Proposing Release, *supra* note 22, at n.33 and accompanying text.

<sup>94</sup> ICI Report, *supra* note 6, at 101.

<sup>95</sup> *Id.* at 100.

\$1035.8 billion (95.7 percent) of first tier and \$46.7 billion (4.3 percent) of second tier.<sup>96</sup> The size of the second tier market has remained consistently small over time.<sup>97</sup>

In addition, second tier securities present potentially substantially more risk than first tier securities. As the following chart shows, during the market disruptions of last fall, second tier securities experienced significantly wider credit spreads than first tier securities.<sup>98</sup>



Source of Data: Federal Reserve, available at <http://www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP>.

Second tier securities as an asset class also are of weaker credit quality in terms of interest coverage ratios, debt coverage ratios, and debt to equity ratios.<sup>99</sup> These data strongly suggest that second tier securities generally present additional risks to a money market fund. This is a conclusion that may have been reached by money market fund managers, most of which (as described below) do not invest in second tier securities. In light of the risks that second tier securities generally present to money market funds, and the consequences to funds and fund investors of breaking a dollar, we are proposing to limit funds to investing in first tier securities. We believe such a limitation would make it less likely that a money market fund would hold a problematic security, or a security that would lose significant value as a result of market disruptions.

It does not appear that amending rule 2a-7 to eliminate money market funds' ability to acquire second tier securities would be materially disruptive to funds. Prior to our amendments to rule 2a-7 in 1991, non-government money market

<sup>96</sup> See Federal Reserve Board Commercial Paper Outstanding Chart, available at <http://www.federalreserve.gov/releases/cp/outstandings.htm> (showing weekly levels of rule 2a-7-eligible commercial paper outstanding).

<sup>97</sup> See Federal Reserve Board Commercial Paper Data Download Program, available at <http://www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP> (select year-end outstandings from the preformatted data package menu and follow the instructions for download). Over the last eight years, the market for second tier securities on average has represented only 4.6 percent of the rule 2a-7-eligible commercial paper market.

<sup>98</sup> See Federal Reserve Board Commercial Paper Rates Chart, available at <http://www.federalreserve.gov/releases/cp/default.htm>. See also Frank J. Fabozzi, *The Handbook of Fixed Income Securities*, at 4 (7th ed. 2005) ("Default risk or credit risk refers to the risk that the issuer of a bond may be unable to make timely payment of principal or interest payments....The spread between Treasury securities and non-Treasury securities that are identical in all respects except for quality is referred to as a *credit spread* or *quality spread*.").

<sup>99</sup> See Standard & Poor's, *Creditstats: 2007 Adjusted Key U.S. Industrial and Utility Financial Ratios*, at 6, Table 3 (Sept. 10, 2008), available at [http://www2.standardandpoors.com/spf/pdf/fixedincome/CreditStats\\_2007\\_Adjusted\\_Key\\_Financial\\_Ratios.pdf](http://www2.standardandpoors.com/spf/pdf/fixedincome/CreditStats_2007_Adjusted_Key_Financial_Ratios.pdf) (showing A-2 rated commercial paper had EBIT interest coverage of 7.2x, free operating cash flow to debt of 16.7%, and debt to debt plus equity of 45.1%, compared to A-1 averages of 11.5x, 31.3%, and 37.1%, respectively, represented as three-year (2005–2007) averages).

funds held more than eight percent of their assets in second tier securities.<sup>100</sup> After we restricted the amount of second tier securities money market funds could buy, the funds soon reduced their holdings to almost zero.<sup>101</sup> Our staff's review of money market fund portfolios in September 2008 found that second tier securities represented only 0.4 percent of the \$3.6 trillion held by the funds (approximately \$14.6 billion).

We request comment on our proposal to eliminate the ability of money market funds to invest in second tier securities. What would be the impact on funds? Would the benefit of reducing credit risk by eliminating the ability of money market funds to invest in second tier securities outweigh any potential diversification benefits that second tier securities may otherwise provide to money market funds? What, if any, diversification benefits do money market funds currently receive from investing in second tier securities? Would this change have a significant effect on yields?

Would there be a proportionately greater impact of eliminating second tier securities on smaller or less established money market funds or on particular types of funds (e.g., single-state tax exempt funds)? If the proposal to eliminate funds' ability to hold second tier securities is adopted, what transition period should we provide money market funds to dispose of their existing second tier holdings in an orderly manner? Should we allow funds that hold second tier securities after the amended rule becomes effective to continue to hold such securities until maturity?

Are there alternatives to eliminating entirely the ability of a money market fund to invest in second tier securities? For example, should money market funds instead be limited to investing in second tier securities (i) with a maximum maturity of, for example, 45 days, or (ii) as a smaller portion of fund assets, such as two percent of the total assets, or (iii) a combination of both? A security with a shorter maturity presents less credit risk to a fund (because the exposure is shorter) and less liquidity risk (because cash will be available sooner). Would such an approach address, or at least partly address, the concerns raised by the ICI Report and in this Release?<sup>102</sup> Could additional credit risk analysis or other procedures be imposed with respect to second tier securities to address these concerns?

## 2. Eligible Securities

### a. Use of NRSROs

As discussed above, rule 2a-7 currently requires a money market fund to limit its portfolio investments to eligible securities, i.e., short-term securities that at the time of acquisition have received ratings from the "requisite NRSROs" in one of the two highest short-term debt rating categories and securities that are comparable to rated securities.<sup>103</sup>

A determination that a security is an eligible security as a result of its NRSRO ratings is a necessary but not sufficient finding in order for a fund to acquire the security.<sup>104</sup> References to NRSRO ratings in rule 2a-7 and other regulations were designed to provide a clear reference point to regulators and market participants. The reliability of credit ratings, however, has been questioned, in particular in light of developments during the recent financial crisis. As a result, there have been calls to produce higher quality ratings. Last year, we proposed to eliminate the use of NRSRO ratings in rules under the Investment Company Act, including rule 2a-7, and instead to rely solely on the fund manager's credit risk determination.<sup>105</sup> In 2003, in a concept release seeking comment on various issues relating to credit rating agencies, we also asked whether credit ratings should be used as a minimum objective standard in rule 2a-7. Most commenters who

<sup>100</sup> See Crabbe & Post, *supra* note 15, at 11, Table 2.

<sup>101</sup> See *id.*, at 11-12.

<sup>102</sup> See ICI Report, *supra* note 6, at 100-101.

<sup>103</sup> See *supra* note 84 and accompanying text. A "rated security" generally means a security that (i) has received a short-term rating from an NRSRO, or whose issuer has received a short-term rating from an NRSRO with respect to a class of debt obligations that is comparable in priority and security with the security; or (ii) is subject to a guarantee that has received a short-term rating from an NRSRO, or a guarantee whose issuer has received a short-term rating from an NRSRO with respect to a class of debt obligations that is comparable in priority and security with the guarantee. Rule 2a-7(a)(19).

<sup>104</sup> The rule also requires fund boards (which typically rely on the fund's adviser) to determine that the security presents minimal credit risks, and specifically requires that determination "be based on factors pertaining to credit quality in addition to any ratings assigned to such securities by an NRSRO." Rule 2a-7(c)(3)(i).

<sup>105</sup> See, e.g., References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327 (July 1, 2008) [73 FR 40124 (July 11, 2008)] ("NRSRO References Proposal").

addressed the specific question in 2003 supported retaining the ratings requirement in rule 2a-7.<sup>106</sup> One commenter asserted that “[t]he combination of this objective test with the ‘subjective test’ (credit analysis performed by the adviser to the money market fund) provides an important complementary rating structure under Rule 2a-7.”<sup>107</sup> Similarly, in our proposal last year, a substantial majority of commenters disagreed with the proposed elimination of the ratings requirement.<sup>108</sup> The ICI Report summed up the views of many of these commenters, asserting that elimination of the NRSRO ratings’ “floor...would remove an important investor protection from Rule 2a-7, introduce new uncertainties and risks, and abandon a regulatory framework that has proven to be highly successful.”<sup>109</sup> A few commenters supported removing the ratings requirement in 2003 and as proposed in 2008, however. One of these commenters noted that “one of the core causes of the sub-prime crisis was dependence on inaccurate and unsupportable credit ratings.”<sup>110</sup>

In light of recent market developments, we request that commenters again address whether or not the approach we proposed last year would provide safeguards with respect to credit risk that are comparable to the continued inclusion of NRSRO references in the rule. What other alternatives could we adopt to encourage more independent credit risk analysis and meet the regulatory objectives of rule 2a-7’s requirement of NRSRO ratings? Are there additional factors that we should consider with respect to last year’s proposal? Should we consider establishing a roadmap for phasing in the eventual removal of NRSRO references from the rule? We are also considering an approach under which a money market fund’s board would designate three (or more) NRSROs that the fund would look to for all purposes under rule 2a-7 in determining whether a security is an eligible security.<sup>111</sup> In addition, the board would be required to determine at least annually that the NRSROs it has designated issue credit ratings that are sufficiently reliable for that use.<sup>112</sup> We request comment on an approach in which the fund board designates NRSROs. Would the inclusion of a number of “designated NRSROs” improve rule 2a-7’s use of NRSRO ratings as a threshold investment criterion and be consistent with the goals of Congress in passing the Rating Agency Reform Act?<sup>113</sup> What are the advantages and disadvantages of such an approach? Should funds be required to designate a minimum number of NRSROs to use in determining thresholds for Eligible Securities or in monitoring ratings? If so, would at least three be the appropriate number, as some have suggested?<sup>114</sup> Would more be appropriate to address these purposes (e.g., four, five or six)? Should we permit fund boards to designate different NRSROs with respect to different types of issuers of securities in which the fund invests? Should the funds be required to disclose these designated NRSROs in their statements of additional information?<sup>115</sup>

<sup>106</sup> See, e.g., Comment Letter of Fidelity Investments (July 25, 2003) (File No. S7-12-03). Comment letters on File No. S7-12-03 are available at <http://www.sec.gov/rules/concept/s71203.shtml>.

<sup>107</sup> Comment Letter of Denise Voigt Crawford, Securities Commissioner, Texas State Securities Board (July 28, 2003) (File No. S7-12-03).

<sup>108</sup> See, e.g., Comment Letter of T. Rowe Price Family of Funds (Sept. 5, 2008) (File No. S7-19-08). Comment letters on File No. S7-19-08 are available at <http://www.sec.gov/comments/s7-19-08/s71908.shtml>.

<sup>109</sup> See ICI Report, *supra* note 6, at 81.

<sup>110</sup> See Comment Letter of Professor Frank Partnoy (received Sept. 5, 2008) (File No. S7-19-08).

<sup>111</sup> Commenters on our NRSRO References Proposal and the ICI Report recommended similar approaches. See Comment Letter of Federated Investors, Inc. (Sept. 5, 2008) (File No. S7-19-08) (suggesting that rule 2a-7 require the board or its delegate to select by security type at least three NRSROs on which the fund would rely under the rule); Comment Letter of OppenheimerFunds, Inc. (Sept. 4, 2008) (File No. S7-19-08) (suggesting the rule allow fund boards to designate (presumably after considering any recommendations of the investment manager) the identity and number of NRSROs whose ratings will be used to determine eligible portfolio securities); ICI Report, *supra* note 6, at 82 (recommending the fund designate three or more NRSROs that the fund would use in determining the eligibility of portfolio securities). See also Comment Letter of Stephen A. Keen on behalf of Federated Investors, Inc. (Mar. 12, 2007) (File No. S7-04-07) (in response to our 2007 proposal on oversight of NRSROs, asserting that investment advisers should be free to choose which NRSROs they will rely upon and monitor only their ratings).

<sup>112</sup> The only time that funds would be required to look to all NRSROs under this approach would be, as under the current rule, in determining whether a long-term security with a remaining maturity of 397 calendar days or less that does not, and whose issuer does not, have a short-term rating is an eligible security. See *infra* section II.A.2.b.

<sup>113</sup> See Senate Committee on Banking, Housing, and Urban Affairs, Credit Rating Agency Reform Act of 2006, S. Rep. No. 109-326, at 2 (2006) (“Senate Report 109-326”) (purposes of the Act include improving the quality of NRSRO credit ratings by fostering accountability, transparency, and competition in the credit rating industry).

<sup>114</sup> See *supra* note 111.

<sup>115</sup> See Part B of Form N-1A.

What impact would a requirement that the fund board designate NRSROs have on competition among NRSROs? Would NRSROs compete through ratings to achieve designation by money market funds? Given that the staff believes it is reasonable to assume that the three NRSROs that issued almost 99 percent of all outstanding ratings across all categories that were issued by the 10 registered NRSROs as of June 2008,<sup>116</sup> also issued well over 90 percent of all outstanding ratings of short term debt, and in light of concerns about enhancing competition among NRSROs, should the minimum number of designated NRSROs be greater than three, such as four, five, or six?<sup>117</sup> What are the advantages and disadvantages of requiring boards to monitor the ratings issued by all NRSROs? Should rule 2a-7 specify certain minimum policies and procedures for monitoring NRSROs? Should money market fund boards be permitted to designate credit rating agencies or credit evaluation providers that are not registered as NRSROs with the Commission under the Securities Exchange Act of 1934 and the rules we have adopted under those provisions?<sup>118</sup> Should a board be solely responsible for designating and annually reviewing a designated NRSRO or should we permit delegation of this responsibility? How many NRSROs would money market fund boards be likely to evaluate before making their designations? After a fund board had designated NRSROs, what incentives would the board have to change the designated NRSROs?

We request comment on the impact of any of these approaches on funds and their ability to maintain a stable net asset value. Would any particular requirement help funds to better determine whether a security is an eligible security? We also request comment on the potential impact on competition among NRSROs.

*b. Long-Term Unrated Securities*

Rule 2a-7 permits money market funds to invest in a long-term security with a remaining maturity of 397 calendar days or less (“stub security”) that is an unrated security (i.e., neither the security nor its issuer or guarantor has a short-term rating) *unless* the security has received a long-term rating from any NRSRO that is not within the NRSRO’s three highest categories of long-term ratings.<sup>119</sup> Under rule 2a-7, the measure of quality is the rating given to the issuer’s short-term debt. In the absence of a short-term rating, the minimum long-term rating is designed to provide an independent check on a fund’s quality determination.<sup>120</sup> In light of the changes we are proposing above to increase the portfolio quality standards of the rule, we propose to permit money market funds to acquire such securities only if they have received long-term ratings in the highest two ratings categories to more narrowly limit the credit risk to which a money market fund may be exposed.<sup>121</sup> As under the current rule, fund boards would continue to be required to determine that such a security is “of comparable quality” to a rated security if it met these proposed conditions.<sup>122</sup>

We request comment on this proposed change. Given our proposal to increase the quality standards of the rule, is the proposed change appropriate? Should we consider permitting funds to acquire these stub securities only if they have received long-term ratings in the highest rating category? What impact would the proposed amendment have on money market funds’ current portfolio holdings? We request commenters expressing views on this change to provide us with data identifying the relationship between the long-term ratings on these stub securities and short-term ratings.

<sup>116</sup> The staff’s belief is based on its report that three NRSROs issued almost 99 percent of all the outstanding ratings across all categories that were issued by the 10 registered NRSROs as of June 2008. See SEC, Annual Report on Nationally Recognized Statistical Rating Organizations at 35 (June 2008) (“2008 NRSRO Report”).

<sup>117</sup> According to the ICI Report, requiring money market funds to designate at least three NRSROs whose ratings the fund would use in determining eligible portfolio securities could encourage competition among NRSROs to achieve designation by money market funds. See ICI Report, *supra* note 6, at 82.

<sup>118</sup> See 15 U.S.C. 78o-7; 17 CFR 240.17g-1 (rules governing the registration of NRSROs).

<sup>119</sup> Rule 2a-7(a)(10)(ii)(A). Nonetheless, the security may be an eligible security if it has received a long-term rating from the requisite NRSROs in one of the three highest long-term rating categories and (as with any unrated security that is an eligible security) is of comparable quality to a rated security. *Id.*

<sup>120</sup> See 1991 Adopting Release, *supra* note 20, at text accompanying nn.65–68.

<sup>121</sup> Proposed rule 2a-7(a)(11)(iv)(A). Similar to the provision in the current rule, the security might be an eligible security even if it received a long-term rating below the two highest long-term rating categories if the requisite NRSROs rate the security in one of the two highest long-term rating categories. *Id.*

<sup>122</sup> Proposed rule 2a-7(a)(11)(iv).

### 3. Credit Reassessments

Rule 2a-7 currently requires a money market fund's board of directors to promptly reassess whether a portfolio security continues to present minimal credit risks if, subsequent to its acquisition by the fund, (i) the security has ceased to be a first tier security (e.g., the security is downgraded to second tier by one of the requisite NRSROs), or (ii) the fund's adviser *becomes aware* that an unrated or second tier security has received a rating from *any* NRSRO below the second highest short-term rating category.<sup>123</sup> In light of the proposed elimination of second tier securities from the definition of eligible security, we propose to amend rule 2a-7 so the only circumstance in which the fund's board of directors would be required to reassess whether a security continues to present minimal credit risks would be if, subsequent to its acquisition by the fund, the fund's money market fund adviser becomes aware that an unrated security has received a rating from any NRSRO below the highest short-term rating category.<sup>124</sup>

We request comment on whether these are appropriate circumstances under which to require a reassessment in light of our proposal to eliminate the ability of money market funds to invest in second tier securities.

### 4. Asset Backed Securities

Rule 2a-7 contains provisions that specifically address asset backed securities ("ABSs"),<sup>125</sup> including the circumstances under which an ABS is an eligible security,<sup>126</sup> the maturity of an ABS,<sup>127</sup> and how a fund must treat such an investment under the diversification provisions.<sup>128</sup> The rule, however, does not specifically address how a fund board (or its delegate) should determine that an investment in an ABS (or other potential portfolio investment) presents minimal credit risks, nor does it specifically address liquidity issues presented by a money market fund's investment in an ABS.

Both such matters were raised in 2007 by money market funds' investment in SIVs, which we discussed briefly above. SIVs issued commercial paper to finance a portfolio of longer term, higher yielding investments, including residential mortgages. Unlike other commercial paper programs, SIVs typically did not have access to liquidity facilities to protect commercial paper investors (including money market funds) against the risk of the issuer's inability to reissue (or "rollover") commercial paper caused by either a credit event of the issuer or a disruption in the commercial paper market.<sup>129</sup> When they could no longer rollover their debt beginning in 2007, those SIVs, unable to secure liquidity support from sponsoring banks, were forced to begin selling the vehicles' assets into depressed markets to pay maturing debt and to begin winding down their operations. SIV credit ratings deteriorated rapidly as they deleveraged, placing pressure on valuations of SIV securities held by money market funds. We understand that eventually most funds holding SIV securities not supported by a large bank entered into agreements with affiliates of the fund to support the fund's stable net asset value per share.

We request comment on whether, and if so how, we should amend rule 2a-7 to address risks presented by SIVs or similar ABSs. As discussed above, rule 2a-7 requires that money market funds only invest in securities that the board of directors or its delegate determines present minimal credit risks.<sup>130</sup> The Commission has stated that "[d]etermining that an ABS presents minimal credit risks requires an examination of the criteria used to select the underlying assets, the credit quality of the put providers, and the conditions of the contractual relationships among the parties to the arrangement. When an

<sup>123</sup> Rule 2a-7(c)(6)(i)(A)(1) and (2).

<sup>124</sup> Proposed rule 2a-7(c)(7)(i)(A). As under the current rule, the proposed rule amendment would not require, and we would not expect, investment advisers to subscribe to every rating service publication in order to comply with the requirement that the board reassess when the fund's adviser becomes aware that any NRSRO has rated an unrated security below its highest rating. We would expect an investment adviser to become aware of a subsequent rating if it is reported in the national financial press or in publications to which the adviser subscribes. See 1991 Adopting Release, *supra* note 20, at n.71.

<sup>125</sup> An asset backed security is defined very generally to mean a fixed income security that entitles its holders to receive payments that depend primarily on the cash flow from financial assets underlying the asset backed security. See rule 2a-7(a)(3).

<sup>126</sup> See rule 2a-7(a)(10)(ii)(B).

<sup>127</sup> See rules 2a-7(a)(8)(ii) and 2a-7(d).

<sup>128</sup> See rule 2a-7(c)(4)(ii)(D).

<sup>129</sup> For a discussion of the evolution of the asset backed commercial paper market and SIV securities during this period, See generally Jim Croke, *New Developments in Asset-Backed Commercial Paper* (2008), at 2–4, available at <http://www.orricks.com/fileupload/1485.pdf>.

<sup>130</sup> Rule 2a-7(c)(3)(i).

ABS consists of a large pool of financial assets, such as credit card receivables or mortgages, it may not be susceptible to conventional means of credit risk analysis because credit quality is based not on a single issuer but on an actuarial analysis of a pool of financial assets.”<sup>131</sup> We also said, however, that we were concerned that “fund credit analysts may be unable to perform the thorough legal, structural and credit analyses required to determine whether a particular ABS involves inappropriate risks for money market funds” and, as a result, required that any ABS in which a money market fund invested be rated by an NRSRO because of NRSROs’ role in assuring that the underlying ABS assets are properly valued and provide adequate asset coverage for the cash flows required to fund ABSs.<sup>132</sup>

As discussed above, beginning in 2007, SIV securities were rapidly downgraded by NRSROs revealing money market funds’ varying minimal credit risk determinations with respect to these securities. In light of this experience, should we provide additional guidance to money market funds on the required minimal credit risk evaluation with respect to ABSs? We believe that part of this analysis, when evaluating any security, should include an evaluation of the issuer’s ability to maintain its promised cash flows which, in the case of an asset backed security, would entail an analysis of the underlying assets, their behavior in various market conditions, and the terms of any liquidity or other support provided by the sponsor of the security.<sup>133</sup> Should we amend rule 2a-7 to remove the requirement that any ABS be rated by an NRSRO in order to be an eligible security for money market funds in light of the NRSROs’ recent rapid downgrading of these securities? Under our proposed liquidity requirements (discussed below), the liquidity features of an ABS would have to be considered in determining whether the fund holds sufficiently liquid assets to meet shareholder redemptions.<sup>134</sup>

We request comment on whether rule 2a-7 should explicitly require fund boards of directors (or their delegates) to evaluate whether the security includes any committed line of credit or other liquidity support. Are there other factors that we should require money market fund boards to evaluate when determining whether SIV investments or other new financial products pose minimal credit risks? We note that some money market funds invested more significantly in SIV securities while other money market funds avoided such investments entirely. Are there facets of the credit analysis that led certain money market funds to avoid such investments that should be incorporated explicitly into rule 2a-7?<sup>135</sup> Should we limit money market funds to investing in ABSs that the manager concludes can be paid upon maturity with existing cash flow, i.e., the payment upon maturity is not dependent on the ability of the special purpose entity to rollover debt? Alternatively, should the rule itself require ABSs to be subject to unconditional demand features to be eligible securities?<sup>136</sup>

## B. Portfolio Maturity

Rule 2a-7 restricts the maximum remaining maturity of a security that a money market fund may acquire, and the weighted average maturity of the fund’s portfolio, in order to limit the exposure of money market fund investors to certain risks, including interest rate risk. The Commission is proposing changes to the rule’s maturity limits to further reduce such risks, as discussed below. First, we propose to reduce the maximum weighted average portfolio maturity permitted by the rule. Second, we propose a new maturity test that would limit the portion of a fund’s portfolio that could be held in longer term variable- or floating-rate securities. Third, we propose to delete a provision in the rule that

<sup>131</sup> 1993 Proposing Release, *supra* note 81, at text accompanying nn.108–109.

<sup>132</sup> *Id.* at nn.110–112 and accompanying text.

<sup>133</sup> The ICI Report recommended that we amend rule 2a-7 to require money market fund advisers to adopt a “new products committee.” See ICI Report, *supra* note 6, at 79–80. Although such committees may be useful, their usefulness would turn on what might be a “new product” as well as the judgment of its members, whose judgment is today required to be brought to bear on whether the security presents minimal credit risks.

<sup>134</sup> See *infra* Section II.C.

<sup>135</sup> The staff’s recent examinations of money market funds indicate that credit analysts for money market funds that invested in SIVs that subsequently defaulted appear to have had access to the same basic set of information on SIVs as did analysts at money market funds that did not and that the judgment of these credit analysts regarding minimal creditworthiness of the SIVs that subsequently defaulted appeared to have been different. The staff’s exams also appear to indicate that credit analysts for money market funds that invested in SIVs that subsequently defaulted placed less emphasis on the length of time that payment experience was available on assets in the collateral pool and they were willing to accept sub-prime mortgage credits as a seasoned asset class. In addition, their decision, in part, may have been influenced by the greater amount of over-collateralization of the collateral pools and the high yields paid by notes supported by sub-prime credits.

<sup>136</sup> Rule 2a-7(a)(26) defines an “unconditional demand feature” as a “demand feature” that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

permits certain money market funds to acquire Government securities with extended maturities of up to 762 calendar days. We are also requesting comment on other ways of adjusting the rule's maturity provisions in order to accomplish our goal of decreasing the risks associated with a money market fund holding longer term investments.

### 1. *Weighted Average Maturity*

Rule 2a-7 requires a money market fund to maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value or price per share, but in no case greater than 90 days.<sup>137</sup> We adopted this provision because securities that have shorter periods remaining until maturity (and are of higher quality) generally exhibit a low level of volatility and thus provide a greater assurance that the money market fund will continue to be able to maintain a stable share price.<sup>138</sup>

Having a portfolio weighted towards securities with longer maturities poses several risks to a money market fund. First, as we have noted in the past, a longer weighted average maturity increases a fund's exposure to interest rate risk.<sup>139</sup> Second, and as we discuss in more detail below, longer maturities also amplify the effect of widening credit and interest rate spreads on a fund.<sup>140</sup> Finally, a fund holding securities with longer maturities generally is exposed to greater liquidity risk, because fewer securities mature on a daily or weekly basis. Perhaps in recognition of these risks, few fund managers maintain weighted average maturity at or near the maximum permissible 90 days.<sup>141</sup>

In view of the extraordinary market conditions we have witnessed recently, the Commission is concerned that the 90-day maximum weighted average maturity under the rule may be too long. Particularly during the market events of last fall, funds with shorter portfolio maturities were much better positioned to withstand heavy redemptions, because a greater portion of their portfolios matured each week and provided cash to pay to redeeming investors. They also were better able to withstand increased credit spreads in certain financial sector notes because of the shorter period of exposure to such distressed securities. Finally, interest rate spreads on longer maturity securities widened to a much greater degree than interest rate spreads on shorter maturity securities.<sup>142</sup>

The ICI Report recommended reducing the maximum weighted average maturity to 75 days.<sup>143</sup> Historically, however, most funds have maintained shorter maturities. During the last 20 years, the average weighted average maturity of taxable money market funds (as a group) has never exceeded 58 days.<sup>144</sup> As of June 16, 2009, it was 53 days.<sup>145</sup> Some money market funds have, from time to time, extended their maturities substantially longer than the average to gain a yield advantage, anticipating declining or stable interest rates. By doing so, these funds assumed greater risk and would

<sup>137</sup> See rule 2a-7(c)(2)(iii).

<sup>138</sup> See 1983 Adopting Release, *supra* note 3, at n.7 and accompanying text.

<sup>139</sup> See 1990 Proposing Release, *supra* note 22, at text accompanying n.60. See also Standard & Poor's, Money Market Fund Ratings Criteria, at 21 (2007) available at <http://www2.standardandpoors.com/spf/pdf/events/MMX709.pdf> ("S&P 2007 Ratings Criteria") ("The portfolio's weighted average maturity (WAM) is a key determinant of the tolerance of a fund's investments to rising interest rates. In general, the longer the WAM, the more susceptible the fund is to rising interest rates. A fund comprised entirely of Treasury securities with a WAM of 45 days could withstand approximately twice the interest rate increase than could a fund with a 90-day WAM, leaving all other factors aside."); Fabozzi, *supra* note 98, at 4 ("[T]he volatility of a bond's price is closely associated with maturity: Changes in the market level of [interest] rates will wrest much larger changes in price from bonds of long maturity than from otherwise similar debt of shorter life.").

<sup>140</sup> See also *supra* notes 65–71 and accompanying text.

<sup>141</sup> According to monthly statistics kept by the Investment Company Institute, during the past 10 years, the weighted average maturities of funds in the longest maturity categories (the 90th percentile of all taxable prime money market funds) seldom have exceeded 75 days. As of April 30, 2009, these funds maintained an average weighted maturity of 67 days. These statistics are available in File No. S7-11-09.

<sup>142</sup> See, e.g., U.S. Department of the Treasury, *Daily Treasury Yield Curve Rates*, available at [http://www.treasury.gov/offices/domestic-finance/debt-management/interest-rate/yield\\_historical\\_main.shtml](http://www.treasury.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_main.shtml).

<sup>143</sup> See ICI Report, *supra* note 6, at 77.

<sup>144</sup> 2008 Fact Book, *supra* note 13, at Table 38. In 2009, the ICI Fact Book began presenting this information separately for taxable government and taxable non-government money market funds, which had average maturities of 49 days and 47 days, respectively, in 2008. 2009 Fact Book, *supra* note 7, at 150–51, Tables 41 & 42.

<sup>145</sup> See Money Fund Report, iMoneyNet, May 7, 2008. Average maturity for tax exempt money market funds (as a group) is even lower—24 days as of June 16, 2009. *Id.*



be more likely to experience losses that could result in their breaking the buck if interest rates rise, credit markets do not behave as they expect, or they receive substantial redemption requests.

Most European money market funds with stable share prices (many of which are domiciled in Ireland) are limited to 60-day weighted average maturities.<sup>146</sup> So are money market funds rated highly by the NRSROs.<sup>147</sup> In light of these considerations, we believe that a shorter period may be appropriate. Accordingly, we propose that rule 2a-7 be amended to impose a 60-day weighted average maturity limit.<sup>148</sup>

We request comment on the proposed 60-day weighted average maturity limit. Would it decrease portfolio volatility and increase fund liquidity, as we suggest? What would be the anticipated effect on money market fund yields? Would a negative effect on yields make money market funds less attractive to investors? Should a different weighted average maturity limit apply, such as 45 days or 75 days? We request that commenters provide us with data demonstrating the effect that alternative weighted average maturity limits would have had on portfolios of money market funds during the recent economic turmoil.

## 2. Weighted Average Life

We propose to add to rule 2a-7 a new maturity test, which would limit the weighted average life maturity of portfolio securities to 120 days.<sup>149</sup> As explained further below, the weighted average life of a portfolio would be measured without regard to a security's interest rate reset dates, and thus would limit the extent to which a fund could invest in longer term securities that may expose a fund to interest rate spread risk and credit spread risk.<sup>150</sup>

Generally, under rule 2a-7 the maturity of a portfolio security is the period remaining until the date on which the principal must unconditionally be repaid according to its terms (its final "legal" maturity) or, in the case of a security called for redemption, the date on which the redemption payment must be made.<sup>151</sup> The rule contains exceptions from this general approach for specific types of securities, which are referred to as the "maturity shortening" provisions.<sup>152</sup> Among these exceptions are three provisions that allow a fund to treat a variable- or floating-rate security as having a maturity equal to the time remaining to the next interest rate reset date.<sup>153</sup> First, a fund may treat a short-term variable-rate security (i.e., one with a remaining maturity of 397 days or less), as having a maturity equal to the earlier of the

<sup>146</sup> See Irish Financial Services Regulatory Authority, *Valuation of Assets of Money Market Funds*, 2008 Guidance Note 1/08 (Aug. 2008), available at <http://www.financialregulator.ie/industry-sectors/funds/Documents/Guidance%20Note%20108%20Valuation%20of%20Assets%20of%20Money%20Market%20Funds.pdf> ("Financial Regulator Guidance Note 1/08"). As of April 2009, money market funds registered in Ireland managed approximately €317 billion (\$419 billion) in assets. See Irish Financial Regulator statistics available at [http://www.irishfunds.ie/money\\_marketfunds.htm](http://www.irishfunds.ie/money_marketfunds.htm). In addition, the Institutional Money Market Funds Association ("IMMFA") requires the triple-A rated institutional money market funds sponsored by its members to comply with a Code of Practice that generally limits portfolio maturity to 60 days. See IMMFA, Code of Practice, Part IV., 22 (2005), available at <http://www.immfa.org/about/Codefinal.pdf>. As of February 13, 2009, IMMFA-member constant net asset value money market funds managed approximately \$493 billion in assets. See IMMFA statistics, available at <http://www.immfa.org/stats/IMFR130209.pdf>. See also ICI Report, *supra* note 6, at 184, Appendix H.

<sup>147</sup> See S&P 2007 Ratings Criteria, *supra* note 139, at 21; Moody's Investors Service, Frequently Asked Questions about Moody's Ratings of Managed Funds, at 4 (July 20, 2005), available at <http://www.moody.com/moodys/cust/research/MDCdocs/20/2003600000425726.pdf?search=5&searchQuery=Frequently+Asked+Questions+about+Moody>; Fitch Ratings, U.S. Money Market Fund Ratings, at 4 (Mar. 3, 2006), available at [http://www.fitchresearch.com/creditedesk/reports/report\\_frame.cfm?rpt\\_id=266376](http://www.fitchresearch.com/creditedesk/reports/report_frame.cfm?rpt_id=266376).

<sup>148</sup> See proposed rule 2a-7(c)(2)(ii).

<sup>149</sup> See proposed rule 2a-7(c)(2)(iii).

<sup>150</sup> While the proposed rule would ignore interest rate resets for purposes of calculating the fund's weighted average life to maturity, a security's demand features could continue to be used in this calculation. See, e.g., rule 2a-7(d)(3) and (d)(5).

<sup>151</sup> See rule 2a-7(d).

<sup>152</sup> *Id.* We added maturity shortening provisions to the rule in 1986; they are particularly important for tax exempt funds, which invest in municipal obligations, most of which are issued with longer maturities. See 1986 Adopting Release, *supra* note 19, at nn.9–10 and accompanying text.

<sup>153</sup> See rule 2a-7(a)(13) (defining "floating rate security") and (a)(29) (defining "variable rate security"). The interest rate for a variable-rate security is established on set dates, whereas the interest rate for a floating-rate security adjusts whenever a specified interest rate changes. We also may refer to variable- and floating-rate securities collectively in this Release as "adjustable-rate" securities.

interest rate reset date or the time it would take the fund to recover the principal by exercising a demand feature.<sup>154</sup> Second, a fund may treat a short-term floating-rate security (i.e., one with a remaining maturity of 397 days or less) as having a maturity of one day.<sup>155</sup> Third, a variable- or floating-rate Government security generally may be deemed to have a maturity equal to the next reset date even if it is a long-term security.<sup>156</sup> For purposes of calculating weighted average maturity, the rule effectively treats short-term variable- and floating-rate securities and all adjustable-rate Government securities as if they were a series of short-term obligations that are continually “rolled over” on the reset dates at the current short-term interest rates.

As the ICI Report explains, however, longer term adjustable-rate securities are more sensitive to credit spreads (the amount of additional yield demanded by purchasers above a risk-free rate of return to compensate for the credit risk of the issuer) than short-term securities with final maturities equal to the reset date of the longer term security.<sup>157</sup> Longer term adjustable-rate securities also are subject for a longer period of time to risk from widening interest rate spreads.<sup>158</sup> As a result, prices of longer term adjustable-rate securities could fall more than prices of comparable short-term securities in times of market turbulence. The ICI Report also notes that while adjustable-rate securities do protect a fund against changes in interest rates, permitting maturity shortening based on interest rate resets does not protect against liquidity risk to the portfolio.<sup>159</sup>

We are concerned that the traditional weighted average maturity measurement of rule 2a-7 does not require that a manager of a money market fund limit these risks. We understand that some money market fund portfolio managers, to protect the fund, have already begun using a weighted average maturity measurement that ignores interest rate resets.

The ICI Report confirms our observations of the behavior of prices for certain securities last fall, when money market funds found it difficult to sell at amortized cost longer term adjustable-rate securities, including securities issued by agencies of the federal government. We believe that the use of the measurement the ICI recommends, which we will call the “weighted average life” to maturity of a money market fund portfolio, appears to be a prudent limitation on the structure of a money market fund portfolio and would limit credit and interest rate spread risks not encompassed by the weighted average maturity restriction of rule 2a-7. As suggested by the ICI Report, we are proposing that money market funds maintain a weighted average life of no more than 120 days.<sup>160</sup> The Commission believes that a 120-day weighted average life requirement would provide a reasonable balance between strengthening the resilience of money market funds to market stress (e.g., interest rate increases, widening spreads, and large redemptions) while not unduly restricting the funds’ ability to offer a diversified portfolio of short-term, high quality debt securities.

One of the effects of a limit on the weighted average life of a portfolio would appear to be on funds that hold longer term floating-rate Government securities, which are issued by federal agencies. Consider a money market fund with a portfolio consisting 50 percent of overnight repurchase agreements and 50 percent of two-year Government agency floating-rate obligations that reset daily based on the federal funds rate. Using the reset dates as permitted by the rule’s maturity shortening provisions, the portfolio would have a weighted average maturity of one day. In contrast, by applying a measurement that does not recognize resets, the portfolio would have a weighted average life of 365.5 days (i.e., half of the portfolio has a one day maturity and half has a two-year maturity), which would be considerably longer than the 120-day limit we are proposing. The weighted average life limitation would provide an extra layer of protection for funds and their shareholders against spread risk, particularly in volatile markets.

<sup>154</sup> See rule 2a-7(d)(2). See also rule 2a-7(a)(8) (definition of “demand feature”).

<sup>155</sup> See rule 2a-7(d)(4).

<sup>156</sup> See rule 2a-7(d)(1) (allowing a variable-rate Government security where the variable rate is readjusted no less frequently than every 762 days to be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate, and a floating-rate Government security to be deemed to have a remaining maturity of one day).

<sup>157</sup> See ICI Report, *supra* note 6, at 77.

<sup>158</sup> Interest rate spreads can widen because a variable-rate note has a fixed period of time to the next interest reset date and during that time the benchmark interest rate will likely change. Interest rate spreads can also widen because market conditions change after the security is issued such that investors may demand a greater margin to hold the security. See Fabozzi, *supra* note 98, at 196.

<sup>159</sup> See ICI Report, *supra* note 6, at text accompanying n.140.

<sup>160</sup> The proposed rule would require a money market fund to maintain a weighted average maturity not to exceed 120 days, determined without reference to the exceptions in paragraph (d) of the rule regarding interest rate resets. See proposed rule 2a-7(c)(2)(iii).

We request comment on all aspects of the proposed weighted average life limitation. Is this new maturity test appropriate? Is 120 days an appropriate limit? What would be the effect on yield? Does it place too much of a constraint on the ability of money market fund advisers to effectively manage fund portfolios? Does it permit funds to assume too much risk? Would a different limit be more appropriate, such as 90 days or 150 days? Would the proposed weighted average life limitation have a material impact on the issuers of short-term debt and, if so, what would it be?

We request comment on whether there are alternative approaches to measuring these risks. We understand that some fund managers use an alternative maturity test that focuses solely on credit spread risk. Such a test not only disregards interest rate resets, but also excludes Government securities from the weighted average maturity calculation. Would this test provide a clearer indication of the overall credit spread risk of the portfolio? Are there other advantages to such an approach? If so, what would be an appropriate limit? Should it be the same as proposed weighted average life limitation of 120 days, or should it be different, such as 90 days or 150 days? We request that commenters provide us with data demonstrating the effect of such alternative credit limitations and/or weighted average life limitations on their portfolios during the recent economic turmoil.

When the Commission first adopted rule 2a-7, we explained that we were allowing Government securities to use resets for purposes of the maturity limitations under the rule because we understood that the volatility of such instruments would be no greater than the volatility of fixed interest rate instruments having a maturity equal to the period before the security's interest rate reset.<sup>161</sup> The Commission noted, however, that this position was based entirely upon experience with Small Business Administration guaranteed debentures—at the time the only adjustable-rate Government securities of which the Commission was aware.<sup>162</sup> The Commission stated that it would consider amending this provision if market experience indicates that such treatment is inappropriate.<sup>163</sup>

Since 1983, the number and variety of adjustable-rate Government securities have grown and, in particular, the issuance of such securities by Freddie Mac and Fannie Mae increased significantly with the growth in mortgage-backed securities. While adjustable-rate securities historically have maintained market values similar to equivalent short-term fixed-rate securities, last fall these Government securities experienced increased credit and interest rate spreads and greater volatility than Government securities with maturities similar to the reset dates of the adjustable-rate securities.<sup>164</sup> Further, as noted above, other short-term adjustable-rate securities also experienced increased credit and interest rate spreads and greater volatility than securities with maturities similar to the reset dates.

Currently, rule 2a-7 permits funds to rely on these reset provisions to shorten portfolio maturities only if boards or their delegates can reasonably expect that the security's market value will approximate its amortized cost on the reset date.<sup>165</sup> However, recent experience suggests that in times of market stress, this expected performance may not hold true. Would the weighted average life to maturity limitation adequately address this risk? Are there other alternative limitations or tests that would have mitigated this risk last fall? Should we restrict a fund's ability to use the maturity-shortening provisions of the rule to those adjustable-rate securities, including Government securities, with maximum final maturities of no more than two years, three years, or four years? What would be the impact of the weighted average life limitation on longer term adjustable-rate Government securities issuers?

### 3. Maturity Limit for Government Securities

The Commission is proposing to delete a provision of the rule that permits a fund that relies exclusively on the penny-rounding method of pricing to acquire Government securities with remaining maturities of up to 762 days, rather than

<sup>161</sup> See 1983 Adopting Release, *supra* note 3, at n.16.

<sup>162</sup> See *id.*

<sup>163</sup> See *id.*

<sup>164</sup> See Jody Shenn, *Fannie Mae Debt Spreads Hit Records as GMAC Seeks Bank Status*, Bloomberg, Nov. 20, 2008; Jody Shenn, *Agency Mortgage-Bond Spreads Head for Worst Month on Record*, Bloomberg, Oct. 31, 2008, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aSc8k8D7ZMw0>.

<sup>165</sup> See rule 2a-7(a)(13) and (a)(29).

the 397-day limit otherwise provided by the rule.<sup>166</sup> We are unaware of money market funds today that rely solely on the penny-rounding method of pricing, and none that hold *fixed-rate* Government securities with remaining maturities of two years, which we are concerned would involve the assumption of a substantial amount of interest rate risk. We request comment on our proposal to delete the provision. Are we correct that funds no longer use it? If not, are there reasons why we should retain it?

#### 4. Maturity Limit for Other Portfolio Securities

Currently, in order to qualify as an eligible security under rule 2a-7, an individual security generally cannot have a remaining maturity that exceeds 397 days.<sup>167</sup> We request comment on whether we should consider reducing the maximum maturity for individual non-Government securities acquired by a money market fund from 397 days to, for example, 270 days.<sup>168</sup>

The length of time remaining before a security matures affects its sensitivity to increases in interest rates. In addition, a shorter maturity decreases the amount of time a fund is exposed to potential investment losses for a particular security. On the other hand, it is less clear that such a change would produce a significant increase in the safety and stability of money market funds if we were to adopt it in addition to adopting the proposed 60-day weighted average maturity and 120-day weighted average life limitations. Moreover, unlike the weighted average maturity and weighted average life limitations, a stricter maturity limitation on individual securities could have a substantially greater adverse impact on issuers of short-term obligations other than commercial paper, including issuers of tax exempt municipal securities.

What would be the effects on money market funds and the capital markets of shortening the maturity limit on individual portfolio securities to 270 days? Would there be benefits to funds from shortening the maturities of individual securities beyond the benefits that would be attained through the 60-day weighted average maturity and 120-day weighted average life limitations? What would be the likely impact on money market fund yields? What effect, if any, would shortening the maturity limit have on the supply of rule 2a-7-eligible securities? Should Government securities be excluded from a 270-day maturity limit?<sup>169</sup> If we were to adopt a maximum 270-day maturity for individual securities, should we include or exclude securities issued by municipalities, which typically issue debt securities with maturities of a year or more?

### C. Portfolio Liquidity

Rule 2a-7 does not contain any provisions limiting the ability of a money market fund to hold or acquire illiquid assets.<sup>170</sup> Money market funds are, however, subject to section 22(e) of the Act, which requires registered investment companies to satisfy redemption requests in no more than seven days—a requirement we have construed as restricting a money market fund from investing more than 10 percent of its assets in illiquid securities.<sup>171</sup> Since rule 2a-7 was first adopted we have emphasized the importance of a money market fund holding sufficiently liquid securities. Money market funds often have a greater, and perhaps less predictable, volume of redemptions than other open-end investment companies.<sup>172</sup> And because many promise to provide redemptions sooner than other types of open-end funds—often on the same day that

<sup>166</sup> See rule 2a-7(c)(2)(ii). We added this provision in 1991. See 1991 Adopting Release, *supra* note 20, at nn.53–57 and accompanying text. In a conforming change, we also propose to revise the maturity-shortening provision of the rule for variable-rate Government securities to require that the variable rate of interest is readjusted no less frequently than every 397 days, instead of 762 days as currently permitted. See rule 2a-7(d)(1); proposed rule 2a-7(d)(1).

<sup>167</sup> See rule 2a-7(a)(10)(i) and (c)(2)(i).

<sup>168</sup> A maturity limit of 270 days would be consistent with the exemption for commercial paper under section 3(a)(3) of the Securities Act of 1933 [15 U.S.C. 77c(a)(3)].

<sup>169</sup> We note that, while posing less credit risk, Government securities are subject to much the same risks as corporate securities from rising spreads between their market price and money market benchmarks, whether due to liquidity concerns, changes in interest rates, or other factors. For this reason some rating agencies have imposed limitations on remaining maturities of adjustable-rate Government securities held by money market funds. See, e.g., S&P 2007 Ratings Criteria, *supra* note 139, at 30 (setting a two-year limit for remaining maturities of floating- or variable-rate Government securities held by money market funds for the fund to maintain the highest rating).

<sup>170</sup> See 1983 Adopting Release, *supra* note 3 at n.37 and accompanying text (“[Rule 2a-7] does not limit a money market fund’s portfolio investments solely to negotiable and marketable instruments...”).

<sup>171</sup> See, e.g., *id.* at nn.37–38 and accompanying text; 1986 Adopting Release, *supra* note 19, at n.21 and accompanying text.

<sup>172</sup> See, e.g., 1986 Adopting Release, *supra* note 19, at text preceding and accompanying n.22; 1983 Adopting Release, *supra* note 3, at text following n.39.

the redemption request is received—money market funds need sufficient liquidity to meet redemption requests on a more immediate basis.<sup>173</sup>

By holding illiquid securities, a money market fund exposes itself to a risk that it may be unable to satisfy redemption requests promptly, without selling illiquid securities at a loss that could impair its ability to maintain a stable net asset value per share.<sup>174</sup> Illiquid securities also complicate the valuation of the fund’s portfolio.<sup>175</sup> Moreover, illiquid securities are subject to greater price volatility, exposing the fund to greater risk of breaking a buck as a result of net asset values eroding in a declining market.<sup>176</sup>

We have not included a specific provision in rule 2a-7 regarding liquidity because, until recently, money market funds had not experienced a severe liquidity shortfall. As discussed above, in September 2008, the markets for both traditional and asset backed commercial paper essentially seized up. Large portions of many money market fund portfolios became illiquid when buyers of asset backed and traditional commercial paper fled the market.<sup>177</sup> At the same time, many money market funds—principally institutional money market funds—received substantial redemption requests.<sup>178</sup> The ability of these funds to maintain a stable net asset value turned on their ability to convert portfolio holdings to cash without selling them at “fire sale” prices.

These events suggest to us that rule 2a-7 should be amended to address liquidity risks that money market funds face. We propose to amend rule 2a-7 to add new risk-limiting conditions designed to improve money market funds’ ability to meet significant redemption demands.

### 1. *Limitation on Acquisition of Illiquid Securities*

We propose to prohibit money market funds from acquiring securities unless, at the time acquired, they are liquid, i.e., securities that can be sold or disposed of in the ordinary course of business within seven days at approximately their amortized cost value.<sup>179</sup> In light of the risk to the fund of securities *becoming* illiquid as a result of market events, such as those that occurred last fall, investing any portion of the fund in securities that are already illiquid may be imprudent and thus should be prohibited by rule 2a-7.

We request comment on our proposal to preclude funds from acquiring illiquid securities. We understand that some funds make very limited investments in securities that, at the time of acquisition, are illiquid, such as insurance company funding agreements, loan participations, and structured notes that have no demand features. Would this proposed

<sup>173</sup> See 1983 Adopting Release, *supra* note 3, at text following n.39.

<sup>174</sup> *Id.* at text preceding, accompanying and following nn.37–39.

<sup>175</sup> *Id.* at text preceding section titled “Obligation of the Board to Maintain Stable Price.”

<sup>176</sup> S&P 2007 Ratings Criteria, *supra* note 139, at 21.

<sup>177</sup> See Board of Governors of the Federal Reserve, Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (undated), *available at* <http://www.federalreserve.gov/monetarypolicy/files/129amlf.pdf> at 1–2 (“In ordinary circumstances, MMMFs would have been able to meet these redemption demands by selling assets. At the time of the establishment of the AMLF, however, many money markets were extremely illiquid, and the forced liquidation of assets by MMMFs was placing increasing stress on already strained financial markets.”); See generally Board of Governors of the Federal Reserve, Monetary Policy Report to the Congress (Feb. 24, 2009), Part 2, [http://www.federalreserve.gov/monetarypolicy/mpr\\_20090224\\_part2.htm](http://www.federalreserve.gov/monetarypolicy/mpr_20090224_part2.htm).

<sup>178</sup> See ICI Mutual Fund Historical Data, *supra* note 47 (in the week ending September 17, the day after the Reserve Primary Fund announced that it would break a dollar, institutional money market fund assets fell by more than \$119 billion while retail money market fund assets fell by \$1.1 billion).

<sup>179</sup> Proposed rule 2a-7(c)(5). “Liquid security” would be defined in proposed rule 2a-7(a)(19). Last year in the NRSRO References Proposal, we proposed to define “liquid security” as a security that can be sold or disposed of in the ordinary course of business within seven days at approximately the cost ascribed to it by the money market fund. See *supra* note 105, at n.28 and accompanying text. See also 1986 Adopting Release, *supra* note 19, at text following n.21 (“The term ‘illiquid security’ generally includes any security which cannot be disposed of promptly and in the ordinary course of business without taking a reduced price.”). The one comment we received on the proposed definition recommended the definition refer to the “shadow price” rather than the “value” ascribed to the security by the money market fund. Most funds that rely on rule 2a-7 value their securities using the amortized cost method and thus would be required to acquire securities that can be sold or disposed of in the ordinary course of business within seven days at approximately amortized cost value.

provision (which would not prohibit funds from continuing to hold securities that become illiquid after their purchase) have a significant impact on money market funds? What would be the impact on funds of not being able to buy illiquid securities? Would there be a material impact on yield?

## *2. Cash and Securities that Can Be Readily Converted to Cash*

As discussed above, liquidity of a money market fund portfolio is critical to the fund's ability to maintain a stable net asset value. Our traditional notions of liquidity incorporated into our guidelines (discussed above) appear to be inadequate to meet the needs of a money market fund because the guidelines assume that a fund has time (up to seven days) to sell securities and that there will be a market for the securities. As noted above, money market funds typically undertake to pay their investors more quickly (frequently the same or following day). As the events of last fall demonstrated, money market funds may be unable to rely on a secondary or dealer market ready to provide immediate liquidity at amortized cost under all market conditions. Therefore we are proposing new liquidity tests that would be based on the fund's legal right to receive cash rather than its ability to find a buyer of the security.

The amount of liquidity a fund will need will vary from fund to fund and will turn on cash flows resulting from purchases and redemptions of shares. As a general matter, a fund that has some large shareholders, any one of which could redeem its entire position in a single day, will have greater liquidity needs than a retail fund that has thousands of relatively small shareholders. A fund that competes for yield-sensitive shareholders (e.g., "hot money") through electronic "portals" will have substantially greater liquidity needs than a fund holding the cash of commercial enterprises that have predictable needs (such as payrolls).<sup>180</sup>

Our proposed formulation of a new liquidity standard is designed to take into consideration each of these factors. The proposed daily and weekly standards, discussed immediately below, would be minimum standards; the proposed general standard (which we discuss after the minimum standards) may require a fund to maintain a higher portion of its portfolios in cash or securities that can readily be converted into cash.

### *a. Minimum Daily Liquidity Requirement*

*Taxable Retail Funds.* We propose to require each taxable retail money market fund to invest at least five percent of its assets in cash, U.S. Treasury securities, or securities that can provide the fund with daily liquidity, i.e., securities that the fund can reasonably expect to convert to cash within a day.<sup>181</sup> Unlike our liquidity guidelines discussed above, which allow for a period during which a fund would be expected to seek buyers in a secondary market, these daily liquidity requirements would be significantly more demanding, requiring a portion of the funds' assets be held in "daily liquid assets," which the rule would define as: (i) cash (including demand deposits); (ii) securities (including repurchase agreements) for which the fund has a contractual right to receive cash within one business day either because the security

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<sup>180</sup> See *Money Market Funds Tackle "Exuberant Irrationality,"* Standard & Poor's, RatingsDirect (Sept. 30, 2008), available at [http://www2.standardandpoors.com/spf/pdf/media/MoneyMarketFunds\\_Irrationality.pdf](http://www2.standardandpoors.com/spf/pdf/media/MoneyMarketFunds_Irrationality.pdf) ("It is likely that certain yield-sensitive institutions commonly referred to as 'hot money' accounts, moved money from one investment to another to capture a higher yielding, or *Seemingly* safer, option. For example, after Lehman Bros. filed for bankruptcy, corporations that issued commercial paper (CP) to fund their business operations were forced to pay a significantly higher premium to obtain funding because of investor concerns with holding debt from any nongovernment issuer. The subsequent 'flight to quality' pushed some overnight and 30-day CP rates up by 0.5% (to approximately 3.5%) for issuers whose credit or financial/risk profile did not *Seem* to change. As a result, these hot money accounts moved their investments from money market funds yielding less than 2.75%.")

<sup>181</sup> Proposed rule 2a-7(c)(5)(iii).

will mature or the fund can exercise a demand feature;<sup>182</sup> or (iii) U.S. Treasury securities, which have historically traded in deep, liquid markets, even in times of market distress.<sup>183</sup>

Under the proposed amendments, a money market fund that is a “retail fund” could not acquire any securities other than daily liquid assets if, immediately after the acquisition, the fund would have invested less than five percent of its total assets in those assets (“minimum daily liquidity requirement”).<sup>184</sup> Compliance with the daily liquidity requirement would be determined at the time each security is acquired, and thus a fund would not have to dispose of less liquid securities (and potentially realize an immediate loss) if the portion of the fund held in highly liquid securities fell below five percent as a result of redemptions.

Retail money market funds experienced relatively modest redemption demands last fall, even in the midst of substantial market turbulence.<sup>185</sup> Thus we believe that a five percent requirement, which was recommended in the ICI Report, may be sufficient.<sup>186</sup> We request comment on our analysis, and whether a five percent standard is appropriate in light of the liquidity needs of retail money market funds (which we distinguish from institutional money market funds in the next section of this release). Should we consider a higher percentage, such as 10 percent or 15 percent, or a lower percentage, such as two percent or three percent? Do our proposed amendments strike the right balance between reducing liquidity risk and limiting the impact on yield? What would be the effect on yields of a lower or higher minimum daily liquidity requirement? There may be a number of factors that influence the lower redemption rates among retail investors, including investment purposes and practices, size of investments and possible differences in the information that retail as opposed to institutional investors obtain and the time when they obtain the information. We solicit comment on whether these factors did or would in the future influence the level of retail redemptions. If so, how should the proposed rule be revised to address such factors?

We also request comment on the definition of “daily liquid assets.” Are there other securities that are sufficiently liquid that should be included in the definition?

A fund’s contractual rights to cash will be different if the fund is relying on an unconditional demand feature rather than a conditional demand feature, which the fund may not be able to exercise if there is a default or other credit event with

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<sup>182</sup> A “demand feature” means a feature permitting (i) the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise, and (ii) the holder of an asset backed security unconditionally to receive principal and interest within 397 calendar days of making demand. Rule 2a-7(a)(8).

<sup>183</sup> U.S. Treasury securities were highly liquid last fall. *See, e.g., FRB Open Market Committee Oct. 28–29 Minutes, supra* note 51, at 5 (“Yields on short-term nominal Treasury coupon securities declined over the intermeeting period, reportedly as a result of substantial flight-to-quality flows and heightened demand for liquidity. In contrast, higher term premiums and expectations of increases in the supply of Treasury securities associated with the Emergency Economic Stabilization Act and other initiatives Seemed to put upward pressure on longer term nominal Treasury yields. Yields on longer term inflation-indexed Treasury securities, which are relatively illiquid, rose more sharply than did those on nominal securities.”); *Minutes of the Federal Open Market Committee*, Federal Reserve Board, Dec. 15–16, 2008, at 5, *available at* <http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20081029.pdf> (“*FRB Open Market Committee Oct. 28–29 Minutes*”) (Dec. 15–16, 2008), at 4, *available at* <http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20081216.pdf> (“Yields on nominal Treasury coupon securities declined significantly over the intermeeting period in response to safe-haven demands as well as the downward revisions in the economic outlook and the expected policy path. Meanwhile, yields on inflation-indexed Treasury securities declined by smaller amounts, leaving inflation compensation lower. Although the decline in inflation compensation occurred amid sharp decreases in inflation measures and energy prices, it was likely amplified by increased investor preference for the greater liquidity of nominal Treasury securities relative to that of inflation-protected Treasury securities.”).

<sup>184</sup> The term “daily liquid assets” is defined in proposed rule 2a-7(a)(8). A “retail fund” would be defined as any fund other than an institutional fund. Proposed rule 2a-7(a)(24). For a discussion of the definition of “institutional fund,” *See infra* text preceding, accompanying and following note 196. “Total assets” means with respect to a money market fund using the amortized cost method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets. Rule 2a-7(a)(27).

<sup>185</sup> *See supra* note 178. On September 17, 2008, approximately 4% of prime retail money market funds and 25% of prime institutional money market funds had outflows greater than 5%; on September 18, 2008, approximately 5% of prime retail funds and 30% of prime institutional funds had outflows greater than 5%; and on September 19, 2008, approximately 5% of prime retail funds and 22% of prime institutional funds had outflows greater than 5%. This information is based on analysis of data from the iMoneyNet Money Fund Analyzer database.

<sup>186</sup> *See* ICI Report, *supra* note 6, at 74.

respect to the issuer of the securities.<sup>187</sup> Rule 2a-7 permits both to be used to shorten the maturity of an instrument.<sup>188</sup> For purposes of determining the daily liquidity requirement, should the rule distinguish between securities subject to conditional and unconditional demand features?

As discussed above, compliance with the daily liquidity requirement would be determined at the time each security is acquired. A fund could acquire only daily liquid assets until the portfolio investments met the five percent daily liquidity test.<sup>189</sup> Because the requirement applies only at the time of acquisition, a money market fund would not have to maintain a specified percentage of its assets in daily liquid assets at all times (subject to the general liquidity requirement discussed below), even though the fund is exposed to liquidity risk at all times. We request comment on whether to impose a minimum liquidity maintenance requirement, i.e., require that a money market fund maintain five percent of its portfolio *at all times* in daily liquid assets. What are the advantages and disadvantages of each approach?

*Taxable Institutional Funds.* We propose to limit a taxable institutional fund to acquiring daily liquid assets unless, immediately after acquiring a security, the fund holds at least 10 percent of its total assets in daily liquid assets.<sup>190</sup> Institutional money market funds typically maintain a greater portion of their assets in cash and overnight repurchase agreements than retail funds, which reflects the greater liquidity needs of these funds.<sup>191</sup> These greater needs were demonstrated last fall, when (as discussed above) institutional funds were subject to substantially greater redemption pressure than retail funds.<sup>192</sup> We understand that some of these institutional funds had cash positions of almost 50 percent in their portfolios in anticipation of substantial redemptions following the large amount of inflows during 2007 through August 2008.

We request comment on whether institutional money market funds should be subject to a higher daily liquidity requirement (10 percent) than retail funds (five percent). Should we consider a higher percentage, such as 15 or 20 percent? Ten percent daily liquidity could seem high for a money market fund that reserved the right to delay payment of redemptions for seven days. We are not proposing to adjust the appropriate minimum daily liquidity requirement for institutional or retail funds solely by reference to the seven day period, however, because many money market funds undertake to pay redemption proceeds on the same day or the next day, and an announcement by a fund of a delay in payment of redemption could itself precipitate a run on funds. We request comment on whether a five percent daily liquidity requirement for retail funds or a 10 percent daily liquidity requirement for institutional funds should turn on the representations the money market fund has made to its investors regarding the timing of payments of redemption proceeds.

We propose to add two new definitions to rule 2a-7 to distinguish between retail and institutional money market funds. Although the ICI and others who compile data about money market funds have traditionally distinguished between retail and institutional money market funds, in practice the distinctions are not always clear.<sup>193</sup> An institutional fund may have investors who invest on behalf of retail investors. For example, institutional money market funds commonly

<sup>187</sup> See rule 2a-7(a)(26) (defining “unconditional demand feature”); rule 2a-7(a)(6) (defining “conditional demand feature”).

<sup>188</sup> See rule 2a-7(d)(3), (5).

<sup>189</sup> This is also the approach rule 2a-7 takes with respect to money market fund credit quality and diversification requirements. See rule 2a-7(c)(3), (4).

<sup>190</sup> Proposed rule 2a-7(c)(5)(iii).

<sup>191</sup> This information is based on analysis of data from the iMoneyNet Money Fund Analyzer database.

<sup>192</sup> See *supra* note 178.

<sup>193</sup> See, e.g., ICI, Frequently Asked Questions About Money Market Funds, [http://www.ici.org/faqs/faqs\\_money\\_funds](http://www.ici.org/faqs/faqs_money_funds) (describing (i) institutional money market funds as “held primarily by businesses, governments, institutional investors, and high-net worth households” that as of July 2008, held 63 percent of all money market fund assets and (ii) retail money market funds as “offered primarily to individuals with moderate-sized accounts” that as of July 2008, held around 37 percent of all money market fund assets); iMoneyNet home page, <http://imoney.net.com/> (separates information and analysis on money market funds into institutional and retail categories); Crane Data, Money Fund Intelligence (June 2009) at 30, <http://www.cranedata.us/products/money-fund-intelligence/> (select issue 2009-06-01 (Vol.4, #6)) (classifying money market funds as institutional or individual based on expense ratio, minimum investment and “who they’re sold to”).



have investors that are bank sweep accounts or master funds in master-feeder arrangements.<sup>194</sup> Although these investors ordinarily provide cash flows to the fund that are more similar to retail funds, a single decision-maker may be in a position to redeem all of the shares of the money market fund and move the sweep account to another money market fund. In addition, some funds have a single portfolio but issue separate classes of shares to retail and institutional investors that bear different expenses. In these cases, the cost of managing the institutional share class's relatively greater cash flow volatility is shared with the retail investors.

Our proposed amendments would require that a money market fund's board determine, no less frequently than once each calendar year, whether the fund is an institutional money market fund for purposes of meeting the liquidity requirements.<sup>195</sup> In particular, the fund's board of directors would determine whether the money market fund is intended to be offered to institutional investors or has the characteristics of a fund that is intended to be offered to institutional investors, based on the: (i) nature of the record owners of fund shares; (ii) minimum amount required to be invested to establish an account; and (iii) historical cash flows, resulting or expected cash flows that would result, from purchases and redemptions.<sup>196</sup> The provision is designed to permit fund directors to evaluate the overall characteristics of the fund based on relevant factors.<sup>197</sup> Under the provision, a fund offered through two classes, a majority of whose shares are held by retail investors, should nonetheless be deemed to be an institutional fund by the fund board if the cash flows from purchases and redemptions and the portfolio management required to meet liquidity needs based on those cash flows are more characteristic of an institutional money market fund.

We request comment on our proposed definitions. The differences today in the liquidity management of institutional and retail money market funds suggest to us that fund managers (and perhaps fund boards) currently distinguish between retail and institutional funds. Would our proposed definition permit them to continue to draw the distinctions they draw today? Are there additional factors the board should consider in determining whether a fund is an institutional fund? Would a different approach result in better distinctions? If we cannot distinguish between retail and institutional funds, should we amend rule 2a-7 to apply the minimum daily liquidity requirements we propose for institutional funds to all funds? Would setting the same minimum daily liquidity requirement for institutional and retail funds impose unnecessary costs (in terms of lower yields) on retail investors in light of retail funds' reduced liquidity needs?

Might one effect of the proposed amendments be that funds currently offering two classes of shares, one retail and one institutional, would decide to divide the fund into two funds and manage them differently? Would one of the advantages of such a result be that retail investors would not bear the cost of maintaining liquidity for institutional investors? Would a disadvantage be the loss to retail investors of the economies of scale in these multi-class funds? What additional advantages and disadvantages do commenters foresee? Retail investors may not be aware of the higher redemption rates that institutional funds experienced last fall. Should we consider requiring institutional funds to provide additional disclosures regarding the risk to the fund of large redemptions?

*Tax Exempt Money Market Funds.* We propose to exempt tax exempt funds from the minimum daily liquidity requirements.<sup>198</sup> We understand that most of the portfolios of tax exempt funds consist of longer term floating- and variable-rate securities with seven day demand features from which the fund obtains much of its liquidity. We understand that these funds are unlikely to have investment alternatives that would permit them to meet a daily liquidity requirement.<sup>199</sup> We request comment on whether tax exempt money market funds could meet a daily liquidity

<sup>194</sup> A "master-feeder fund" is an arrangement in which one or more funds with identical investment objectives ("feeder funds") invest all their assets in a single fund ("master fund") with the same investment objective. Investors purchase securities in the feeder fund, which is an open-end fund and a conduit to the master fund. *See* H.R. Rep. No. 622, 104th Cong., 2d Sess., at 41 (1996) ("H.R. Rep. No. 622"); *See generally* Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master Feeder Funds; Voting on Distribution Plans; Final Rules and Proposed Rule, Investment Company Act Release No. 20915 (Feb. 23, 1995) [60 FR 11876, 11876-77 (Mar. 2, 1995)].

<sup>195</sup> Proposed rule 2a-7(c)(5)(v).

<sup>196</sup> Proposed rule 2a-7(a)(18) (defining "institutional fund").

<sup>197</sup> Proposed rule 2a-7(a)(24) would define "retail fund" as any money market fund that the board of directors has not determined within the calendar year is an institutional fund.

<sup>198</sup> Proposed rule 2a-7(c)(5). Rule 2a-7 defines a "tax exempt fund" as a money market fund that holds itself out as distributing income exempt from regular federal income tax. Rule 2a-7(a)(24).

<sup>199</sup> *See* ICI Report, *supra* note 6, at 74.

requirement, such as we have proposed for taxable retail funds. Do tax exempt retail money market funds nevertheless have similar liquidity requirements as taxable retail funds? If so, should rule 2a-7 treat them differently and how?

*b. Minimum Weekly Liquidity Requirement*

We propose that all money market funds (including tax exempt funds) also be subject to a minimum weekly liquidity requirement (“minimum weekly liquidity requirement”). Specifically, retail and institutional funds could not acquire any securities other than U.S. Treasury securities or securities (including repurchase agreements) that mature or are subject to a demand feature exercisable and payable in five business days (together with cash, “weekly liquid assets”) if, immediately after the acquisition, (i) the retail fund would have invested less than 15 percent of its total assets in weekly liquid assets and (ii) the institutional fund would have invested less than 30 percent of its total assets in weekly liquid assets.<sup>200</sup>

The proposed minimum weekly liquidity requirement would supplement the proposed minimum daily liquidity requirement (discussed above) and give greater assurance that money market funds could meet their statutory obligations to redeem shareholders in times of market turbulence. We estimate that under our proposed minimum weekly liquidity requirement, approximately 93 percent of retail funds and 91 percent of institutional funds would have been able to satisfy the level of redemption demands during the periods of greatest redemption pressure last fall without having to sell portfolio securities.<sup>201</sup>

We request comment on the minimum weekly liquidity requirements. Would a minimum daily liquidity requirement alone be sufficient to allow funds to adequately manage risk in the event of unexpected shareholder redemptions in excess of the daily threshold and market illiquidity? Are the proposed minimums of 15 percent of a retail fund’s total assets and 30 percent of an institutional fund’s total assets sufficient?<sup>202</sup> Should we, as the ICI Report suggests, adopt the same (20 percent of total assets) test for both retail and institutional funds? As discussed above, we designed our minimum weekly liquidity requirements so that more than 90 percent of retail and institutional funds could have met redemption requests during the week of September 15–19, 2008, without selling portfolio securities. Should we set the threshold lower, such as at 80 percent or 70 percent? Should we set the threshold higher at 95 percent or 100 percent? The weekly liquidity requirement would be essentially the same as the daily liquidity requirement, except that the fund must be able to access cash on a weekly rather than daily basis. Compliance with the test would be determined upon the acquisition of a security, and demand features could be used to determine the maturity of a portfolio security for purposes of the test.

We propose to treat as weekly liquid assets for purposes of the weekly liquidity requirements, the same securities that would be daily liquid assets except that the requirement for maturing securities or demand features would be five business days rather than one.<sup>203</sup> The ICI Report suggests that we ought to treat as a weekly liquid asset a security issued by an agency of the U.S. Government that, when originally issued, had a maturity of 95 days or less.<sup>204</sup> Is there a basis on which to treat these agency securities as weekly liquid assets? If so, why should the maturity of the security be 95 days based on original issue rather than specifying a period remaining to maturity? We urge commenters supporting such treatment to submit market data to support their views.

*c. General Liquidity Requirement*

As discussed above, the daily and weekly liquidity requirements would be minimum requirements a fund would have to satisfy upon acquisition of a security. A fund’s liquidity needs, however, depending upon the volatility of its cash flows, may be greater. Therefore, we also propose to require that a money market fund at all times hold highly liquid securities sufficient to meet reasonably foreseeable redemptions in light of its obligations under section 22(e) of the Act and any

<sup>200</sup> Proposed rule 2a-7(c)(5)(iv). The term “weekly liquid assets” would be defined in proposed rule 2a-7(a)(32).

<sup>201</sup> During the week of September 15–19, 2008, approximately 6% of retail funds had net redemptions that exceeded 15%, and 9% of institutional money market funds had redemptions that exceeded 30% of assets. In addition, in the 52 weeks preceding September 17, 2008, roughly the same portion of redemption requests in institutional and retail funds (less than 2%) would have exceeded the weekly liquidity requirements. This information is based on analysis of data from iMoneyNet Money Fund Analyzer database.

<sup>202</sup> We note that for most weeks during the past year, prime institutional money market funds maintained over 30% of their assets in securities maturing in seven days or less. This information is based on analysis of data from iMoneyNet Money Fund Analyzer database.

<sup>203</sup> Compare proposed rule 2a-7(a)(8) with proposed rule 2a-7(a)(32).

<sup>204</sup> See ICI Report, *supra* note 6, at 74.

commitments the fund has made to shareholders, such as undertaking to pay redemptions more quickly than seven days.<sup>205</sup>

To comply with this condition, we would expect money market funds to consider a number of factors that could affect the fund's liquidity needs. For example, a money market fund would have to understand the characteristics of its investors and their likely liquidity needs. A volatile investor base, e.g., one consisting of a few relatively larger investors that are likely to make significant redemptions, would require a fund to maintain greater liquidity than a stable investor base, which is generally associated with a retail fund with many hundreds or thousands of smaller investors. With this information, a fund manager could take different steps to protect the fund from greater liquidity risk. For example, the fund manager could increase the amount of daily or weekly liquid assets above those required by the daily and weekly requirements, or could decline to accept new investments from investors whose liquidity needs are inconsistent with the objectives of the management of the fund.<sup>206</sup>

We request comment on this proposed requirement for liquidity. Should we consider incorporating specific objective standards for liquidity in this requirement? Should we provide guidance regarding the steps fund advisers could take to evaluate the fund's liquidity needs? If so, what should the guidance be?

Because the obligation would be ongoing, we believe a fund should adopt policies and procedures to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders, particularly those that hold their securities through omnibus accounts, or access the fund through "portals" or through other arrangements that provide the fund with little or no transparency with respect to the beneficial shareholder. We are not proposing to amend rule 2a-7 to require that funds adopt specific procedures because we believe those procedures would be required by rule 38a-1, the "compliance rule" under the Investment Company Act, if we adopt the proposed general liquidity requirement.<sup>207</sup> Should the Commission provide guidance to funds to assist them in determining the adequacy of their policies and procedures? Should we consider specifying any particular aspects of the policies and procedures?

In their consideration of these procedures and in their oversight of their implementation, fund directors should understand that fund managers' interest in increasing fund assets, and thus their advisory fees, may lead them to accept investors who present greater risks to the fund than they might otherwise have accepted. We urge directors to consider the need for establishing guidelines for advisers to money market funds that address this potential conflict. We are aware of more than one occasion in which a fund adviser (or its affiliate that served as the principal underwriter to the fund) has marketed the fund to "hot money" in order to increase fund assets, which has exposed the fund to substantially higher risks.

### 3. Stress Testing

We are also proposing to amend rule 2a-7 to require the board of directors of each money market fund using the amortized cost method to adopt procedures providing for periodic stress testing of the money market fund's portfolio.<sup>208</sup> The procedures would require testing of the fund's ability to maintain a stable net asset value per share based upon certain hypothetical events, including an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on a portfolio security, and widening or narrowing of spreads between yields on an appropriate

<sup>205</sup> Proposed rule 2a-7(c)(5)(ii). Our proposal is similar to the liquidity standard we proposed last year in the proposal on NRSRO references. See NRSRO References Proposal, *supra* note 105, at Section III.A.2. Among the commenters that specifically addressed that proposed standard, two suggested that codification of the standard was not needed because money market fund advisers already understand and adhere to the current standards. See Comment Letter of Fidelity Management & Research Company (Aug. 29, 2008) (File No. S7-19-2008); Comment Letter of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force (Sept. 4, 2008) (File No. S7-19-2008). A third suggested eliminating the standard because it involves "subjective, forward-looking estimates," while retaining a proposed maximum level for illiquid securities holdings to "preserve a clearer bright-line test". See Comment Letter of Morrison & Foerster (Sept. 5, 2008) (File No. S7-19-2008).

<sup>206</sup> We do not mean to suggest that each money market fund should minimize the volatility of cash flows, but rather should limit its liquidity risks. Some money market funds with the most volatile shareholder base manage liquidity risk by, for example, investing exclusively in overnight repurchase agreements or Treasury debt.

<sup>207</sup> See rule 38a-1(a)(1) (requiring funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund).

<sup>208</sup> Proposed rule 2a-7(c)(8)(ii)(D)(J).

benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund.

Our proposal would require funds to test for certain hypothetical events, but would not specify other details of the stress testing. The proposal would require that stress tests be conducted at intervals that the board of directors determines appropriate and reasonable in light of current market conditions. This is the same approach that rule 2a-7 currently takes with respect to the frequency of shadow pricing.<sup>209</sup>

The proposed amendments also would leave to the money market fund's board of directors (and the fund manager) the specifics of the scenarios or assumptions on which the tests are based. Boards should, for example, consider procedures that require the fund to test for the concurrence of multiple hypothetical events, e.g., where there is a simultaneous increase in interest rates *and* substantial redemptions. The proposed amendments also would require that the board receive a report of the results of the testing at its next regularly scheduled meeting, which report must include: (i) the date(s) on which the fund portfolio was tested; and (ii) the magnitude of each hypothetical event that would cause the money market fund to break the buck.<sup>210</sup> Thus, a fund must test each hypothetical event to a degree of severity that it would result in the market-based per share net asset value of the fund to fall below \$0.995 (in the case of a fund that is maintaining a stable net asset value at \$1.00). The proposed amendment also would require the written procedures to include the provision of an assessment by the adviser of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.<sup>211</sup> The adviser's assessment would provide the fund board context within which to evaluate the magnitude of the events that would cause the fund to break the buck. Finally, funds would be required to maintain records of the stress testing for six years, the first two years in an easily accessible place.<sup>212</sup>

We believe that the proposed stress testing procedures would provide money market fund boards a better understanding of the risks to which the fund is exposed and would give managers a tool to better manage those risks. We understand that stress testing is already a best practice followed by many money market funds. The ICI Report recommends that rule 2a-7 require money market funds regularly to "stress test" their portfolios, although it does not suggest a particular means of stress testing.<sup>213</sup> The Institutional Money Market Funds Association provides guidance for its members in stress testing money market fund portfolios,<sup>214</sup> and the ratings agencies stress test the portfolios of money market funds they rate.<sup>215</sup>

We request comment on our proposed stress test requirement. Would this requirement allow fund managers to better understand and manage the risks to which the fund is exposed? Have we identified the correct stress events? If not, what additional or alternative scenarios or assumptions should we require the fund to test? Should we specify at least one base-line stress test that would test the fund portfolio against a combination of two or more events? For example, the rule could require that the market value per share of the fund be tested against an assumed 50 basis point increase in LIBOR and a redemption of 15 percent of fund shares. Are there alternative base-line tests we should consider requiring?

We request comment on our proposal to require that the board receive a report on these tests. Would the report help the board identify when a fund adviser is exposing the fund to greater risks? Should the board only receive a report when the tests indicate a particular level of risk? If so, what particular level of risk should the rule identify? Should we consider including additional information in the report, and if so, what should it be? Should the rule provide for a minimum

<sup>209</sup> Rule 2a-7(c)(7)(ii)(A)(I).

<sup>210</sup> Proposed rule 2a-7(c)(8)(ii)(D)(2).

<sup>211</sup> Proposed rule 2a-7(c)(8)(ii)(D)(3).

<sup>212</sup> Proposed rule 2a-7(c)(11)(vii).

<sup>213</sup> ICI Report, *supra* note 6, at 75.

<sup>214</sup> See Institutional Money Market Funds Association, *Stress Testing for Money Market Funds* (Feb. 2009).

<sup>215</sup> See, e.g., Standard & Poor's, *Fund Ratings Criteria*, at 9 (2007), available at <http://www2.standardandpoors.com/spf/pdf/events/FundRatingsCriteria.pdf>. See also Financial Regulator Guidance Note 1/08, *supra* note 146, at 5 (requirements of the Irish Financial Services Authority for money market funds domiciled in Ireland include stress testing: "A money market fund is expected to be subject to monthly portfolio analysis incorporating stress testing to examine portfolio returns under various market scenarios to determine if the portfolio constituents are appropriate to meet pre-determined levels of credit risk, interest rate risk, market risk and investor redemptions.").

frequency of testing? If so, what should be the frequency (*e.g.*, monthly, weekly, or a shorter period)? Should we consider different intervals for different types of money market funds? If so, what intervals would be appropriate for what types of money market funds? Should the frequency depend upon the market-based value of the fund portfolio or other criteria or events?

We note that certain of the hypothetical events we propose funds include in their testing may not be meaningful for some money market funds. For example, U.S. Treasury money market funds (*i.e.*, funds that invest solely in direct obligations of the U.S. government such as U.S. Treasury bills and other short term securities backed by the full faith and credit of the U.S. government) are not likely to experience downgrades or defaults on those securities. Should these money market funds be exempted from testing certain hypothetical events, such as a downgrade of or default on a portfolio security, that may not present risks to the fund? Are there other money market funds that we should exempt from testing for certain of the proposed hypothetical events? If so, which funds should have exemptions and which events should be exempted from their testing?

The ICI Report suggests that the results of stress testing could be used to evaluate whether a money market fund's liquidity thresholds need to be adjusted.<sup>216</sup> Should we consider imposing minimum liquidity requirements based on the results of a particular stress test? For example, should we require that a fund invest 50 percent of its portfolio in daily or weekly liquid assets if a five percent increase in shareholder redemptions would cause the fund to break the buck? If we considered imposing minimum liquidity requirements, should they be different for retail and institutional funds?

#### D. Diversification

Rule 2a-7 requires a money market fund's portfolio to be diversified, both as to the issuers of the securities it acquires and to the guarantors of those securities.<sup>217</sup> Generally, money market funds must limit their investments in the securities of any one issuer (other than Government securities), to no more than five percent of fund assets.<sup>218</sup> They must also generally limit their investments in securities subject to a demand feature or a guarantee to no more than ten percent of fund assets from any one provider.<sup>219</sup> The Commission adopted these requirements in order to limit the exposure of a money market fund to any one issuer or guarantor.<sup>220</sup>

The issuer diversification provisions of the rule generally were not implicated by the market turbulence last fall.<sup>221</sup> The Reserve Primary Fund, for example, held only 1.2 percent of its assets in Lehman Brothers commercial paper, well below what rule 2a-7 permits. The market turbulence did, however, implicate the guarantor and demand feature diversification provisions—many funds (particularly tax exempt funds) were heavily exposed to bond insurers, and some were heavily exposed to a few major securities firms that served as liquidity providers.<sup>222</sup>

Should we propose to further restrict the diversification limits of the rule? If so, by how much should we reduce them? Should the five percent diversification limit for issuers be reduced to, for example, three percent? Would it be possible to further reduce the guarantor diversification limits without reducing the quality of portfolio securities? Even a diversification limitation of one percent would not preclude a fund from breaking a buck if the security should sustain

<sup>216</sup> See ICI Report, *supra* note 6, at 75.

<sup>217</sup> Rule 2a-7(c)(4)(i). The diversification requirements of rule 2a-7 differ in significant respects from the requirements for diversified management investment companies under section 5(b)(1) of the Act. A money market fund that satisfies the applicable diversification requirements of the paragraphs (c)(4) and (c)(5) of the rule is deemed to have satisfied the requirements of section 5(b)(1). Rule 2a-7(c)(4)(v). Subchapter M of the Internal Revenue Code contains other diversification requirements for a money market fund to be a "regulated investment company" for federal income tax purposes. 26 U.S.C. 851 *et seq.* See also 1990 Proposing Release, *supra* note 22, at n.25.

<sup>218</sup> Rule 2a-7(c)(4)(i)(A). The rule contains a safe harbor where a taxable and national tax exempt fund may invest up to 25 percent of its assets in the first tier securities of a single issuer for a period of up to three business days after acquisition (but a fund may use this exception for only one issuer at a time). Rule 2a-7(c)(4)(i)(A).

<sup>219</sup> Rule 2a-7(c)(4)(iii). With respect to 25 percent of total assets, holdings of a demand feature or guarantee provider may exceed the 10 percent limit subject to certain conditions. See rule 2a-7(c)(4)(iii)(A), (B), and (C). See also rule 2a-7(a)(8) (definition of "demand feature") and (a)(15) (definition of "guarantee").

<sup>220</sup> See 1990 Proposing Release, *supra* note 22, at II.1. ("Diversification limits investment risk to a fund by spreading the risk of loss among a number of securities.")

<sup>221</sup> The positions held by funds in distressed securities were in almost all cases well below the rule's diversification limits.

<sup>222</sup> See, *e.g.*, Brunnermeier, *supra* note 66, at 87.

sufficient losses as did the securities issued by Lehman Brothers. Moreover, such a diversification limit may force funds to invest in relatively lower quality securities. If so, might lower diversification limits increase the likelihood of a default or other credit event affecting a money market fund while diminishing the impact of such an event on the fund? We request that commenters address the tradeoffs of lower diversification limits for different types of money market funds.

Last fall, money market funds did appear to be extensively exposed to securities issued by participants in the financial sector, which contributed significantly to the difficulties they experienced.<sup>223</sup> Money market funds are not subject to any industry concentration limitations under rule 2a-7. Should we consider proposing such a limitation? If we did, what should the concentration limit be? Are distinctions among industry sectors sufficiently clear that a concentration limitation would be meaningful?<sup>224</sup>

### E. Repurchase Agreements

Money market funds typically invest a significant portion of their assets in repurchase agreements, many of which mature the following day and provide an immediate source of liquidity.<sup>225</sup> In a typical repurchase agreement, a fund purchases securities from a broker-dealer or a bank (“counterparty”), upon an agreement that the counterparty will repurchase the same securities at a specified price, at a later date. The securities purchased serve as the collateral for the agreement.

Money market funds may treat the acquisition of a repurchase agreement as an acquisition of the collateral underlying the repurchase agreement for purposes of meeting rule 2a-7’s diversification requirement, provided that the repurchase agreement is “collateralized fully.”<sup>226</sup> A repurchase agreement collateralized fully must, among other things, qualify for an exclusion from any automatic stay of creditors’ rights against the counterparty under applicable insolvency law.<sup>227</sup> We propose two amendments to rule 2a-7 affecting a money market fund’s investment in repurchase agreements.

First, we propose to limit money market funds to investing in repurchase agreements collateralized by cash items or Government securities in order to obtain special treatment under the diversification provisions of rule 2a-7.<sup>228</sup> Such a limitation would make it less likely that, in the event of the default of a counterparty during a period of market turmoil such as last fall, a money market fund would experience losses upon the sale of collateral that had become illiquid. Such a

<sup>223</sup> See, e.g., U.S. Dollar Money Market Funds, *supra* note 17, at 67 (mid-2008 holdings of 15 largest prime money market funds showed they had invested \$1 trillion, or half of their portfolios, with non-U.S. banks).

<sup>224</sup> In 1992, our staff observed that “the current [statutory] treatment of ‘concentration’ suffers from problems of industry definition. There is no clear standard to determine what constitutes an ‘industry,’ much less ‘a group of industries.’ Indeed, as the boundaries between different industries erode and the trend toward corporate diversification and conglomeration continues, it is often difficult to fit companies into distinct industry categories....” Division of Investment Management, U.S. Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation*, at n.103 (May 1992).

<sup>225</sup> In 2008, repurchase agreements accounted for 26.4% of taxable Government money market funds’ total net assets and 9.1% of taxable non-Government money market funds’ total net assets. See 2009 Fact Book, *supra* note 7, at 150–151, Tables 41 & 42.

<sup>226</sup> See rule 2a-7(c)(4)(ii)(A). We have allowed this “look-through” treatment, for diversification purposes, based on the notion that a money market fund looks to the collateral rather than the counterparty as the ultimate source of repayment. See *Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities*, Investment Company Act Release No. 25058 (July 5, 2001) [66 FR 36156 (July 11, 2001)] (“2001 Repo Rule Adopting Release”), at Background. Rule 5b-3 allows the same treatment for purposes of section 5 and section 12(d)(3) of the Act. The rule 5b-3(c)(1) definition of collateralized fully, which is cross-referenced by rule 2a-7(a)(5), sets forth the related conditions. Money market funds may enter into repurchase agreements that are not collateralized fully. Any agreement or portion of agreement that is not collateralized fully would be deemed an unsecured loan. As such the loan itself would have to meet the quality requirements set forth in rule 2a-7, both with respect to the minimal credit risk and the high quality rating, as well as the five percent diversification test. See 1991 Adopting Release, *supra* note 20, at n.31.

<sup>227</sup> See rule 5b-3(c)(1)(v).

<sup>228</sup> Proposed rule 2a-7(a)(5). Under the current definition of collateralized fully, a money market fund may look through repurchase agreements collateralized with cash items, Government securities, securities with the highest rating or unrated securities of comparable credit quality. Rule 5b-3(c)(1)(iv). Repurchase agreements have traditionally been collateralized with U.S. Treasury and agency securities, but over the years borrowers have increasingly used investment grade corporate bonds, mortgage-backed securities and other potentially illiquid securities. See Martin Duffy et al., *supra* note 191, at 3. Our staff’s examination of the portfolio holdings in the 15 largest money market fund complexes last spring indicated that approximately 75% of the collateral supporting repurchase agreements held by the funds consisted of Government securities (48.3% agencies and 26.4% U.S. Treasuries). The exam further indicated that the remaining collateral consisted of a variety of instruments, such as equities, commercial paper, corporate notes, and mortgage loan obligations.

consequence is more likely in the case of a default by a large counterparty when, as a result, many investors in repurchase agreements seek to liquidate similar collateral at the same time.<sup>229</sup>

We request comment on this amendment. We understand that most money market funds that take advantage of the diversification “look-through” provision enter into repurchase agreements that are collateralized by Government securities. Is our understanding correct? If so, would this amendment have a significant impact on money market funds? Would the amendment significantly reduce the risk of losses upon the default of a repurchase agreement counterparty? Would it negatively impact money market funds’ yields? Should we apply this limitation to repurchase agreements that are not collateralized fully, and thus do not qualify for the special “look-through” treatment?

Second, we propose to require that the money market fund’s board of directors or its delegate evaluate the creditworthiness of the counterparty, regardless of whether the repurchase agreement is collateralized fully.<sup>230</sup> We eliminated this requirement in 2001 in light of amendments to relevant bankruptcy law that protected funds from the automatic stay of creditors’ rights under applicable bankruptcy law.<sup>231</sup> The events of last fall, which involved the failure of a large investment bank holding company that served as a counterparty, suggest we should revisit this determination.<sup>232</sup> We are concerned that in the midst of a crisis following the bankruptcy of a counterparty, a money market fund may find it difficult to protect fully its interests in the collateral without incurring losses.<sup>233</sup> A fund should seek to avoid such a crisis by limiting its counterparties to those that are creditworthy. We request comment on this proposed amendment.

## F. Disclosure of Portfolio Information

### 1. Public Website Posting

The Commission is proposing to amend rule 2a-7 to require money market funds to disclose information about their portfolio holdings each month on their websites. Specifically, a fund would be required to disclose the fund’s schedule of investments, as prescribed by rules 12-12 to 12-14 of Regulation S-X,<sup>234</sup> identifying, among other things, the issuer, the title of the issue, the principal amount of the security, and its current amortized cost.<sup>235</sup> The fund would be required to post the information no later than the second business day of the month, current as of the last business day of the previous month, and would have to maintain the information on the website for at least twelve months.<sup>236</sup>

<sup>229</sup> If the counterparty defaults, a money market fund might be required to dispose of the collateral as soon as possible to the extent that the collateral, now part of the fund’s portfolio, does not meet the fund’s maturity or liquidity requirements. Such requirements do not apply to the collateral when it is not part of the fund’s portfolio. See 1991 Adopting Release, *supra* note 20, at n.33 and accompanying text.

<sup>230</sup> Proposed rule 2a-7(c)(4)(ii)(A). It appears that this evaluation is already being made in many fund complexes. See ICI Report, *supra* note 6, at n.90.

<sup>231</sup> See 2001 Repo Rule Adopting Release, *supra* note 226, at nn.18–20 and accompanying text.

<sup>232</sup> We understand that a number of money market funds discontinued entering into repurchase agreements with The Bear Stearns Companies Inc. (“Bear Stearns”) when it was threatened with collapse in March 2008. ICI Report, *supra* note 6, at 51.

<sup>233</sup> See Stephen Morris & Hyun Song Shin, *Financial Regulation in a System Context*, Brookings Papers on Economic Activity, Fall 2008, at 229, 239 (noting that “if Bear Stearns had become illiquid, and the assets pledged as collateral reverted to the money market funds, they would have been forced to sell those assets quickly, possibly at a large loss.”). Cf. *Calyon N.Y. Branch v. Am. Home Mortg. Corp. (In re Am. Home Mortg., Inc.)*, 379 B.R. 503, 520-22 (Bankr. D. Del. 2008) (Holding that seller in bankruptcy was not required to transfer to the buyer the right to service the collateral of the repurchase agreement. The court found that the servicing provisions of the agreement were severable from the repurchase provisions, dismissing the buyer’s argument that without the servicing rights the buyer’s ability to liquidate the collateral would have been impaired.)

<sup>234</sup> 17 CFR 210.12-12–12-14.

<sup>235</sup> Proposed rule 2a-7(c)(12).

<sup>236</sup> *Id.*

Currently, money market funds must report portfolio holdings information to us four times a year, no earlier than within 60 days of the close of the covered period.<sup>237</sup> Many funds today provide this information to their investors much more frequently on their websites, with some funds updating information each day.<sup>238</sup>

We understand that the greater transparency provided by many funds today responds to demands from investors, particularly institutional investors, who wish to have a better understanding of the current risks to which the fund is exposed.<sup>239</sup> Those investors find that the quarterly reports are too infrequent in light of the rapid turnover of money market fund portfolios. We believe that the greater transparency of fund portfolios is a positive development by which investors can exert influence on risk-taking by fund advisers, and thus reduce the likelihood that a fund will break the buck.

We request comment on the proposed monthly portfolio disclosure requirement. Should we require more information from funds than what we have proposed? If so, what additional information should we require? Should we require that money market funds also post their market-based net asset value per share and the market-based prices of their portfolio securities? This information would enable investors to understand the fund's exposure to distressed securities (the market value of which would be less than the amortized cost). In addition, it could help investors understand the risk that the fund may be unable to maintain a \$1.00 stable net asset value. Currently, only larger, more sophisticated investors may be able to gauge this risk, by themselves estimating the market value of portfolio securities disclosed on fund websites. Thus, a requirement that funds disclose the market-based values may help to level the playing field for all investors. On the other hand, we acknowledge that disclosure of shadow pricing could cause certain investors to redeem their holdings once the shadow price drops below a certain threshold and thus potentially introduce greater instability.

We request comment on how investors might react to the disclosure of market-based values and the consequences to funds and shareholders if such information were disclosed. Would investors seek to redeem their shares when the fund's market-based net asset value falls below a certain threshold because of concerns that other investors may seek to redeem? Would market analysts follow and report this information and thereby cause investors to redeem if the fund's market-based net asset value falls below a certain threshold? Would the disclosure of market-based values, in addition to amortized cost, confuse investors, particularly retail investors? Are there costs to disclosing this information, and, if so, what are they? Alternatively, would this information provide shareholders with useful information regarding the fund's risk characteristics? Would it enable investors to make better informed investment decisions? Would this information benefit investors, and, if so, how? If the market-based values were required to be disclosed, how frequently should they be disclosed? Would monthly disclosure be frequent enough for investors to understand how often and to what extent a money market fund's market-based share price deviates from the \$1.00 stable share price?

Should we omit any of the proposed disclosure requirements? If so, what information should be omitted from the proposed requirement, and why?

Each money market fund would have to update its portfolio schedule as of the end of each month and post the update no later than two business days after the end of the month. Should we provide for a longer delay to prevent cash investors other than shareholders from trading along with the fund, to the possible detriment of the fund and its shareholders? The ICI Report recommended monthly disclosure with a two-day delay, asserting that "front-running" concerns are less of a risk for money market funds than other types of mutual funds.<sup>240</sup> We understand that funds that already post portfolio schedules frequently have come to the same conclusion. Should funds be required to provide more frequent disclosure of portfolio holdings (e.g., weekly or biweekly)?

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<sup>237</sup> Money market funds must provide a full schedule of their portfolio holdings in quarterly filings to the Commission. See Form N-CSR [17 CFR 274.128] (form used by registered management investment companies to file shareholder reports); Form N-Q [17 CFR 274.130] (form used by registered management investment companies to file quarterly reports of portfolio holdings after the first and third quarters).

<sup>238</sup> See Colleen Sullivan & Mike Schnitzel, *Money Funds Move to Update Holdings Faster*, Fund Action, Sept. 29, 2008, available at <http://www.fundaction.com/pdf/FA092908.pdf>.

<sup>239</sup> See *id.*

<sup>240</sup> See ICI Report, *supra* note 6, at 93.



The amendments would require that a fund post the information on its website for at least 12 months. Should the information be accessible on the website for a longer or shorter time period? Should we require this information somewhere other than on the fund's website? Do all money market funds have websites?

## 2. Reporting to the Commission

We are also proposing a new rule requiring money market funds to provide the Commission a monthly electronic filing of more detailed portfolio holdings information.<sup>241</sup> The information would enable the Commission to create a central database of money market fund portfolio holdings, which could enhance our oversight of money market funds and our ability to respond to market events.<sup>242</sup>

Our current information on money market fund portfolios is limited to quarterly reports filed with us which, as noted above, quickly become stale. Moreover, the reports are not filed in a format that allows us to search expeditiously across portfolios or within a portfolio to identify securities that may raise concerns. In 2007, our staff was not able to ascertain quickly which money market funds held SIVs, and last fall we had to engage in lengthy and time-consuming inquiries to determine which money market funds held commercial paper issued by Lehman Brothers after it declared bankruptcy. Further, if we had had such data immediately available to us, we could have provided additional assistance to the Treasury Department or the Federal Reserve Board in structuring the programs they put into place to protect investors.<sup>243</sup> In preparing this release we have relied in part on data about money market funds available only through industry associations and publications.<sup>244</sup>

Proposed rule 30b1-6 would provide us information that would assist our staff in analyzing the portfolio holdings of money market funds, and thus enhance our understanding of the risk characteristics of individual money market funds and money market funds as a group and industry trends. We would be able to identify quickly those funds that are holding certain types of securities or specific securities, such as distressed securities, and funds that have unusual portfolios that may involve greater risks than are typical (e.g., funds that have higher gross yields).

Although the portfolio reports to the Commission are not primarily designed for individual investors, we would expect to make the information available to the public two weeks after their filing. We anticipate that academic researchers, financial analysts and economic research firms would use this information to study money market fund holdings and evaluate their risk information. Their analyses may further help investors and regulators better understand risks in money market funds. In addition, we believe that delaying the public availability of this information would alleviate possible concerns about the public disclosure of the detailed portfolio holdings information contained in the filing, without compromising its utility.<sup>245</sup>

Proposed rule 30b1-6 would require money market funds to file a monthly portfolio holdings report on new Form N-MFP (for "money fund portfolio" reporting) no later than the second business day of each month, current as of the

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<sup>241</sup> Proposed rule 30b1-6.

<sup>242</sup> In 1995, the Commission proposed, but did not adopt, a similar rule that would have required money market funds to file quarterly reports of portfolio holdings. Money Market Fund Quarterly Reporting, Investment Company Act Release No. 21217 (July 19, 1995) [60 FR 38467 (July 26, 1995)]. *See also* Rulemaking Petition from Fund Democracy, et al. (Jan. 16, 2008) (File No. 4-554) (recommending that the Commission require money market funds to make nonpublic monthly electronic filings of their portfolio holdings).

<sup>243</sup> The Treasury's Guarantee Program requires a participating money market fund to provide a schedule of its portfolio holdings if its market-based net asset value falls below 99.75 percent of its stable net asset value. *See* U.S. Department of the Treasury, "Guarantee Agreement (Stable Value)," 5(b), *available at* [http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-docs/Guarantee\\_Agreement\\_Stable-Value.pdf](http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-docs/Guarantee_Agreement_Stable-Value.pdf).

<sup>244</sup> *See, e.g., supra* note 68.

<sup>245</sup> As discussed above, we understand the confidentiality of certain portfolio holdings information is not of critical importance to money market funds. Accordingly, the proposed amendments to rule 2a-7 would require money market funds to disclose certain monthly portfolio holdings information on their websites within two days after the end of month. *See also* ICI Report, *supra* note 6, at 93 (recommending that funds disclose monthly portfolio holdings information after a two-day delay). Here, however, the more detailed information included in the filing to the Commission may present more significant concerns.

last business day of the previous month.<sup>246</sup> Proposed Form N-MFP would require the fund to report, with respect to each portfolio security held on the last business day of the prior month, among other things: (i) the name and CIK number of the issuer; (ii) the title of the issue; (iii) the CUSIP number or other unique identifier; (iv) the category of investment (e.g., Treasury debt, government agency debt, corporate commercial paper, structured investment vehicle notes, etc.); (v) the current credit ratings of the issuer and the requisite NRSROs giving the ratings; (vi) the maturity date as determined under rule 2a-7, (vii) the final legal maturity date; (viii) whether the maturity date is extendable; (ix) whether the instrument has certain enhancement features; (x) the identity of any enhancement provider; (xi) the current credit rating of the enhancement provider; (xii) the principal amount; (xiii) the current amortized cost value; (xiv) certain valuation information (i.e., whether the inputs used in determining the value of the securities are Level 1, Level 2, or Level 3,<sup>247</sup> if applicable); and (xv) the percentage of the money market fund's assets invested in the security.<sup>248</sup> In addition, Form N-MFP would require funds to report to us information about the fund's risk characteristics, such as the fund's dollar weighted average maturity of its portfolio and its 7-day gross yield.

Given the rapidly changing composition of money market fund portfolios, which is largely the result of securities maturing, we believe that monthly reports would improve the timeliness and relevance of portfolio information. Once a money market fund has established a system for tagging and filing a Form N-MFP, we expect the marginal costs of filing additional reports would be minimal.<sup>249</sup>

Under the proposed rule, Form N-MFP would be filed electronically through the Commission's EDGAR system in an eXtensible Markup Language ("XML") tagged data format.<sup>250</sup> We understand that money market funds already maintain the requested information, and therefore would need only to tag the data and file the reports with the Commission.<sup>251</sup> We anticipate that, in the future, many funds may be able to collect, tag, and file this information with the Commission through even more efficient, automated processes, thereby minimizing the related costs and potential for clerical error.

We request comment on the proposed monthly portfolio reporting requirement. Should we require funds to file the portfolio holdings report on a more frequent basis? As discussed above, we intend to make this information publicly available two weeks after the report is filed with the Commission. Would such a delay alleviate concerns about possible front-running or other possible harms that might be caused by making the information public? Should the lag time between the filing of the form and its public availability be longer or shorter? Should the information be immediately available to the public upon filing? Should we instead provide that all or a portion of the requested information be submitted in nonpublic reports to the Commission? If so, please identify the specific items that should remain nonpublic and explain why.

Proposed Form N-MFP requires money market funds to disclose certain items that would be relevant to an evaluation of the risk characteristics of the fund and its portfolio holdings. Should we require additional or alternative information, such as the fund's client concentration levels, the percentage of the issue held by the fund, or last trade price and trade

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<sup>246</sup> The portfolio securities information that money market funds currently must report is more limited in scope, and includes information about the issuer, the title of the issue, the balance held at the close of the period, and the value of each item at the close of the period. *See* Form N-Q, Item 1 [17 CFR 274.130]; Rules 12-12-12-14 of Regulation S-X [17 CFR 210.12-12-12.14].

<sup>247</sup> *See* Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 157, "Fair Value Measurement,"* available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818754924&blobheader=application%2Fpdf>.

<sup>248</sup> In addition, proposed Form N-MFP would include an "Explanatory Notes" item to permit funds to add miscellaneous information that may be material to other disclosure in the form.

<sup>249</sup> *See also infra* Section V.

<sup>250</sup> We anticipate that the XML interactive data file would be compatible with a wide range of open source and proprietary information management software applications. Continued advances in interactive data software, search engines, and other web-based tools may further enhance the accessibility and usability of the data.

<sup>251</sup> We understand that many funds often provide this type of information in different formats to various information services and third-parties, including NRSROs. Standardizing the data format in proposed Form N-MFP may encourage standardization across the industry, resulting in cost savings for money market funds.

volume for each security?<sup>252</sup> Should we require funds to disclose market-based values (including the value of any credit support agreement), which would allow us to identify funds that have market-based net asset values that sufficiently deviate from their amortized cost that they present a risk of breaking the buck? Would the two-week delay in making the information publicly available mitigate any concerns about the disclosure of this information? Alternatively, should we require funds to provide the market-based values information to us on a nonpublic basis?<sup>253</sup> If funds were required to provide market-based values information to us on a nonpublic basis, should we require funds to provide this information more frequently once the fund's net asset value per share falls below a certain threshold? If so, how frequently should funds be required to provide this information (e.g., weekly or daily) and what should be the threshold (e.g., \$0.9975)?

Should we omit any proposed disclosure requirement? Are there specific items that the proposed form would require that are unnecessary or otherwise should not be required?

We request comment on feasible alternatives that would minimize the reporting burdens on money market funds.<sup>254</sup> We also request comment on the utility of the reports to the Commission in relation to the costs to money market funds of providing the reports.<sup>255</sup> In addition, we request comment on whether funds should be permitted to post a human readable version of their Forms N-MFP on their websites to satisfy the proposed monthly website disclosure requirement.

The Commission anticipates that the data to be required by proposed Form N-MFP would be clearly defined and often repetitive from one month to the next. Therefore, we believe the XML format would provide us with the necessary information in the most timely and cost-effective manner. Should the Commission allow or require the form to be provided in a format other than XML, such as eXtensible Business Reporting Language ("XBRL")? Is there another format that is more widely used or would be more appropriate for the required data? Is there a need for more detailed categories of data? What would be the costs to funds of providing data in the XML format? Would there be a disproportionate cost burden on smaller fund companies? Is there another format that would be less costly but still allow investors and analysts easily to view (or download) and analyze the data from a central database? Should the Commission use the EDGAR database or should it create a new database? Should the Commission consider the implementation of reporting on Form N-MFP initially through a voluntary pilot program?

### 3. Amendment to Rule 30b1-5

To avoid unnecessarily duplicative disclosure obligations, we propose to amend rule 30b1-5 to exempt money market funds from the requirement to file their schedules of investments pursuant to Item 1 of Form N-Q, a quarterly schedule of portfolio holdings of management investment companies.<sup>256</sup> We request comment on this exemption. We are not proposing to exempt money market funds from the controls and procedures and certification requirements of Form N-Q. Should we also exempt money market funds from Item 2 of Form N-Q, which requires disclosure of certain information about a fund's controls and procedures, and/or Item 3 of Form N-Q, which requires certain fund officers to file a certification as an exhibit to the form?<sup>257</sup> Should we exempt money market funds from the portions of Items 2 and 3 that pertain to the schedule of investments required by Form N-Q? Alternatively, should we amend Form N-Q and/or rule 30b1-5 to apply similar controls and procedures and certification requirements to the proposed monthly reporting requirement? Should we exempt money market funds from requirements to provide portfolio schedules in Form N-CSR?<sup>258</sup>

<sup>252</sup> See Rulemaking Petition from Fund Democracy, *supra* note 242 (recommending that the Commission require money market funds to disclose to the Commission, among other things, the percentage of an issue owned by a fund and its affiliates and the last trade price and trade volume for each portfolio security).

<sup>253</sup> See *supra* discussion at paragraph following note 239 and paragraph preceding note 240.

<sup>254</sup> See section 30(c)(2)(A) of the Investment Company Act (requiring Commission to consider and seek public comment on feasible alternatives to the required filing of information that minimize reporting burdens on funds).

<sup>255</sup> See section 30(c)(2)(B) of the Investment Company Act (requiring Commission to consider and seek public comment on the utility of information, documents and reports to the Commission in relation to the associated costs).

<sup>256</sup> Item 1 of Form N-Q requires funds to file the schedule of investments, as of the close of the reporting period, in accordance with rules 12-12 – 12-14 of Regulation S-X.

<sup>257</sup> 17 CFR 274.130.

<sup>258</sup> See *supra* note 237.

## G. Processing of Transactions

We are proposing to require that each money market fund's board determine in good faith, at least once each calendar year, that the fund (or its transfer agent) has the capacity to redeem and sell its securities at a price based on the current net asset value per share.<sup>259</sup> This proposed amendment would require money funds to have the operational capacity to “break a dollar” and continue to process investor transactions in an orderly manner.<sup>260</sup>

Money market funds that seek to maintain a stable net asset value do not guarantee that they will be able to maintain the stable net asset value. Indeed, each money market fund prospectus must disclose that an investor may lose money by investing in the fund.<sup>261</sup> Nonetheless, we understand that some money market funds do not have in place systems to process purchases and redemptions at prices other than the funds' stable net asset value. In other words, the systems of these money market funds and their transfer agents are “hardwired” to process shareholder transactions at only the stable net asset value.

The consequences of such an operational limitation contributed to the delays in redeeming shareholders of The Reserve Primary Fund after that fund broke the buck in September 2008. We understand that all transactions thereafter had to be processed manually, a time-consuming and expensive process that extended the time that shareholders had to wait for the proceeds from their shares.<sup>262</sup>

We believe that money market funds that do not have the operational capacity to price shares according to market values expose their shareholders to unnecessary risks—risks that may render a money market fund unable to meet its obligations under section 22(e) of the Act to pay the proceeds of a redemption within seven days. Therefore, we propose to amend rule 2a-7 to require that a money market fund's board determine in good faith, no less frequently than once each calendar year, that the fund (or its transfer agent) has the capacity to redeem and sell fund shares at prices based on the current net asset value per share. The proposed amendment also clarifies that this capacity includes the capacity to sell and redeem shares at prices that do not correspond to the stable net asset value or price per share.<sup>263</sup>

We request comment on this proposed amendment. Is it appropriate? Should the board play a role in this determination? Should we instead revise the risk-limiting conditions of the rule to require that the fund simply *have* the capacity to redeem and sell securities at market-based prices? Alternatively, should the rule require that the board determine that the fund has *adopted procedures* adequate to enable the fund to redeem and sell securities at market-based prices? Or should the rule require that the board *approve* such procedures? If the rule requires a determination by the board, is an annual determination appropriate? Should the determination be more frequent (e.g., quarterly) or less frequent (e.g., every three years)?

<sup>259</sup> Proposed rule 2a-7(c)(1) (new last two sentences).

<sup>260</sup> Once a fund has broken the buck, the fund could no longer use the amortized cost method of valuing portfolio securities, and therefore would have to compute share price by reference to the market values of the portfolio with the accuracy of at least a tenth of a cent. See 1983 Adopting Release, *supra* note 3, at n.6 and accompanying text. Thus, a fund whose market-based net asset value was determined to be \$0.994 would, upon ceasing to use the amortized cost method of valuation, begin to redeem shares at \$0.994 (rather than at \$0.990). See generally *id.*

<sup>261</sup> Item 2(c)(1)(ii) of Form N-1A [17 CFR 239.15A, 274.11A]. Similar disclosure is required in money market fund advertisements and sales literature. See rule 482(b)(4) under the Securities Act of 1933 [17 CFR 230.482]; rule 34b-1(a).

<sup>262</sup> See Press Release, The Reserve Fund, Timeframe for Initial Distribution Payment of Reserve Primary Fund (Sept. 30, 2008) (explaining that “[m]oney market management systems...are programmed to accommodate a constant \$1.00 NAV [and that making] a distribution to holders that have made redemption requests since September 15, 2008, necessitated a series of system modifications designed to ensure an accurate and equitable distribution of funds”); Press Release, The Reserve Fund, Reserve Primary Fund Disbursement Update (Oct. 15, 2008) (explaining that Reserve Fund investors were “supported by complex technology at The Reserve as well as their own systems, which had to be adjusted due to the decline of the net asset value below \$1.00 on September 16...[and that The Reserve Fund was] working diligently to enhance...existing software and add new programs to hasten the distribution process”). See also Press Release, The Reserve Fund, Statement About The Reserve Yield Plus Fund (Oct. 17, 2008) (“apologiz[ing] for the delay in meeting redemption requests” in a short-term bond fund, and explaining that the fund’s sponsor needed to “first move the Fund to a different computer platform that’s able to account for a share price below \$1.00...[which] wasn’t anticipated when the Fund was created”).

<sup>263</sup> Proposed 2a-7(c)(1) (new third sentence).

## H. Exemption for Affiliate Purchases

The Commission is proposing to amend rule 17a-9, which provides an exemption from section 17(a) of the Act to permit affiliated persons of a money market fund to purchase distressed portfolio securities from the fund.<sup>264</sup> The amendment would expand the circumstances under which affiliated persons can purchase money market fund portfolio securities.<sup>265</sup> The Commission is also proposing a related amendment to rule 2a-7, which would require that funds report all such transactions to the Commission.

### 1. Expanded Exemptive Relief

In 1996, the Commission adopted rule 17a-9 under the Act to permit affiliated persons to purchase a security from an affiliated money market fund that is no longer an eligible security under rule 2a-7, as long as the purchase price is paid in cash and is equal to the amortized cost of the security or its market price, whichever is greater.<sup>266</sup> The rule codified a series of staff no-action letters in which the staff agreed not to recommend enforcement action to the Commission if affiliated persons of a money market fund purchased portfolio securities from the fund in order prevent the fund from realizing losses on the securities that may otherwise have caused it to break the buck.<sup>267</sup> When we adopted the rule we explained that experience had shown that such transactions appeared to be fair, reasonable, in the best interests of fund shareholders, and consistent with the requirement that money market funds dispose of a defaulted security in an orderly manner as soon as practicable.<sup>268</sup>

The current rule exempts only purchases of securities that are no longer “eligible securities” under rule 2a-7 because, for example, their ratings have been downgraded. This limitation served as a proxy indicating that the market value of the security was likely less than its amortized cost value, and thus the resulting transaction was fair to the fund and did not involve overreaching.<sup>269</sup> Since rule 17a-9 was adopted, our staff has responded to several emergency requests for no-action relief for transactions involving portfolio securities that remained eligible securities. In some cases, the fund’s adviser anticipated that the securities would be downgraded and sought to arrange a purchase by an affiliate as a preventive measure before the distressed security could impact the fund’s market-based net asset value.<sup>270</sup> In other cases, markets for portfolio securities had become illiquid and the affiliated person sought to provide the fund with cash to satisfy

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<sup>264</sup> Absent a Commission exemption, section 17(a)(2) prohibits any affiliated person or promoter of or principal underwriter for a fund (or any affiliated person of such a person), acting as principal, from knowingly purchasing securities from the fund. Rule 17a-9 exempts certain purchases of securities from a money market fund from section 17(a). For convenience, in this Release, we refer to all of the persons who would otherwise be prohibited by section 17(a)(2) from purchasing securities of a money market fund as “affiliated persons.” “Affiliated person” is defined in section 2(a)(3) of the Act.

<sup>265</sup> The proposed expansion of the rule would not include “capital support agreements” supporting the net asset value per share of money market funds, which support fund affiliates provided in several instances in reliance on no-action assurances by our staff. *See supra* note 38. Unlike direct purchases of securities by affiliates, the nature and terms of these agreements are highly customized and terminate after a limited period of time. As a result, these situations do not readily lend themselves to being addressed in a rule of general applicability.

<sup>266</sup> Rule 17a-9(a) and (b). *See* 1996 Adopting Release, *supra* note 20, at nn.190–94 and accompanying text.

<sup>267</sup> *See* 1996 Adopting Release, *supra* note 20, at nn.190–92 and accompanying text.

<sup>268</sup> *See id.*

<sup>269</sup> *See id.* at text following n.194 (“The rule, as adopted, is available for transactions involving securities that are no longer eligible securities because they no longer satisfy either the credit quality or maturity limiting provisions (e.g., the securities are long-term adjustable-rate securities whose market values no longer approximate their par values on the interest rate readjustment dates).”)

<sup>270</sup> *See, e.g.*, Fixed Income Shares – Allianz Dresdner Daily Asset Fund, SEC Staff No-Action Letter (May 5, 2008); First American Funds, Inc. – Prime Obligation Fund, SEC Staff No-Action Letter (Dec. 3, 2007); MainStay VP Series Fund – MainStay VP Cash Management Portfolio, SEC Staff No-Action Letter (Oct. 22, 2008); Institutional Liquidity Trust – Prime Master Series, SEC Staff No-Action Letter (Apr. 30, 2008); Penn Series Funds, Inc. – Money Market Fund, SEC Staff No-Action Letter (Oct. 22, 2008); Phoenix Opportunities Trust – Phoenix Money Market Fund and Phoenix Edge Series Fund – Phoenix Money Market Series, SEC Staff No-Action Letter (Oct. 22, 2008); USAA Mutual Funds Trust – USAA Money Market Fund, SEC Staff No-Action Letter (Oct. 22, 2008). SEC staff no-action letters are available on the SEC website at <http://www.sec.gov/divisions/investment/im-noaction.shtml> under the hyperlink for the relevant letter.

redemptions by purchasing portfolio securities.<sup>271</sup> In all cases, the terms of the transactions met all the requirements of rule 17a-9 except that the securities were eligible securities.

Our staff's experience is that these transactions appear to be similarly fair and reasonable and in the best interest of shareholders. We are therefore proposing to extend the exemption to additional types of transactions, which will eliminate the need for affiliated persons to seek no-action assurances from our staff for these transactions when the delay would not be in the best interests of shareholders.

Currently, under rule 17a-9 a security must no longer be an eligible security for an affiliated person of a money market fund to purchase such security. Under the proposed amendment, a money market fund could sell a portfolio security that has defaulted (other than an immaterial default unrelated to the financial condition of the issuer), to an affiliated person, even though the security continued to be an eligible security.<sup>272</sup> Any such transaction would have to satisfy the existing requirements of rule 17a-9.<sup>273</sup>

In addition, we propose to add a new provision to rule 17a-9 that would permit affiliated persons, for any reason, to purchase other portfolio securities (e.g., eligible securities that have not defaulted) from an affiliated money market fund for cash at the greater of its amortized cost value or market value, provided that such person promptly remits to the fund any profit it realizes from the later sale of the security.<sup>274</sup> Because in these circumstances there may not be an objective indication that the security is distressed (and thus that the transaction is clearly in the interest of the fund), the proposed "claw-back" provision would eliminate incentives for fund advisers and other affiliated persons to buy securities for reasons other than protecting fund shareholders from potential future losses.

We request comment on all aspects of the proposed expansion of rule 17a-9. Should we instead expand the exemption to include only those portfolio securities that fall within enumerated categories (e.g., securities have defaulted, have become illiquid, have been determined by the board of directors to no longer present minimal credit risk)? If so, what would those categories be and why? Would any additional conditions be needed with respect to particular categories of purchases to control for potential conflicts of interest on the part of the adviser? If so, what conditions should we include? Is it appropriate to subject only eligible securities that have not defaulted to the proposed claw-back provision? Is such a provision necessary and fair? Should we provide a time limit after purchase when the required claw-back provision would no longer apply? Should we exclude from the claw-back requirement potential payments to money market funds that are subsequently liquidated?

## 2. New Reporting Requirement

The Commission is also proposing an amendment to rule 2a-7 that would require a money market fund whose securities have been purchased by an affiliated person in reliance on rule 17a-9 to provide us with prompt notice of the transaction via electronic mail.<sup>275</sup> We proposed a similar amendment last summer in connection with the NRSRO References Proposal.<sup>276</sup> That proposal is superseded by the requirement we propose here, which contains one change.<sup>277</sup> Due to the nature of the proposed amendments to rule 17a-9, which do not restrict the purchase of a portfolio security from

<sup>271</sup> See, e.g., Dreyfus Money Funds, SEC Staff No-Action Letter (Oct. 20, 2008); Mount Vernon Securities Lending Trust, Inc. – Mount Vernon Securities Lending Prime Portfolio, SEC Staff No-Action Letter (Oct. 22, 2008); Morgan Stanley Money Market Funds, SEC Staff No-Action Letter (Oct. 22, 2008); Reserve New York Municipal Money-Market Trust – New York Municipal Money-Market Fund, SEC Staff No-Action Letter (Nov. 18, 2008); Russell Investment Company – Russell Money Market Fund, SEC Staff No-Action Letter (Oct. 20, 2008).

<sup>272</sup> Proposed rule 17a-9(a). Other provisions of rule 2a-7 currently except immaterial defaults unrelated to the financial condition of the issuer. See rule 2a-7(c)(6)(ii)(A). As we have noted in the past, this exception is intended to exclude defaults that are technical in nature, such as where the obligor has failed to provide a required notice or information on a timely basis. See 1991 Adopting Release, *supra* note 20, at Section II.E.2.

<sup>273</sup> Proposed rule 17a-9(a)(1) and (2).

<sup>274</sup> Proposed rule 17a-9(b)(2).

<sup>275</sup> Proposed rule 2a-7(c)(7)(iii)(B). The electronic mail notification would be directed to the Director of our Division of Investment Management, or the Director's designee. Proposed rule 2a-7(c)(7)(iii).

<sup>276</sup> See NRSRO References Proposal, *supra* note 105, at n.35 and accompanying text.

<sup>277</sup> Proposed rule 2a-7(c)(7)(iii)(B).

a fund to particular categories, we propose to require not only notice of the fact of the purchase, but also the reasons for the purchase. Such reasons might include, for example, that the fund's adviser expected that the security would be downgraded, that due to the decreased market value of the security the fund was at risk of breaking the buck, or that the fund was experiencing heightened redemption requests and wished to avoid a "fire sale" of assets to satisfy such requests.

We continue to believe that the current notice requirement in rule 2a-7, which is triggered when a security over a threshold amount of the fund's assets defaults, provides us with incomplete information about money market fund holdings of distressed securities, particularly those that have engaged in affiliated transactions.<sup>278</sup> We also continue to believe that this proposed notice requirement, which is a concept supported by some commenters last summer,<sup>279</sup> would impose little burden on money market funds or their managers, and would enhance our oversight of money market funds especially during times of economic stress. We request comment on this proposed notice requirement. Is the proposed requirement that the notice include the reasons for the purchase by the affiliate sufficiently clear? Should we require that any additional information be included in the notice and should the notice take a particular form?

## I. Fund Liquidation

### 1. Proposed Rule 22e-3

The Commission is proposing a new rule 22e-3, which would exempt money market funds from section 22(e) to permit them to suspend redemptions in order to facilitate an orderly liquidation of the fund. The new rule would replace rule 22e-3T, a temporary rule that provides a similar exemption for money market funds participating in the Treasury Department's Guarantee Program.<sup>280</sup>

Section 22(e) of the Act generally prohibits funds, including money market funds, from suspending the right of redemption, and from postponing the payment or satisfaction upon redemption of any redeemable security for more than seven days. The provision was designed to prevent funds and their investment advisers from interfering with the redemption rights of shareholders for improper purposes, such as the preservation of management fees.<sup>281</sup> Although section 22(e) permits funds to postpone the date of payment or satisfaction upon redemption for up to seven days, it does not permit funds to suspend the right of redemption, absent certain specified circumstances or a Commission order.

As discussed above, on September 22, 2008, we issued an order under section 22(e) to permit two series of The Reserve Fund to suspend redemptions and postpone payments in the midst of a run on the fund. In November 2008, we adopted rule 22e-3T to permit money market funds participating in the Treasury's Guarantee Program to suspend redemptions and postpone the payment of redemption proceeds if a fund breaks the buck and begins liquidation proceedings under the Guarantee Program.<sup>282</sup>

The temporary rule was intended to facilitate the orderly disposal of assets in a manner that would protect the interests of all shareholders. Absent the exemption provided by rule 22e-3T, a fund participating in the Guarantee Program that faces a run would be compelled by section 22(e) to continue to redeem shares. In order to raise the money to pay redemption proceeds to shareholders, a fund may have to sell portfolio securities. Massive redemption requests could thus force a fund to liquidate positions in a fire sale, further depressing the fund's market value share price. Earlier redeeming shareholders would receive higher share prices (at or near the amortized cost) but, as a result of the fund's diminishing asset base, later redeeming shareholders may receive lower prices.<sup>283</sup> Moreover, as demonstrated by the events of last fall,

<sup>278</sup> See NRSRO References Proposal, *supra* note 105, at Section III.A.4.

<sup>279</sup> See, e.g., Comment Letters of the Investment Company Institute (Sept. 5, 2008); Commenter Letter of the Mutual Fund Directors Forum (Sept. 5, 2008); Comment Letter of OppenheimerFunds, Inc. (Sept. 4, 2008); Comment Letter of Charles Schwab Co., Inc. (Sept. 5, 2008). Comment letters may be accessed on the Commission's website at <http://www.sec.gov/comments/s7-19-08/s71908.shtml>.

<sup>280</sup> The Treasury's Guarantee Program guarantees that shareholders of a participating money market fund will receive the fund's stable share price for each share owned as of September 19, 2008, if the fund liquidates under the terms of the Program. See *supra* note 55 and accompanying text.

<sup>281</sup> See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 291 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC).

<sup>282</sup> See Rule 22e-3T Adopting Release, *supra* note 31.

<sup>283</sup> *Id.*

a run on a single fund can quickly spread to other funds and, as multiple funds attempt to meet redemption requests, seriously deplete the value of portfolio holdings and drain the availability of cash and more liquid securities.

We believe that rule 22e-3T, which will expire on October 18, 2009, in conjunction with the Guarantee Program, should be replaced with a rule that would provide for a similar exemption independent of the Guarantee Program.<sup>284</sup> Proposed rule 22e-3 would permit all money market funds to suspend redemptions upon breaking a buck, if the board, including a majority of independent directors, approves liquidation of the fund, in order to liquidate in an orderly manner. The proposed rule is intended to reduce the vulnerability of investors to the harmful effects of a run on a fund, and minimize the potential for disruption to the securities markets.

Proposed rule 22e-3(a) would permit a money market fund to suspend redemptions if: (i) the fund's current price per share, calculated pursuant to rule 2a-7(c), is less than the fund's stable net asset value per share; (ii) its board of directors, including a majority of directors who are not interested persons, approves the liquidation of the fund; and (iii) the fund, prior to suspending redemptions, notifies the Commission of its decision to liquidate and suspend redemptions, by electronic mail directed to the attention of our Director of the Division of Investment Management or the Director's designee.<sup>285</sup> These proposed conditions are intended to ensure that any suspension of redemptions will be consistent with the underlying policies of section 22(e). We understand that suspending redemptions may impose hardships on investors who rely on their ability to redeem shares. Accordingly, our proposal is limited to permitting suspension of this statutory protection only in extraordinary circumstances. Thus, the proposed conditions, which are similar to those of the temporary rule, are designed to limit the availability of the rule to circumstances that present a significant risk of a run on the fund. Moreover, the exemption would require action of the fund board (including the independent directors), which would be acting in its capacity as a fiduciary.<sup>286</sup>

The proposed rule contains an additional provision that would permit us to take steps to protect investors. Specifically, the proposed rule would permit us to rescind or modify the relief provided by the rule (and thus require the fund to resume honoring redemptions) if, for example, a liquidating fund has not devised, or is not properly executing, a plan of liquidation that protects fund shareholders.<sup>287</sup> Under this provision, the Commission may modify the relief "after appropriate notice and opportunity for hearing," in accordance with section 40 of the Act.

Paragraph (b) of the proposed rule would provide a limited exemption from section 22(e) for certain conduit funds that invest, pursuant to section 12(d)(1)(E) of the Act, all of their assets in a money market fund that suspends redemption in reliance on paragraph (a) of the proposed rule.<sup>288</sup> Without this exemption, these conduit funds may be placed in the position of having to honor redemption requests while being unable to liquidate shares of money market funds held as portfolio securities. We anticipate that this provision would be used principally by insurance company separate accounts issuing variable insurance contracts and by funds participating in master-feeder arrangements.<sup>289</sup>

<sup>284</sup> One commenter on rule 22e-3T recommended that we make the rule a permanent rule for any fund preparing to liquidate, independent of the Guarantee Program. *See* Comment Letter of the Investment Company Institute (Dec. 24, 2008). Two other comment letters related to matters unique to the Guarantee Program. *See* Comment Letter of the Coalition of Mutual Fund Investors (Dec. 14, 2008) (recommending that any fund that liquidates and relies on the Guarantee Program be required to provide information obtained pursuant to rule 22c-2 under the Investment Company Act); Comment Letter of Michael F. Johnson (Nov. 20, 2008) (requesting information concerning the applicability of the Guarantee Program to a particular fund). The only other comment letter that the Commission received concerning interim final rule 22e-3T was a letter from the Committee of Annuity Insurers, discussed below. *See infra* note 288 and accompanying text. Comments on interim final rule 22e-3T, File No. S7-32-08, are *available at* <http://www.sec.gov/comments/s7-32-08/s73208.shtml>. Once rule 22e-3T expires, the Commission would stand ready to consider applications for exemptive relief under section 22(e).

<sup>285</sup> Proposed rule 22e-3(a).

<sup>286</sup> We also note that the potential for abuse may be mitigated because the impending liquidation of the fund would ultimately eliminate a source of advisory fees for the adviser. *See* Rule 22e-3T Adopting Release, *supra* note 31, at text accompanying nn.19–20.

<sup>287</sup> Proposed rule 22e-3(c). We adopted a similar provision in rule 22e-3T. Rule 22e-3T(b); *See also* Rule 22e-3T Adopting Release, *supra* note 31.

<sup>288</sup> Proposed rule 22e-3(b). This provision is based on a suggestion we received in a comment letter submitted in connection with rule 22e-3T. *See* Comment Letter of the Committee of Annuity Insurers (Dec. 23, 2008) (requesting that the Commission extend the application of rule 22e-3T to insurance company separate accounts). Proposed rule 22e-3(b) also would require a fund to promptly notify the Commission that it has suspended redemptions in reliance on the rule.

<sup>289</sup> For a discussion of master-feeder arrangements, *See supra* note 194.



We request comment generally on all aspects of proposed rule 22e-3. Is it appropriate to permit money market funds that break the buck to suspend redemptions during liquidation? Should the exemption be available to other types of open-end investment companies? Should there be additional or alternative conditions with regard to the exemption (e.g., should the fund be required to disclose its liquidation plan to shareholders)? Should there be a limit on the suspension period so that shareholder assets are not “locked up” for an unduly lengthy period? If so, what should be the maximum length of the suspension period (e.g., 60 or 90 days)?

## *2. Request for Comment on Other Regulatory Changes*

We also request comment on certain additional changes that we are considering but are not currently proposing, relating to the suspension of redemptions that may provide additional protections to money market fund investors.

### *a. Temporary Suspensions for Exigent Circumstances*

Should we include a provision in rule 22e-3 that would permit fund directors to temporarily suspend redemptions during certain exigent circumstances other than liquidation of the fund? The ICI Report recommends that we permit a fund’s directors to suspend temporarily the right of redemption if the board, including a majority of its independent directors, determines that the fund’s net asset value is “materially impaired.”<sup>290</sup> Under this approach, the fund could suspend redemptions for up to five days, during which time the fund could attempt to restore its net asset value (e.g., by securing credit support agreements). In the event that the fund could not restore its net asset value within that period, the fund would be required to begin the liquidation process. A fund would be permitted to exercise this option only once every five years. This “time out” could give money market funds some time during turbulent periods to assess the viability of the fund.<sup>291</sup>

We request comment generally on whether we should provide this additional relief. Would it make money market funds less appealing to investors? Would it provide time for directors to find a solution? Or might it accelerate redemptions from shareholders once the suspension period ends, regardless of any action taken by the board of directors?<sup>292</sup> Could the accumulating redemptions “hanging over the fund” place pressure on the prices of fund portfolio securities? How could we ensure that directors would use this authority only in exigent circumstances? When is a money market fund’s net asset value “materially impaired”? Would this term include circumstances in which the fund has overvalued securities, which, if sold to satisfy redemptions, would have to be marked down?

We also request comment on how a temporary suspension should operate. What disclosures should a money market fund be required to make, and when and where should the fund make them? Should a fund be required to calculate its net asset value during the suspension period, and, if so, should the net asset value be publicly disclosed? Should the suspension period be longer or shorter than five days? What factors should the board of directors take into consideration when deciding whether to suspend redemptions temporarily? How would directors weigh the various and possibly competing interests of shareholders?

### *b. Options for Shareholders in Liquidating Funds*

If a fund suspends redemptions in order to liquidate, the directors would likely distribute money to investors as it becomes available from the sale of portfolio securities, while maintaining a reserve to cover expenses and potential liabilities. As we have seen, this process can be lengthy. Should we include conditions in any rule regarding the treatment

<sup>290</sup> ICI Report, *supra* note 6, at 85–89.

<sup>291</sup> Similarly, the Treasury’s Guarantee Program and rule 22e-3T effectively provide funds with the ability to temporarily suspend redemptions. The Guarantee Program requires funds that break the buck to commence liquidation proceedings within five days, unless the fund restores its net asset value to a level equal to or above \$0.995 within that period. Meanwhile, rule 22e-3T permits funds to suspend redemptions if a fund breaks the buck and has not yet “cured” the event.

<sup>292</sup> In other situations, temporary restrictions on redemptions may have exacerbated the situation and increased the rate of redemptions. See Svea Herbst-Bayliss, “Gates” May Have Hurt More Than Helped Hedge Funds, Reuters, Mar. 26, 2009, available at <http://www.reuters.com/article/PrivateEquityandHedgeFunds09/idUSTRE52P4JJ20090326>.

of shareholders in a liquidation?<sup>293</sup> For example, should we require that fund assets be distributed on a pro rata basis? Should there be a limit on allowable reserves?

Alternatively, should we permit or require a fund board to recognize that investors will have different preferences for liquidity and capital preservation? For example, a fund that decides to liquidate and suspend redemptions could be allowed to offer shareholders the choice of redeeming their shares immediately at a reduced net asset value per share that reflects the fair market value of fund assets, i.e., at a price below the fund's stable net asset value. Remaining shareholders would receive their redemption proceeds at the end of the liquidation process and may receive the economic benefit of an orderly disposal of assets. Would such an approach be fair to all fund shareholders? What conditions would be necessary and appropriate to ensure that shareholders are treated fairly? Specifically, how would such a mechanism operate? Should funds be able to deduct an additional discount or "haircut" from earlier redeeming shareholders to provide additional protection for later redeeming shareholders? Should we permit boards to decide the amount of the haircut? If so, what factors should boards use to decide such haircuts? What disclosures and information would be necessary to permit shareholders to make an informed decision between the options?

Should investors be required to choose their preferences at the time they purchase fund shares? Should investors be able to change their preferences? If so, how and when? Should they be able to choose their preferences when a fund announces its intention to liquidate and suspend redemptions under the rule? If so, should we (or the fund board) establish a default assumption for investors that fail to respond to the inquiry?

### III. REQUEST FOR COMMENT

The Commission requests comment on the rules and amendments proposed in this release. Commenters are requested to provide empirical data to support their views. The Commission also requests suggestions for additional changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this release.

We recognize that the events of the last two years raise the question of whether further and perhaps more fundamental changes to the regulatory structure governing money market funds may be warranted. Therefore we are exploring other ways in which we could improve the ability of money market funds to weather liquidity crises and other shocks to the short-term financial markets. We invite interested persons to submit comments on the advisability of pursuing any or all of the following possible reforms, as well as to provide other approaches that we might consider to achieve our goals. We expect to benefit from the comments we receive before deciding whether to propose these changes.<sup>294</sup>

#### A. Floating Net Asset Value

When the Commission adopted rule 2a-7 in 1983,<sup>295</sup> it facilitated money market funds' maintenance of a stable net asset value by permitting them to use the amortized cost method of valuing their portfolio securities. As discussed above, section 2(a)(41) of the Act, in conjunction with rules 2a-4 and 22c-1, normally require a registered investment company to calculate its current net asset value per share by valuing its portfolio securities for which market quotations are readily available at current market value and its other securities at their fair value as determined, in good faith, by the board of directors. Therefore, using the amortized cost method of valuation is an exception to the general requirement under

<sup>293</sup> The Investment Company Act does not contain any provisions governing the liquidation of an investment company, including a money market fund; rather, liquidations are primarily effected in accordance with applicable state law. The Act does include, however, a provision authorizing Federal district courts to enjoin a plan of reorganization upon a proceeding initiated by the Commission on behalf of security holders, if the court determines that the plan of reorganization is not "fair and equitable to all security holders." Section 25(c) of the Act. A plan of "reorganization" includes a voluntary dissolution or liquidation of a fund. Section 2(a)(33) of the Act.

<sup>294</sup> In addition, we note that the U.S. Department of the Treasury's white paper on Financial Regulatory Reform calls for the President's Working Group on Financial Markets to prepare a report by September 15, 2009, assessing whether more fundamental changes are necessary to further reduce the money market fund industry's susceptibility to runs, such as eliminating the ability of a money market fund to use a stable net asset value or requiring money market funds to obtain access to reliable emergency liquidity facilities from private sources. See Department of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, at 38–39 (June 2009).

<sup>295</sup> See 1983 Adopting Release, *supra* note 3.

the Act that investors in investment companies should pay and receive market value or fair value for their shares.<sup>296</sup> The Commission did not take lightly its decision to permit money market funds to use the amortized cost method of valuation. Rule 2a-7 essentially codified several of the Commission's exemptive orders relating to money market funds, and these orders were issued only after an administrative hearing in the late 1970s at which the use of the amortized cost method of valuation was a matter of considerable debate.<sup>297</sup>

The balance the Commission struck was that, in exchange for permitting this valuation method, it would impose certain conditions on money-market funds designed to ensure that these funds invested only in instruments that would tend to promote a stable net asset value per share and would impose on the funds' boards of directors an ongoing obligation to determine that it remains in the best interest of the funds and their shareholders to maintain a stable net asset value. Further, money market funds are permitted to use the amortized cost method of valuation only so long as their boards believe that it fairly reflects the funds' market-based net asset value per share.<sup>298</sup>

The \$1.00 stable net asset value per share has been one of the trademark features of money market funds. It facilitates the funds' role as a cash management vehicle, provides tax and administrative convenience to both money market funds and their shareholders,<sup>299</sup> and promotes money market funds' role as a low-risk investment option. Many investors may hold shares in money market funds in large part because of these features.<sup>300</sup> We are mindful that if we were to require a floating net asset value, a substantial number of investors might move their investments from money market funds to other investment vehicles.

However, a stable \$1.00 net asset value per share also creates certain risks for a money market fund and its investors. These risks are a consequence of the amortized cost method of valuation and the resulting insensitivity of the \$1.00 net asset value per share to market valuation changes. It may create an incentive for investors to redeem their shares when a fund's market-based net asset value per share falls between \$0.995 and \$1.00 because they will obtain \$1.00 in exchange for their right to fund assets worth less than \$1.00 per share. Regardless of the motivation underlying the redemptions, the unrealized losses attributable to redeeming shareholders are now borne by the remaining money market fund shareholders.

Further, particularly in times of market turbulence and illiquidity, regardless of the motivation behind the redemptions, redemptions at \$1.00 in a money market fund whose market-based net asset value is below \$1.00 can further depress the fund's market-based net asset value, exacerbating the impact on remaining shareholders. It can create a level of unfairness in permitting the remaining fund shareholders to pay for the liquidity needs and unrealized losses of redeeming fund shareholders. Because there is a limited window where only so many shareholders can redeem at \$1.00 in a fund with a portfolio under threat (because of holding distressed securities or facing significant shareholder redemptions) before the board of the fund must consider whether to re-price the fund's shares or take other action, there can be an incentive to be the first shareholder to place a redemption request upon any hint of stress at a money market fund. Generalized market dislocations or illiquidity can create this stress on a number of money market funds simultaneously, leading to runs on money market funds similar to those we witnessed in September 2008. Even further, a run may result in fire sales of securities, placing pressure on market prices and transmitting problems that may be originally associated with a single money market fund to other money market funds. Finally, larger, institutional money market fund investors, especially those with fiduciary responsibilities for managing their clients' assets, are more likely to recognize negative events

<sup>296</sup> Rule 2a-7 is not the only exception permitting open-end investment companies to value short-term debt securities in their portfolios on an amortized cost basis. Subject to certain conditions, the amortized cost method of valuation may be used by open-end investment companies to value investments with a remaining maturity of 60 days or less in accordance with the Commission's interpretation set forth in Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Investment Company Act Release No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)].

<sup>297</sup> See 1982 Proposing Release, *supra* note 25, at text preceding, accompanying, and following nn.2-4.

<sup>298</sup> See rule 2a-7(c)(1).

<sup>299</sup> A \$1.00 stable net asset value per share relieves shareholders of the administrative task of tracking the timing and price of purchase and sale transactions for capital gain and wash sale purposes under tax laws.

<sup>300</sup> Some institutional investors are prohibited by board-approved guidelines or firm policies from investing certain assets in money market funds unless they have a stable net asset value per share. See ICI Report, *supra* note 6, at 109. One survey also reported that 55% of institutional cash managers would substantially decrease their investments in money market funds if the funds had a floating value. See *id.* at 110 (citing a January 2009 survey by Treasury Strategies, Inc.).

potentially affecting the money market fund and to be in a position to quickly redeem shares of the money market fund and thus protect their money market investments and those of their clients, leaving other smaller, more passive money market investors to bear their losses.

When we determined to permit money market funds to use amortized cost valuation in 1983, money market funds held only about \$180 billion in assets<sup>301</sup> and played a minor role in the short-term credit markets. Their principal benefit was to provide *retail* investors with a cash investment alternative to bank deposits, which at the time paid fixed rates substantially below short-term money market rates. Since that time, money market funds have grown tremendously and have developed into an industry driven in large part by *institutional* investors, who hold approximately 67 percent of the over \$3.7 trillion in money market fund assets.<sup>302</sup> As noted earlier, with the ability of institutional investors today to make hourly redemption requests to money market funds, these investors have the ability to move substantial amounts of money in and out of money market funds (or between money market funds), with potentially detrimental effects on the funds, their remaining shareholders, and the marketplace.

The influx of institutional investments in money market funds, the increased transparency of fund holdings, and the speed with which large shareholders can buy and redeem shares may have increased the possibility that the value of some fund investors' shares will be diluted as a result of the fund's use of the amortized cost valuation method.<sup>303</sup> When short-term interest rates decrease, the fund's portfolio holdings (with their now above-market yields) become more valuable. Institutional investors may pay \$1.00 per share to purchase fund shares whose market value is, for example, \$1.002 per share. Such institutional inflows would be invested by the fund in securities offering the new, reduced market yields, diluting the yield advantage that existing fund shareholders would otherwise enjoy. These institutional investors, in effect, are able to earn a yield through a money market fund above the market rate they could earn on a direct investment. They achieve this yield advantage by capturing a portion of the benefit from declining interest rates that otherwise would benefit existing money market fund investors.<sup>304</sup> Similarly, when interest rates increase, institutional investors could sell shares of money market funds, obtaining \$1.00 per share for a fund that all things being equal likely will be worth less, e.g., \$0.997 per share.<sup>305</sup> If instead the institutional investor sells commercial paper in the market under the same conditions, it could only sell such securities at a discount.

In stable markets and with small shareholdings, amortized cost pricing at most results in shareholders who purchase or redeem shares receiving slightly more or less (in shares or in redemption proceeds) than they otherwise would if the fund's net asset value were to fluctuate according to market-based pricing. Net redemptions generally are funded by cash on hand. Any deviation between the market-based net asset value per share of the fund and its amortized cost value is small enough to have an immaterial effect on the fund, and no effect on investors. It could be compared to a rounding convention in a billing system.

In a market under significant stress and with institutions holding billions of dollars of money market fund shares, however, a real arbitrage opportunity can arise, and a race or threat of a potential race for redemptions may become a real possibility. For example, during last fall's market turbulence, as credit spreads on many money market fund portfolio securities widened and the market value of these securities fell, we understand that the market-based net asset value of some money market funds dropped low enough that redemptions by a few large shareholders in the fund at \$1.00 per share alone could have caused the fund to break the buck.

<sup>301</sup> See ICI Report, *supra* note 6, at 1.

<sup>302</sup> See ICI Mutual Fund Historical Data, *supra* note 47 (data for week ended June 10, 2009).

<sup>303</sup> We have considered the impact of dilution in money market funds using the amortized cost method of valuation in the past. See, e.g., 1982 Proposing Release, *supra* note 25, at n.6 and accompanying text.

<sup>304</sup> This benefit would otherwise be paid out to money market fund shareholders in the form of greater dividend payments from the increased yield.

<sup>305</sup> See S&P 2007 Ratings Criteria, *supra* note 139, at 27. Standard and Poor's gives the example of an investor holding \$1 million in 90-day U.S. Treasury bills yielding 5%. If interest rates increased 150 basis points, the value of the investment would drop by approximately \$3700 and the investor's yield would remain at 5%. Compare this to an investor holding one million shares of a money market fund holding exclusively Treasury bills yielding 5% (setting aside fund expenses). If interest rates rose 150 basis points, the investor could sell the fund investment for \$1.00 per share and not experience any loss. The investor could then purchase 90-day Treasury bills yielding 6.5%, instantaneously increasing its return by 1.5%. If the fund is forced to sell these securities to meet redemption requests, the \$3,700 unrealized loss would be borne by the fund and its remaining shareholders.

We recognize that a floating net asset value would not necessarily eliminate the incentive to redeem shares during a liquidity crisis—shareholders still would have an incentive to redeem before the portfolio quality deteriorated further from the fund selling securities into an illiquid market to meet redemption demands. But a floating net asset value may lessen the impact of any portfolio deterioration by eliminating the ability of shareholders to redeem their shares for more than the current market value per share of the fund’s portfolio. It also might better align investors’ expectations of risk with the actual risks posed by money market fund investments. We expect that, at least under stable market conditions, the other risk-limiting conditions of rule 2a-7 would tend to promote a relatively stable net asset value per share even if we eliminated the ability of money market funds to rely on the amortized cost method of valuation.

We request comment on the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation. Would such a change render money market funds a more stable investment vehicle? Would it lessen systemic risk by making money market funds less susceptible to runs? Would it make the risks inherent in money market funds more transparent? Many money market funds’ stable net asset value was supported voluntarily by fund affiliates over the last two years, and shareholders may not have understood that this support was provided on a voluntary basis and may not be provided in the future.

On the other hand, would such a change make money market funds more susceptible to runs because investors might respond quickly to small changes in net asset value? As discussed above, a stable net asset value per share creates certain administrative, tax, and cash management conveniences for fund investors. Accordingly, would prohibiting the use of the amortized cost method of valuation in money market funds encourage investors to shift assets from money market funds to unregulated offshore funds, bank accounts, or other investments? Would it result in some institutional money market funds deregistering with the Commission (in reliance on section 3(c)(7) of the Act) in order to continue to maintain a stable net asset value? Is this a result with which the Commission should be concerned?

What impact would this have on investors’ cash management activities? What impact might such a change have on the short-term credit markets and issuers of short-term debt securities? How would money market funds whose share prices were based on market-based net asset values differ from current short-term bond funds? Should any rule amendment eliminating the ability of money market funds to rely on the amortized cost method of valuation to create a stable net asset value be limited to institutional money market funds? As discussed above, institutional money market funds are at greater risk of instability, runs and the dilutive effect of large redemptions.

## B. In-Kind Redemptions

As noted above, one of our concerns relates to the ability of large institutional shareholders to rapidly redeem substantial amounts of fund assets, which can pose a threat to the stable net asset value of the fund and can advantage one group of shareholders over another by requiring remaining shareholders to pay for the liquidity needs of large redeeming shareholders.<sup>306</sup> While the liquidity requirements we are proposing today may ameliorate pressures created by redeeming shareholders, during severe market dislocations even more steps may be necessary to help ensure the stability of a stable net asset value money market fund. Accordingly, if we retain a stable net asset value for money market funds, we are interested in exploring other methods of reducing the risks and unfairness posed by significant sudden redemptions.

One possible way of addressing these issues would be to require that funds satisfy redemption requests in excess of a certain size through in-kind redemptions.<sup>307</sup> Money market funds currently are permitted to and many money market funds disclose in their prospectuses that they may satisfy redemption requests through in-kind redemptions.<sup>308</sup> In the

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<sup>306</sup> This situation to some extent could be analogized to the situation that can be created by market timing in which selling shareholders receive benefits to the detriment of remaining mutual fund shareholders.

<sup>307</sup> An in-kind redemption occurs when a shareholder’s redemption request to a fund is satisfied by distributing to that shareholder portfolio assets of that fund instead of cash.

<sup>308</sup> See section 2(a)(32) of the Act (defining a redeemable security as a security where the holder “is entitled...to receive approximately his proportionate share of *the issuer’s current net assets*, or the cash equivalent thereof” (italics added)). See also rule 18f-1, which provides an exemption from certain prohibitions of section 18(f)(1) of the Act with regard to redemptions in kind and in cash.

wake of last fall's redemption pressures on money market funds, however, only one announced that it would do so.<sup>309</sup> In-kind redemptions would lessen the impact of large redemptions on remaining money market fund shareholders and would require the redeeming investor to bear part of the cost of its liquidity needs. If shareholders did not immediately sell these securities, requiring in-kind redemptions in such circumstances may mitigate the impact of large redemptions on short-term credit markets by reducing the likelihood of large fire sales of short-term securities into the market. Finally, it also may encourage large investors to diversify their money market fund holdings among a variety of funds, perhaps lessening the risk that any individual fund would be threatened by a few redemptions.<sup>310</sup> If proposed, we would expect to set a threshold for requiring in-kind redemptions sufficiently high that we could reasonably assume that such an investor would be in the position to assume ownership of such securities.

We request comment on requiring money market funds to satisfy redemption requests in excess of a certain size through in-kind redemptions. What would be the advantages and disadvantages of this approach? What type of threshold redemption request should trigger this requirement? Should there be a different threshold for third-party shareholders versus affiliated shareholders of a money market fund? Should there be other restrictions on affiliate redemptions (e.g., prioritizing non-affiliate redemptions over affiliate redemption requests that are submitted on the same day)? How should the fund determine the value of the securities to be distributed as a result of such a redemption request? The securities' amortized cost value? The securities' fair value, as determined based on current market quotations or, if no such quotations are readily available, as determined in good faith by the fund's board of directors? Would these shareholders be able to assume ownership of such securities?

We note that a board of directors alternatively could cause a money market fund to impose a redemption fee under rule 22c-2 to impose some of the fund's costs from shareholders' liquidity needs on the redeeming shareholders.<sup>311</sup> What would be the advantages and disadvantages of this alternative approach to addressing our concerns regarding significant shareholder redemptions?

#### IV. PAPERWORK REDUCTION ACT ANALYSIS

Certain provisions of the proposed amendments to rules 2a-7 and 30b1-5 and proposed new rules 22e-3 and 30b1-6 and Form N-MFP under the Investment Company Act contain "collections of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>312</sup> The titles for the existing collections of information are: (1) "Rule 2a-7 under the Investment Company Act of 1940, Money market funds" (OMB Control No. 3235-0268); (2) "Rule 30b1-5 under the Investment Company Act of 1940, Quarterly filing of schedule of portfolio holdings of registered management investment companies" (OMB Control No. 3235-0577); and (3) "Form N-Q under the Investment Company Act of 1940, Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company" (OMB Control No. 3235-0578). The titles for the new collections of information are: (1) "Rule 22e-3 under the Investment Company Act of 1940, Exemption for liquidation of money market funds;" (2) "Rule 30b1-6 under the Investment Company Act of 1940, Monthly report for money market funds;" and (3) "Form N-MFP under the Investment Company Act of 1940, Portfolio Holdings of Money Market Funds." The Commission is submitting these collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. Our proposed amendments and new rules are designed to make money market funds more resilient to risks in the short-term debt markets, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

<sup>309</sup> On September 19, 2008, the American Beacon Money Market Portfolio announced it would honor redemption requests exceeding \$250,000 in a 90-day period through pro rata payments of cash and "in-kind" distributions of securities held by the fund, to prevent redemptions from "forcing" the sale of fund assets. *See* American Beacon Funds, Prospectus Supplement for BBH ComSet Class, Institutional Class, Cash Management Class, and PlanAhead Class (Sept. 30, 2008), *available at* [http://www.sec.gov/Archives/edgar/data/809593/000080959308000045/sep3008\\_prosupbeacon.txt](http://www.sec.gov/Archives/edgar/data/809593/000080959308000045/sep3008_prosupbeacon.txt).

<sup>310</sup> Large investors that did not wish to receive in-kind redemptions could avoid this risk by spreading their investments among several money market funds such that no single money market fund investment was large enough to possibly trigger the in-kind redemption requirement.

<sup>311</sup> The redemption fee cannot exceed two percent of the value of the shares redeemed.

<sup>312</sup> 44 U.S.C. 3501-3521.

## A. Rule 2a-7

Rule 2a-7 under the Investment Company Act exempts money market funds from the Act's valuation requirements, permitting money market funds to maintain stable share pricing, subject to certain risk-limiting conditions. As discussed above, we are proposing to amend rule 2a-7 in several respects. Our proposal would amend the rule by: revising portfolio quality and maturity requirements; introducing liquidity requirements; requiring money market fund boards to adopt procedures providing for periodic stress testing of the fund's portfolio; requiring funds to disclose monthly on their websites information on portfolio securities; and finally, requiring money market fund boards to determine, at least once each calendar year, that the fund has the capability to redeem and issue its securities at prices other than the fund's stable net asset value per share.<sup>313</sup> Three of the proposed amendments would create new collection of information requirements. The respondents to these collections of information would be money market funds or their advisers, as noted below.

### 1. Stress Testing

The proposed amendments would require money market fund boards to adopt written procedures that provide for the periodic testing of the fund's ability to maintain a stable net asset value per share based on certain hypothetical events.<sup>314</sup> These procedures also would have to provide for a report of the testing results to be submitted to the board of directors at its next regularly scheduled meeting, and an assessment by the fund's adviser of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.<sup>315</sup> Compliance with this proposed disclosure requirement would be mandatory for any fund that holds itself out as a money market fund in reliance on rule 2a-7. The information when provided to the Commission in connection with staff examinations or investigations would be kept confidential to the extent permitted by law.

We anticipate that stress testing would give fund advisers a better understanding of the effect of potential market events and shareholder redemptions on their funds' ability to maintain a stable net asset value, the fund's exposure to that risk, and actions the adviser may need to take to mitigate the possibility of the fund breaking the buck.

Commission staff believes that in light of the events of last fall most, if not all, money market funds currently conduct some stress testing of their portfolios as a matter of routine fund management and business practice.<sup>316</sup> These procedures likely vary depending on the fund's investments. For example, a prime money market fund that is offered to institutional investors may test for hypothetical events such as potential downgrades or defaults in portfolio securities while a U.S. Treasury money market fund may not. Some funds that currently conduct testing may be required to include additional hypothetical events under our proposed amendments. These funds likely provide regular reports of the test results to senior management. We expect, however, that most funds do not have written procedures documenting the stress testing, do not report the results of testing to their boards of directors, and do not provide an assessment from the fund's adviser regarding the fund's ability to withstand the hypothetical events reasonably likely to occur in the next year.

Commission staff believes that the stress testing procedures are or would be developed for all the money market funds in a fund complex by the fund adviser, and would address appropriate variations for individual money market funds within the complex. Staff estimates that it would take a fund adviser an average of 21 hours for a portfolio risk analyst initially to draft procedures documenting the complex's stress testing, and 3 hours for the board of directors to consider and adopt the written procedures. We estimate that 171 fund complexes with money market funds are subject to rule

<sup>313</sup> See *supra* Section II.A-G.

<sup>314</sup> Proposed rule 2a-7(c)(8)(ii)(D). These events would include, but would not be limited to, a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund.

<sup>315</sup> Proposed rule 2a-7(c)(8)(ii)(D)(2), (3). The report to the board would include the dates on which the testing was performed and the magnitude of each hypothetical event that would cause the deviation of the money market fund's net asset value calculated using available market quotations (or appropriate substitutes that reflect current market conditions) from its net asset value per share calculated using amortized cost to exceed ½ of 1 percent.

<sup>316</sup> The estimates of hour burdens and costs provided in the PRA and cost benefit analyses are based on staff discussions with representatives of money market funds and on the experience of Commission staff. We expect that the board of directors would be the same for all the money market funds in a complex, and thus could adopt the stress test procedures for all money market funds in the complex at the same meeting.

2a-7. We therefore estimate that the total burden to draft these procedures initially would be 4,104 hours.<sup>317</sup> Amortized over a three-year period, this would result in an average annual burden of 8 hours for an individual fund complex and a total of 1,368 hours for all fund complexes.<sup>318</sup> Staff estimates that a risk analyst also may spend an average of 6 hours per year revising the written procedures to reflect changes in the type or nature of hypothetical events appropriate to stress tests and the board would spend 1 hour to consider and adopt the revisions, for a total annual burden of 1,197 hours.<sup>319</sup> Commission staff estimates further that it would take an average of 10 hours of portfolio management time to draft each report to the board of directors, 2 hours of an administrative assistant's time to compile and copy the report and 15 hours of the fund adviser's time to provide an assessment of the funds' ability to withstand reasonably likely hypothetical events in the coming year. The report must be provided at the next scheduled board meeting, and we estimate that the report would cover all money market funds in a complex. We also believe that the fund adviser would provide an assessment each time it provided a report. Finally, we assume that funds would conduct stress tests no less than monthly. With an average of 6 board meetings each year, we estimate that the annual burden would be 162 hours for an individual fund complex with a total annual burden for all fund complexes of 27,702 hours.<sup>320</sup>

The proposed amendment would require the fund to retain records of the reports on stress tests and the assessments for at least 6 years (the first two in an easily accessible place).<sup>321</sup> The retention of these records would be necessary to allow the staff during examinations of funds to determine whether a fund is in compliance with the stress test requirements. We estimate that the burden would be 10 minutes per fund complex per meeting to retain these records for a total annual burden of 171 hours for all fund complexes.<sup>322</sup>

Thus, we estimate that for the three years following adoption, the average annual burden resulting from the stress testing requirements would be 178 hours for each fund complex with a total of 30,438 hours for all fund complexes.<sup>323</sup>

We request comment on these estimates of hourly burdens. Would funds develop stress tests on a complex-wide basis for money market funds? Would the adviser prepare one report regarding stress tests for all the money market funds in a complex, or prepare a separate report for each money market fund?

## 2. Public Website Posting

The proposed amendments would require money market funds to post monthly portfolio information on their websites.<sup>324</sup> We believe that greater transparency of fund portfolios may allow investors to exert influence on risk-taking by fund advisers, and thus reduce the likelihood that a fund will break the buck. Information will be posted on a public website, and compliance with this requirement would be mandatory for any fund that holds itself out as a money market fund in reliance on rule 2a-7. We estimate that there are approximately 750 money market funds that would be affected by this proposal. We understand, based on interviews with industry representatives, that most money market funds already post portfolio information on their webpages at least quarterly.<sup>325</sup> To be conservative, the staff estimates that 20 percent of money market funds, or 150 funds, do not currently post this information at least quarterly, and therefore

<sup>317</sup> This estimate is based on the following calculation: (21 hours + 3 hours) x 171 fund complexes = 4104 hours.

<sup>318</sup> These estimates are based on the following calculations: (21 + 3) ÷ 3 = 8 hours; 8 x 171 fund complexes = 1368 hours. PRA submissions for approval are made every three years. To estimate an annual burden for a collection of information that occurs one time, the total burden is amortized over the three year period.

<sup>319</sup> This estimate is based on the following calculation: (6 hours (analyst) + 1 hour (board)) x 171 fund complexes = 1197 hours.

<sup>320</sup> These estimates are based on the following calculations: (10 hours + 2 hours + 15 hours) x 6 meetings = 162 hours; 162 hours x 171 fund complexes = 27,702 hours.

<sup>321</sup> Proposed rule 2a-7(c)(11)(vii).

<sup>322</sup> This estimate is based on the following calculation: 0.1667 hours x 6 meetings x 171 fund complexes = 171 hours.

<sup>323</sup> These estimates are based on the following calculations: 8 hours (draft procedures) + 7 hours (revise procedures) + 72 hours (6 reports) + 90 hours (assessments) + 1 hour (record retention) = 178 hours; 1,368 hours (draft procedures) + 1,197 hours (revise procedures) + 12,312 hours (6 reports) + 15,390 (6 assessments) + 171 hours (record retention) = 30,438 hours.

<sup>324</sup> Proposed rule 2a-7(c)(12).

<sup>325</sup> Certain of the required information is currently maintained by money market funds for regulatory reasons, such as in connection with accounting, tax and disclosure requirements. We understand that the remaining information is retained by funds in the ordinary course of business. Accordingly, for the purposes of our analysis, we do not ascribe any time to producing the required information.



would need to develop a webpage to comply with the proposed rule. We estimate that a money market fund would spend approximately 24 hours of internal money market fund staff time initially to develop the webpage. We further estimate that a money market fund would spend approximately 4 hours of professional time to maintain and update the relevant webpage with the required information on a monthly basis. Based on an estimate of 750 money market funds posting their portfolio holdings on their webpages, including 150 funds incurring start-up costs to develop a webpage, we estimate that, in the aggregate, the proposed amendment would result in a total of 37,200 average burden hours for all money market funds for each of the first three years.<sup>326</sup>

### 3. Reporting of Rule 17a-9 Transactions

We are proposing to amend rule 2a-7 to require a money market fund to promptly notify the Commission by electronic mail of the purchase of a money market fund's portfolio security by an affiliated person in reliance on the rule and to explain the reasons for such purchase.<sup>327</sup> The proposed reporting requirement is designed to assist Commission staff in monitoring money market funds' affiliated transactions that otherwise would be prohibited. The new collection of information would be mandatory for money market funds that rely on rule 2a-7 and that rely on rule 17a-9 for an affiliated person to purchase a money market fund's portfolio security. Information submitted to the Commission related to a rule 17a-9 transaction would not be kept confidential.<sup>328</sup>

We estimate that fund complexes will provide one notice for all money market funds in a particular fund complex holding a distressed security purchased in a transaction under rule 17a-9. As noted above, Commission staff estimates that there are 171 fund complexes with money market funds subject to rule 2a-7. Of these fund complexes, Commission staff estimates that an average of 25 per year would be required to provide notice to the Commission of a rule 17a-9 transaction, with the total annual response per fund complex, on average, requiring 1 hour of an in-house attorney's time. Given these estimates, the total annual burden of this proposed amendment to rule 2a-7 for all money market funds would be approximately 25 hours.<sup>329</sup>

### 4. Total burden

The currently approved burden for rule 2a-7 is 1,348,000 hours. In a recent renewal submission to OMB, we estimated the collection of information burden for the rule is 310,983 hours. The additional burden hours associated with the proposed amendments to rule 2a-7 would increase the renewal estimate to 378,646 hours annually.<sup>330</sup>

## B. Rule 22e-3

Proposed rule 22e-3 would permit a money market fund to suspend redemptions and postpone the payment of proceeds pending board-approved liquidation proceedings, provided that the fund notifies the Commission by electronic mail of its decision to do so.<sup>331</sup> The proposed rule is intended to reduce the vulnerability of investors to the harmful effects of a run on a fund, and minimize the potential for disruption to the securities markets. The proposed notification requirement is a collection of information under the PRA, and is designed to assist Commission staff in monitoring a money market fund's suspension of redemptions, which would otherwise be prohibited. Only money market funds that break the buck and begin board-approved liquidation proceedings would be able to rely on the rule. The respondents to this information collection therefore would be money market funds that break the buck and elect to rely on the exemption afforded by the rule. Compliance with the notification requirements of rule 22e-3 would be necessary for

<sup>326</sup> The estimate is based on the following calculations. The staff estimates that 150 funds would require a total of 3,600 hours initially to develop a webpage (150 funds x 24 hours per fund = 3,600 hours). In addition, each of the 750 funds would require 48 hours per year to update and maintain the webpage, for a total of 36,000 hours per year (4 hours per month x 12 months = 48 hours per year; 48 hours per year x 750 funds = 36,000). The average annual hour burden for each of the first three years would thus equal 37,200 hours  $([3,600 + (36,000 \times 3)] \div 3)$ .

<sup>327</sup> See proposed rule 2a-7(c)(7)(iii).

<sup>328</sup> Commission rules provide, however, for a procedure under which persons submitting notices under the proposed amendment would be able to request that the information not be disclosed under a Freedom of Information Act request. See 17 CFR 200.83.

<sup>329</sup> The estimate is based on the following calculation: (25 fund complexes x 1 hour) = 25 hours.

<sup>330</sup> This estimate is based on the following calculation: 310,983 (estimated in 2a-7 renewal submission) + 30,438 (stress testing) + 37,200 (website posting) + 25 hours (reporting 17a-9 transactions) = 378,646 hours.

<sup>331</sup> See proposed rule 22e-3(c).

money market funds that seek to rely on rule 22e-3 to suspend redemptions and postpone payment of proceeds pending a liquidation, and would not be kept confidential.

We estimate that, on average, one money market fund would break the buck and liquidate every six years.<sup>332</sup> Staff estimates that a fund providing the required electronic mail notice under proposed rule 22e-3 would spend approximately 1 hour of an in-house attorney's time to prepare and submit the notice. Given these estimates, the total annual burden of proposed rule 22e-3 for all money market funds would be approximately 10 minutes.<sup>333</sup>

## C. Monthly Reporting of Portfolio Holdings

### 1. Rule 30b1-6 and Form N-MFP

Proposed rule 30b1-6 would require money market funds to file an electronic monthly report on proposed Form N-MFP within two business days after the end of each month. The proposed rule is intended to improve transparency of information about money market funds' portfolio holdings and facilitate oversight of money market funds. The information required by the proposed form would be data-tagged in XML format and filed through EDGAR. The respondents to rule 30b1-6 would be investment companies that are regulated as money market funds under rule 2a-7. Compliance with proposed rule 30b1-6 would be mandatory for any fund that holds itself out as a money market fund in reliance on rule 2a-7. Responses to the disclosure requirements would not be kept confidential.

We estimate that 750 money market funds would be required by rule 30b1-6 to file, on a monthly basis, a complete Form N-MFP disclosing certain information regarding the fund and its portfolio holdings. For purposes of this PRA analysis, the burden associated with the requirements of proposed rule 30b1-6 has been included in the collection of information requirements of proposed Form N-MFP.

Based on our experience with other interactive data filings, we estimate that money market funds would require an average of approximately 40 burden hours to compile, tag and electronically file the required portfolio holdings information for the first time and an average of approximately 8 burden hours in subsequent filings.<sup>334</sup> Based on these estimates, we estimate the average annual burden over a three-year period would be 107 hours per money market fund.<sup>335</sup> Based on an estimate of 750 money market funds submitting Form N-MFP in interactive data format, each incurring 107 hours per year on average, we estimate that, in the aggregate, Form N-MFP would result in 80,250 burden hours, on average, for all money market funds for each of the first three years.

### 2. Rule 30b1-5 and Form N-Q

Our proposed amendments to rule 30b1-5 would exempt money market funds from the requirement to file a schedule of investments pursuant to Item 1 of Form N-Q. The proposed amendment is intended to eliminate unnecessarily duplicative disclosure requirements. The proposed amendment would only affect investment companies that are regulated as money market funds under rule 2a-7.

We estimate that 750 money market funds would be affected by the proposed amendment to rule 30b1-5. For the purposes of this PRA analysis, the decrease in burden hours resulting from the proposed amendment is reflected in the collection of information requirements for Form N-Q.

We estimate that money market funds would require an average of approximately 4 hours to prepare the schedule of investments required pursuant to Item 1 of Form N-Q. Based on these estimates, we estimate that the average annual

<sup>332</sup> As discussed above, since the adoption of rule 2a-7 in 1983, only two money market funds have broken the buck.

<sup>333</sup> These estimates are based on the following calculations: (1 hour ÷ 6 years) = 10 minutes per year.

<sup>334</sup> We understand that the required information is currently maintained by money market funds pursuant to other regulatory requirements or in the ordinary course of business. Accordingly, for the purposes of our analysis, we do not ascribe any time to producing the required information.

<sup>335</sup> The staff estimates that a fund would make 36 filings in three years. The first filing would require 40 hours and subsequent filings would require 8 hours each, for an average annual burden of 107 hours (1 filing x 40 hours = 40 hours; 35 filings x 8 hours = 280 hours; 40 hours + 280 hours = 320 hours; 320 hours ÷ 3 years = 107 hours). Thereafter, filers generally would not incur the start-up burdens applicable to the first filing.

burden avoided would be 8 hours per fund.<sup>336</sup> Based on an estimate of 750 money market funds filing Form N-Q, each incurring 8 burden hours per year on average, we estimate that, in the aggregate, our proposed exemption would result in a decrease of 6,000 burden hours associated with Form N-Q.<sup>337</sup>

#### D. Request for Comments

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Elizabeth Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-11-09. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-11-09, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213.

#### V. Cost Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed amendments and new rules, and we request comment on all aspects of this cost benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular covered institutions, including small institutions, as well as any other costs or benefits that may result from the adoption of these proposed amendments and new rules.

##### A. Rule 2a-7

###### 1. *Second Tier Securities, Portfolio Maturity and Liquidity Requirements*

We are proposing several changes to the risk-limiting conditions of rule 2a-7. While we believe that these changes would impart substantial benefits to money market funds, we recognize that they also may impose certain costs.

First, we would limit money market fund investments to first tier securities, i.e., securities receiving the highest short-term debt ratings from the requisite NRSROs or securities that the fund's board of directors or its delegate determines are of comparable quality.<sup>338</sup> We also are proposing to limit money market funds to acquiring long-term securities that have received long-term ratings in the highest two ratings categories.<sup>339</sup>

Second, we are proposing certain changes to rule 2a-7's portfolio maturity limits. We are proposing to reduce the maximum weighted average maturity of a money market fund permitted by rule 2a-7 from 90 days to 60 days.<sup>340</sup> We also are proposing a new maturity limitation based on the "weighted average life" of fund securities that would limit

<sup>336</sup> Funds are required to file a quarterly report on Form N-Q after the close of the first and third quarters of each fiscal year.

<sup>337</sup> The estimate is based on the following calculation: 750 money market funds x 8 hours per money market fund = 6,000 hours.

<sup>338</sup> See proposed rule 2a-7(a)(11)(iii); proposed rule 2a-7(a)(11)(iv); proposed rule 2a-7(c)(3).

<sup>339</sup> See proposed rule 2a-7(a)(11)(iv)(A).

<sup>340</sup> See proposed rule 2a-7(c)(2)(ii).

the portion of a fund's portfolio that could be held in longer term floating- or variable-rate securities. This restriction would require a fund to calculate the weighted average maturity of its portfolio without regard to interest rate reset dates. The weighted average life of a fund's portfolio would be limited to 120 days.<sup>341</sup> Finally, we are proposing to delete a provision in rule 2a-7 that permits money market funds not relying on the amortized cost method of valuation to acquire Government securities with a remaining maturity of up to 762 calendar days. Under the amended rule, money market funds could not acquire any security with a remaining maturity of more than 397 days, subject to the maturity shortening provisions for floating- and variable-rate securities and securities with a Demand Feature.<sup>342</sup>

Third, we are proposing new liquidity requirements on money market funds. Under the proposed amendments, money market funds would be prohibited from acquiring securities unless, at the time acquired, they are liquid, i.e., securities that can be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund.<sup>343</sup> We also propose to limit taxable retail money market funds and taxable institutional money market funds to acquiring Daily Liquid Assets unless five percent of a retail fund's and 10 percent of an institutional fund's assets are Daily Liquid Assets.<sup>344</sup>

In addition, our proposed amendments to rule 2a-7 would impose weekly liquidity requirements on money market funds. Specifically, retail and institutional money market funds would not be permitted to acquire any securities other than weekly liquid assets if, after the acquisition, (i) the retail fund would hold less than 15 percent of its total assets in weekly liquid assets and (ii) the institutional fund would hold less than 30 percent of its total assets in weekly liquid assets.<sup>345</sup> Finally, we are proposing to require that a money market fund at all times hold daily and weekly liquid assets sufficient to meet reasonably foreseeable redemptions in light of its obligations under section 22(e) of the Act and any commitments the fund has made to shareholders.<sup>346</sup>

Our proposed amendments would rely on a money market fund's board of directors to determine, no less frequently than once each calendar year, whether the money market fund is intended to be offered to institutional investors or has the characteristics of a fund that is intended to be offered to institutional investors, based on the: (i) nature of the record owners of fund shares; (ii) minimum amount required to be invested to establish an account; and (iii) historical cash flows resulting, or expected cash flows that would result, from purchases and redemptions.<sup>347</sup>

#### *a. Benefits*

We believe that the proposed amendments to rule 2a-7's risk-limiting conditions would be likely to produce broad benefits for money market fund investors. First, they should reduce money market funds' exposure to certain credit, interest rate, and spread risks. For example, precluding money market funds from investing in second tier securities would decrease money market funds' exposure to credit risk. Reducing the maximum weighted average maturity of money market funds' portfolios would further decrease their interest rate sensitivity, as well as reduce their exposure to credit risk. Introducing the weighted average life limitation on money market funds' portfolios would limit credit spread risk and interest rate spread risk to funds from longer term floating- or variable-rate securities.

We expect that the proposed amendments also would bolster the ability of money market funds to maintain a stable net asset value during times when the level of shareholder redemption demand is high. Fund portfolios with a lower weighted average maturity that include a limited amount of longer term floating- or variable-rate securities would turn over more quickly and the fund would be better able to increase its holdings of highly liquid securities in the face of illiquid markets than funds that satisfy current maturity requirements. The proposed liquidity requirements are designed to increase a money market fund's ability to withstand illiquid markets by ensuring that the fund acquires only liquid securities and that a certain percent of its assets are held in daily and weekly liquid assets. These requirements also should decrease

<sup>341</sup> See proposed rule 2a-7(c)(2)(iii).

<sup>342</sup> See proposed rule 2a-7(c)(2)(i); rule 2a-7(d)(1)-(5).

<sup>343</sup> See proposed rule 2a-7(c)(5)(i).

<sup>344</sup> See proposed rule 2a-7(c)(5)(iii). This restriction would not apply to tax exempt money market funds.

<sup>345</sup> See proposed rule 2a-7(c)(5)(iv).

<sup>346</sup> See proposed rule 2a-7(c)(5)(ii).

<sup>347</sup> See proposed rule 2a-7(a)(18) (defining "Institutional Fund").

the likelihood that a fund would have to realize losses from selling portfolio securities into an illiquid market to satisfy redemption requests. Because the proposed amendments would require a fund to have a contractual right to receive cash for the daily and weekly liquid assets, rather than the current standard, which assumes that a fund would be able to find a buyer for its securities within seven days, we believe that the proposed required liquidity requirements would allow money market fund advisers to more easily adjust the funds' portfolios to increase liquidity when needed.

We believe that a reduction of these credit, interest rate, spread, and liquidity risks would better enable money market funds to weather market turbulence and maintain a stable net asset value per share. The proposed amendments are designed to reduce the risk that a money market fund will break the buck and therefore prevent losses to fund investors. To the extent that money market funds are more stable, they also would reduce systemic risk to the capital markets and provide a more stable source of financing for issuers of short-term credit instruments, thus promoting capital formation. If money market funds become more stable investments as a result of the proposed rule amendments, they may attract further investment, increasing their role as a source of capital formation.

*b. Costs*

We recognize that there are potential costs that would result if we adopted our proposed changes regarding second tier securities, portfolio maturity, and liquidity. Second tier securities, less liquid securities, and longer term credit instruments typically pay a higher interest rate and, therefore, the proposed amendments may decrease money market funds' yields.

Precluding ownership of second tier securities also may deprive money market funds of some benefits of reduced risk through diversification. We invite comment on whether the benefits of reducing credit risk through precluding purchases of second tier securities justifies the costs of the lost diversification benefits that second tier securities may provide.

If, as a result of the proposed amendments, there is a smaller set of Eligible Securities for a money market fund to choose from, that may increase the cost of those securities if their supply is limited. In particular, to the extent that the proposed liquidity requirements increase demand for highly liquid securities that is not countered by increased supply, the cost of those securities may rise as well. Increased costs of portfolio securities will have a negative impact on money market fund yield. Finally, to the extent that actual investor redemptions are significantly lower than our proposed liquidity requirements, money market funds may achieve lower yields as a result of complying with these liquidity requirements.

Although the impact on individual funds would vary significantly, we estimate that the proposed changes to rule 2a-7's requirements regarding portfolio quality, portfolio maturity, and liquidity would decrease the yield that a money market fund is able to achieve in the range of 2 to 4 basis points. We understand that the majority of money market funds are already in compliance with these proposed requirements due either to their own risk-limiting actions or to their voluntary compliance with the recommendations contained in the ICI Report. Accordingly, we expect that the decrease in yield from these changes to rule 2a-7's risk-limiting conditions would have a relatively minor impact on current money market fund yields.

However, this decreased yield may limit the range of choices that individual money market fund investors currently have to select their desired level of investment risk. This might cause some investors to shift their assets to, among other places, offshore or other enhanced cash funds unregulated by rule 2a-7 that are able to offer a higher yield. Alternatively, some investors may choose to shift their assets to bank deposits. When markets come under stress, investors may be more likely to withdraw their money from these offshore or private funds due to their perceived higher risk<sup>348</sup> and substantial redemptions from those funds and accompanying sales of their portfolio securities could increase systemic risk to short-term credit markets, which would impact money market funds. In addition, the proposed stricter portfolio quality, maturity, and liquidity requirements may result in some money market funds having fewer issuers from which to select securities if some issuers only offer second tier securities, less liquid securities or a larger percentage of longer term securities.

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<sup>348</sup> During the recent financial crisis, investors redeemed substantial amounts of assets from ultra-short bond funds and certain offshore money market funds. See ICI Report, *supra* note 6, at 106–07.

Our proposed portfolio quality, maturity, and liquidity restrictions also may impact issuers. Issuers may experience increased financing costs to the extent that they are unable to find alternative purchasers of their second tier securities, less liquid securities, longer term securities, or floating- and variable-rate securities at previous market rates. As noted earlier in the release, we do not believe that money market funds currently hold a significant amount of second tier securities, or securities that are illiquid at acquisition.<sup>349</sup> Thus, we expect that the proposed amendment's impact on issuers of these securities would be minimal. If the proposed amendments result in companies or governments issuing shorter maturity securities, those issuers may be exposed to an increased risk of insufficient demand for their securities and adverse credit market conditions because they must roll over their short-term financing more frequently. We note that this impact could be mitigated if money market funds sufficiently staggered or "laddered" the maturity of the securities in their portfolios. The markets for longer term or floating- and variable-rate securities may become less liquid if the proposed rule amendments cause issuance of these instruments to decline. We generally expect that issuers of floating- or variable-rate securities would respond to the proposed amendments by issuing a greater proportion of their securities with shorter final maturities.

Our proposed requirement that fund boards distinguish between retail and institutional money market funds would require boards to make a determination based on an understanding of the investors in the fund and their behavior. Our proposed liquidity requirements also would require money market funds to "know their customers," including their expected redemption behavior. We expect that most money market funds already have methods to understand their customers and their redemption needs because "knowing your customer" is already a best practice. As a result, we also do not expect that these requirements would impose any material costs on funds.

We do not believe that eliminating the provision in rule 2a-7 that allowed money market funds relying solely on the penny-rounding method of pricing to hold Government securities with remaining maturities of up to 762 days would have a material impact on money market funds, investors, or issuers of longer term Government securities because we believe that substantially all money market funds rely on the amortized cost method of valuation, and not exclusively on the penny-rounding method of pricing, and thus are not eligible to rely on this exception.

We request comment on these costs and benefits. Would money market fund investors benefit from the proposed portfolio quality, maturity and liquidity requirements? Would money market funds experience a significant yield and diversification impact from the proposed changes to rule 2a-7's second tier security, portfolio maturity, and liquidity requirements? We note that the highest rated money market funds currently must have a weighted average maturity of 60 days or less, the average weighted average maturity for taxable money market funds as of June 16, 2009, was 53 days, and very few money market funds hold second tier securities.<sup>350</sup> What other impacts would these changes have on money market funds? What effect would such changes have on the short-term credit market and issuers of longer term or debt instruments held to satisfy the daily or weekly liquidity requirements? How would the proposed amendments impact issuers of, and the market for, longer term variable- or floating-rate debt securities? We encourage commenters to provide empirical data to support their analysis.

## 2. *Use of NRSROs*

As discussed above, we are considering an approach that would require a money market fund's board of directors to designate NRSROs whose credit ratings the fund would use in determining the eligibility of portfolio securities under rule 2a-7 and that the board would annually determine issue credit ratings that are sufficiently reliable for that use. As we also noted above, we proposed eliminating references to NRSROs in rule 2a-7 last year.<sup>351</sup> For a discussion of the costs and benefits of that proposal, please see Section VI of the NRSRO References Release.<sup>352</sup> Are there additional factors we should consider since that release was published?

We request comment on the approach we are considering. We specifically request comment regarding the standard we are considering for the board's annual determination, i.e., that the designated NRSROs issue ratings that are sufficiently

<sup>349</sup> See *supra* note 101 and accompanying and following text, and Section II.C.1.

<sup>350</sup> See *supra* text accompanying note 101, note 145 and accompanying text, and note 147.

<sup>351</sup> See NRSRO References Proposal, *supra* note 105.

<sup>352</sup> See *id.*

reliable for use in determining the eligibility of portfolio securities. Is this standard appropriate, and if not, what would be a more appropriate standard? We expect that in making their initial designation and their annual determination, fund boards would review a presentation by the fund's adviser regarding the relative strength of relevant NRSROs' ratings and ratings criteria. What kind of guidance, if any, should the Commission provide with respect to such a standard?

According to the ICI Report, a requirement that funds designate three or more NRSROs to use in determining the eligibility of portfolio securities could encourage competition among NRSROs to achieve designation by money market funds.<sup>353</sup> We anticipate that the approach we are considering, which would require fund boards annually to determine that the designated NRSROs issue credit ratings sufficiently reliable to use in determining the eligibility of portfolio securities, may promote competition among NRSROs to produce the most reliable ratings in order to obtain designation by money market funds. In addition to the potential for competition among existing NRSROs, the proposed amendment might encourage new NRSROs that issue ratings specifically for money market fund instruments to enter the market. As we noted above, however, the staff believes it is reasonable to assume that the three NRSROs that issued almost 99 percent of all outstanding ratings across all categories that were issued by the 10 registered NRSROs as of June 2008, also issued well over 90 percent of all outstanding ratings of short term debt.<sup>354</sup> If fund boards were required to designate a minimum of three NRSROs and all money market fund boards chose to designate these three NRSROs, the requirement could result in decreased competition among NRSROs. We request comment on the impact that the approach we are considering, particularly the minimum number of NRSROs, might have on competition among NRSROs. We also request comment on the impact, if any, of this approach with respect to the efficiency of fund managers. Finally, we request comment on any potential benefits this approach might have with respect to money market funds or NRSROs.

We recognize that there could be costs associated with the approach we are considering. Staff estimates that the costs of this approach would include: initial costs for the board to designate NRSROs, as well as an annual cost to determine that designated NRSROs continue to issue ratings that are sufficiently reliable for use in determining the eligibility of portfolio securities. We expect that fund advisers currently evaluate the strength of NRSRO ratings and ratings criteria as part of the analysis they perform (under delegated authority from the board) in determining the eligibility of portfolio securities, and that this evaluation includes consideration of whether an NRSRO's rating is sufficient for that use. Accordingly, we anticipate that fund advisers would not incur additional time to perform an evaluation that would be the basis for their recommendations to the board when it makes its initial designation and annual determination, but the adviser would incur costs to draft those recommendations in a presentation or report for board review.

Under the current rule, if a money market fund invests in unrated or second tier securities, the adviser must monitor all NRSROs in case an unrated or second tier security has received a rating from any NRSRO below the second highest short-term rating category.<sup>355</sup> Because fund advisers currently monitor NRSROs, we do not expect that limiting the number of NRSROs that a fund would have to monitor to a number designated by the fund board would result in increased costs to fund advisers to monitor NRSROs.

We request comment on our analysis of the potential costs and benefits of a requirement to designate NRSROs. Do funds currently evaluate NRSRO ratings for reliability? Would there be benefits to funds and their advisers if the board designates three or more NRSROs? Would fund advisers benefit from having fewer NRSROs to monitor? Would fund advisers incur significant costs to make presentations to the board recommending which NRSROs to designate? What would be involved, including specific costs, for fund management to evaluate whether an NRSRO "issues credit ratings that are sufficiently reliable" for the fund's determination of whether a security is an eligible security? Would funds incur costs if we required them to disclose designated NRSROs in the statement of additional information?

We do not anticipate that the designation of NRSROs would have an adverse impact on capital formation. We request comment on whether requiring fund boards to designate NRSROs would have an impact on capital formation.

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<sup>353</sup> See ICI Report, *supra* note 6, at 82.

<sup>354</sup> See *supra* note 116 and accompanying text.

<sup>355</sup> See rule 2a-7(c)(6)(i)(A)(2).

### 3. Stress Testing

We are proposing to require that money market fund boards of directors adopt written procedures that provide for the periodic stress testing of each money market fund's portfolio.<sup>356</sup> The procedures would require testing of the fund's ability to maintain a stable net asset value per share based upon certain hypothetical events.<sup>357</sup> The procedures also would have to provide for a report to be delivered to the fund's board of directors at its next regularly scheduled meeting on the results of the testing and an assessment by the fund's adviser of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.<sup>358</sup>

We anticipate that stress testing would give fund advisers a better understanding of the effect of potential market events and shareholder redemptions on their funds' ability to maintain a stable net asset value, the fund's exposure to the risk that it would break the buck, and actions the adviser may need to take to mitigate the possibility of the fund breaking the buck. We believe that many funds currently conduct stress testing as a matter of routine fund management and business practice. We anticipate, however, that funds that do not currently perform stress testing and funds that may revise their procedures in light of the proposed rule amendments would give their managers a tool to better manage those risks. For fund boards of directors that do not currently receive stress test results, we believe that the regular reports and assessments would provide money market fund boards a better understanding of the risks to which the fund is exposed.

We understand that today rigorous stress testing is a best practice followed by many money market funds.<sup>359</sup> We understand that the fund complexes that conduct stress tests include smaller complexes that offer money market funds externally managed by advisers experienced in this area of management.<sup>360</sup> Accordingly, staff estimates that as a result of the proposed amendments to adopt stress testing procedures, (i) funds that currently conduct rigorous stress testing, including tests for hypothetical events listed in the proposed amendment (and concurrent occurrences of those events) would incur some cost to evaluate whether their current test procedures would comply with the proposed rule amendment, but would be likely to incur relatively few costs to revise those procedures or continue the stress testing they currently perform, (ii) funds that conduct less rigorous stress testing, or that do not test for all the hypothetical events listed in the proposed rule amendment, would incur somewhat greater expenses to revise those procedures in light of the proposed amendments and maintain the revised testing, and (iii) funds that do not conduct stress testing would incur costs to develop and adopt stress test procedures and conduct stress tests. As noted above, we believe that there is a range in the extent and rigor of stress testing currently performed by money market funds. We also expect that stress test procedures are or would be developed by the adviser to a fund complex for all money market funds in the complex while specific stress tests are performed for each individual money market fund. We estimate that a fund complex that currently does not conduct stress testing would require approximately 1 month for 2 risk management analysts and 2 systems analysts to develop stress test procedures at a cost of approximately \$155,000, 21 hours for a risk management analyst to draft the procedures, and 3 hours of board of directors' time to adopt the procedures for a total of approximately \$173,000.<sup>361</sup> Costs for fund complexes that would have to revise or fine-tune their stress test procedures would be less. For purposes of this cost benefit analysis, we estimate that these funds would incur half the costs of development, for a

<sup>356</sup> Proposed rule 2a-7(c)(8)(ii)(D).

<sup>357</sup> The proposed provision includes as hypothetical events a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on a portfolio security, and widening or narrowing of spreads between yields on a benchmark selected by the fund and securities held by the fund. *See* proposed rule 2a-7(c)(8)(ii)(D)(I).

<sup>358</sup> Proposed rule 2a-7(c)(8)(ii)(D)(2), (3). The report must include dates on which the testing was performed and the magnitude of each hypothetical event that would cause the deviation of the money market fund's net asset value calculated using available market quotations (or appropriate substitutes that reflect current market conditions) from its net asset value per share, calculated using amortized cost, to exceed ½ of 1%.

<sup>359</sup> As noted above, the ratings agencies stress test the portfolios of money market funds they rate. In addition, the Irish Financial Services Authority requires stress testing of money market funds domiciled in Ireland, and the Institutional Money Market Funds Association provides guidance for its members in stress testing money market fund portfolios. *See supra* notes 214-215 and accompanying text.

<sup>360</sup> These complexes do not, however, meet the definition of "small entities" under the Investment Company Act for purposes of the Regulatory Flexibility Act of 1980. 5 U.S.C. 603(a). *See infra* note 417.

<sup>361</sup> This estimate is based on the following calculations: \$275/hour x 280 hours (2 senior risk management specialists) + (\$244/hour x 320 hours (2 senior systems analysts) = \$155,080; \$275/hour (1 senior risk management specialist) x 21 hours = \$5,775; \$4,000/hour x 3 hours = \$12,000; \$155,080 + \$5,775 + \$12,000 = \$172,855.



total of approximately \$95,000.<sup>362</sup> Funds that would not have to change their test procedures would incur approximately \$20,000 to determine compliance with the proposed amendment, and to draft and adopt the procedures.<sup>363</sup> We also would anticipate that if there is a demand to develop stress testing procedures, third parties may develop programs that funds could purchase for less than our estimated cost to develop the programs themselves.

As with the development of stress test procedures, the costs funds would incur each year as a result of the proposed amendments to update test procedures, conduct stress tests and provide reports on the tests and assessments to the board of directors would vary. Funds that currently conduct stress tests already incur costs to perform the tests. In addition, some of those funds may currently provide reports to senior management (if not the board) of their test results. We assume, however, that few, if any, fund advisers provide a regular assessment to the board of the fund's ability to withstand the events reasonably likely to occur in the following year. For that reason, we estimate that all fund complexes would incur costs of \$3,000 to provide a written report on the test results to the board, \$4,000 to provide an assessment to the board and \$10 to retain records of the reports and assessments for a total annual cost to a fund complex of approximately \$42,000.<sup>364</sup> We estimate that a portion of funds would incur additional costs each year to perform stress tests and update their procedures each year, up to a maximum of approximately \$113,000.<sup>365</sup>

For purposes of this cost benefit analysis, Commission staff has estimated that 25 percent of fund complexes (or 43 complexes) would have to develop stress test procedures, 50 percent (or 85) would have stress test procedures, but have to revise those procedures, and 25 percent of complexes (or 43 complexes) would review the procedures without having to change them. Based on these estimates, staff further estimates that the total onetime costs for fund complexes to develop or refine existing stress test procedures would be approximately \$19 million.<sup>366</sup> In addition, staff estimates that the annual costs to all funds to conduct stress tests, update test procedures, provide reports and assessments to fund boards and retain records of the reports and assessments would be approximately \$17 million.<sup>367</sup>

We request comment on our estimates. We are particularly interested in comments regarding how many funds currently conduct stress testing, the extent and nature of that testing, including whether the procedures can be adopted on a complex wide basis, and the costs to develop rigorous stress testing procedures. For those money market funds that have stress test procedures, how significantly would they have to change those procedures in light of the proposed rule amendment? What costs would they incur, including specific costs for personnel that would be involved in changes?

#### 4. Repurchase Agreements

We are proposing to modify the conditions under which a money market fund may treat the acquisition of a repurchase agreement collateralized fully to be an acquisition of the repurchase agreement's collateral for purposes of rule 2a-7's diversification requirement.<sup>368</sup> Money market funds would be able to adopt this "look-through" treatment only with

<sup>362</sup> This estimate is based on the following calculation:  $(155,080 \times 0.5)$  (revise procedures) + \$5,775 (draft procedures) + \$12,000 (board approval) = \$93,315.

<sup>363</sup> This estimate is based on the following calculation: \$275/hour (senior risk management specialist) x 8 hours = \$2,200; \$2,200 + \$5,775 + \$12,000 = \$19,975.

<sup>364</sup> This estimate is based on the following calculation: *Report*: \$275/hour x 10 hours (senior risk management specialist) + \$62 x 2 hours (administrative assistant) = \$2874; *Assessment*: \$275/hour x 15 hours (senior risk management specialist) = \$4125; *Record retention*: \$62/hour x 0.1667 hours (administrative assistant) = \$10.33;  $(\$2874 + \$4125 + \$10) \times 6$  (board meetings per year) = \$42,054.

<sup>365</sup> This estimate is based on the following calculations: *Tests*: \$275/hour x 15 hours (senior risk management specialist) + \$244/hour x 20 hours (senior systems analyst) = \$9,005; \$9,005 x 12 (monthly testing) = \$108,060; *Update procedures*: \$275/hour x 5 hours (senior risk management specialist) + \$4000/hour x 1 hour = \$5375; \$108,060 + \$5375 = \$113,435.

<sup>366</sup> This estimate is based on the following calculation:  $(43 \times \$173,000) + (85 \times \$95,000) + (43 \times \$20,000) + (171 \times \$5775) + (171 \times \$12,000) = \$19,413,525$ .

<sup>367</sup> This estimate is based on the following calculation:  $(43 \times \$113,000) + (85 \times \$113,000 \times 0.5) + (171 \times \$42,054)$  (reports and assessments) = \$16,852,734.

<sup>368</sup> See rule 2a-7(c)(4)(ii)(A). The rule 5b-3(c)(1) definition of collateralized fully, which is cross-referenced by rule 2a-7(a)(5), sets forth the related conditions. Under the current definition, a money market fund may look through repurchase agreements collateralized with cash items, Government securities, securities with the highest rating or unrated securities of comparable credit quality.

respect to repurchase agreements collateralized by cash items or Government securities<sup>369</sup> and as to which the board of directors or its delegate has evaluated the creditworthiness of the counterparty.<sup>370</sup>

We believe that the proposed changes would limit money market funds' exposure to credit risk. Collateral other than cash items and Government securities might not adequately protect money market funds because the funds may be unable to liquidate the collateral without incurring a loss if the counterparty defaults. The creditworthiness evaluation, moreover, would make it less likely that a money market fund enters into repurchase agreements with counterparties that will default and be exposed to risks related to the collateral. As discussed above, we believe that the reduction of credit risk would better enable money market funds to weather market turbulence and maintain a stable net asset value per share.

We recognize that these proposed changes could result in costs to money market funds. The limitation on money market funds' ability to invest in repurchase agreements collateralized with securities other than cash items and Government securities may result in lower yields for money market funds to the extent that other investment opportunities do not provide the same returns as those agreements. The limitation also could lead to an increase in the counterparties' short-term financing costs. Counterparties may have to substitute such repurchase agreements with other sources of financing linked to the same type of collateral. If counterparties limited their own investments in securities that are no longer permissible collateral, the issuers of such securities could also be indirectly affected by our proposed change. The restrictions on repurchase agreements held by money market funds might potentially affect the functioning of these important markets. We invite comment on what effects, if any, these restrictions might have on the markets for repurchase agreements.

The creditworthiness evaluation would also impose additional costs. A credit risk evaluation, however, is required with respect to other portfolio securities and to repurchase agreements for which money market funds do not adopt a look-through treatment.<sup>371</sup> We understand, moreover, that many money market fund complexes already perform a creditworthiness evaluation for all repurchase agreement counterparties. Accordingly, we believe that the additional cost imposed on money market funds, if any, would be minimal.

We request comment on any potential costs and benefits. Would the proposed amendments significantly reduce the risk that money market funds incur losses upon the default of their repurchase agreement counterparties? What effect would the limitation on permissible collateral have on counterparties' ability to obtain short-term financing? How would the proposed change impact issuers of securities that would no longer be permissible collateral? Would the required creditworthiness evaluation impose any material cost on money market funds? We encourage commenters to provide empirical data to support their analysis.

##### *5. Public Website Posting*

The proposed amendments to rule 2a-7 would require money market funds to post monthly portfolio information on their websites.<sup>372</sup> The rule is intended to provide shareholders with timely information about the securities held by the money market fund.

We anticipate that the proposal to require funds to post monthly portfolio information on their websites would benefit investors by providing them a better understanding of their own risk exposure and thus enabling them to make better informed investment decisions. The proposed rule may thus instill more discipline into portfolio management and reduce the likelihood of a money market fund breaking the buck. Finally, any increased costs to money market funds from monthly reporting may be offset to a degree by the proposal to exclude them from current requirements to file quarterly

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<sup>369</sup> Proposed rule 2a-7(a)(5).

<sup>370</sup> Proposed rule 2a-7(c)(4)(ii)(A).

<sup>371</sup> See rule 2a-7(c)(3)(i).

<sup>372</sup> Proposed rule 2a-7(c)(12).

portfolio holdings information on Form N-Q. For the purposes of the PRA analysis, we estimate that money market funds would realize, in the aggregate, a decrease of 6,000 burden hours, or \$470,880, from this exclusion.<sup>373</sup>

The proposed website posting requirement would also impose certain costs on funds. We estimate that, for the purposes of the PRA, money market funds would be required to spend 24 hours of internal money market fund staff time initially to develop a webpage, at a cost of \$4,944 per fund.<sup>374</sup> We also estimate that all money market funds would be required to spend 4 hours of professional time to maintain and update the webpage each month, at a total annual cost of \$9,888 per fund.<sup>375</sup> We believe, however, that our estimates may overstate the actual costs that would be incurred to comply with the website posting requirement because many funds currently post their portfolio holdings on a monthly, or more frequent, basis.<sup>376</sup> For purposes of this cost benefit analysis, Commission staff estimates that 20 percent of money market portfolios (150 portfolios) do not currently post portfolio holdings information on their websites. Based on these estimates, we estimate that the total initial costs for the proposed website disclosure would be \$741,600.<sup>377</sup> In addition, we estimate that the annual costs for all money market funds to maintain and update their webpages would be \$7.4 million.<sup>378</sup>

In addition, monthly website disclosure may impose other costs on funds and their shareholders. For example, more frequent disclosure of portfolio holdings may arguably expand the opportunities for professional traders to exploit this information by engaging in predatory trading practices, such as front-running. However, given the short-term nature of money market fund investments and the restricted universe of eligible portfolio securities, we believe that the risk of trading ahead is severely curtailed in the context of money market funds.<sup>379</sup> For similar reasons, we believe that the potential for “free riding” on a money market fund’s investment strategies, i.e., obtaining for free the benefits of fund research and investment strategies, is minimal. Given that shares of money market funds are ordinarily purchased and redeemed at the stable price per share, we believe that there would be relatively few opportunities for profitable arbitrage. Thus, we estimate that the costs of predatory trading practices under this proposal would be minimal. We request comment on the analysis above, and on any other potential costs and benefits of the proposed website disclosure requirement.

### 6. Processing of Transactions

Our proposal would require that a money market fund’s board determine in good faith, on an annual basis, that the fund (or its transfer agent) has the capacity to redeem and sell securities at prices that do not correspond to the fund’s stable net asset value per share.<sup>380</sup> As discussed above, the aftermath of 2008 market events revealed that some funds had not implemented systems to calculate redemptions at prices other than the funds’ stable net asset value per share.<sup>381</sup> Because of this failure, transactions were processed manually, which extended the time that investors had to wait for the proceeds from their redeemed shares.

As noted in Section II.G above, money market funds may be required to process transactions at a price other than the fund’s stable share price and pay the proceeds of redemptions within seven days (or a shorter time that the fund has represented). We believe that funds that do not have the operational capacity to price shares at other than the stable share price risk being unable to meet their obligations under the Act. We expect that the proposed amendments would help eliminate the risk that money market funds would not be able to meet these obligations in the event the fund breaks

<sup>373</sup> This estimate is based on our experience with other filings and an estimated hourly wage rate of \$78.48 (6000 hours x \$78.48 = \$470,880).

<sup>374</sup> The staff estimates that a webmaster at a money market fund would require 24 hours (at \$206 per hour) to develop and review the webpage (24 hours x \$206 = \$4944).

<sup>375</sup> The staff estimates that a webmaster would require 4 hours (at \$206 per hour) to maintain and update the relevant webpages on a monthly basis (4 hours x \$206 x 12 months = \$9888).

<sup>376</sup> See *supra* note 325 and accompanying text.

<sup>377</sup> This calculation is based on the following estimate: (\$4,944 x 150 portfolios) = \$741,600.

<sup>378</sup> This calculation is based on the following estimate: (\$9,888 x 750 portfolios) = \$7,416,000.

<sup>379</sup> See ICI Report, *supra* note 6, at 93.

<sup>380</sup> Proposed rule 2a-7(c)(1).

<sup>381</sup> See *supra* note 262 and accompanying text.

a buck. Shareholders would benefit from the proposed amendments because they would be more likely to receive the proceeds from their investments in the event of a liquidation.

Because funds are obligated to redeem at other than stable net asset value per share, there should be no new cost associated with the requirement for the funds (or their transfer agents) to have the systems that can meet these requirements. To the extent that funds and transfer agents have to change their systems, however, these changes will likely entail costs. If a fund complex were to require one month of a senior systems analyst's time in assuring that the required systems are in place, the total cost for the fund complex would be \$39,040.<sup>382</sup> Based on this estimate we estimate that, if one-third of the fund complexes are not currently able to redeem at prices other than stable net asset value, the total cost to all money market funds would be \$2,225,280.<sup>383</sup> We also anticipate that the board's determination would result in costs. We anticipate that the board's determination would be based on a review at a regularly scheduled board meeting of the fund adviser's or the transfer agent's certification that the operational systems have the requisite capacity. Commission staff estimates that this review would take about 15 minutes of board time at a cost of \$1,000.<sup>384</sup> Based on this estimate we estimate that the total cost to all money market funds of board determinations would be \$171,000.<sup>385</sup> We request comment on the analysis above, and on any other potential costs and benefits of this proposed rule amendment.

## B. Rule 17a-9

The Commission is proposing to amend rule 17a-9 to expand the circumstances under which affiliated persons can purchase money market fund portfolio securities. Under the proposed amendment, a money market fund could sell a portfolio security that has defaulted (other than an immaterial default unrelated to the financial condition of the issuer) to an affiliated person for the greater of the security's amortized cost value or market value (plus accrued and unpaid interest), even though the security continued to be an eligible security.<sup>386</sup>

The proposed amendment essentially would codify past Commission staff no-action letters<sup>387</sup> and should benefit investors by enabling money market funds to dispose of troubled securities (e.g., securities depressed in value as a result of market conditions) from their portfolios quickly without any loss to fund shareholders. It also would benefit money market funds by eliminating the cost and delay of requesting no-action assurances in these scenarios and the uncertainty whether such assurances will be granted.<sup>388</sup> We do not believe that there are any costs associated with this amendment, but we request comment on this analysis.

In addition, we are proposing to permit affiliated persons to purchase other portfolio securities from an affiliated money market fund, for any reason, provided that such person would be required to promptly remit to the fund any profit it realizes from the later sale of the security.<sup>389</sup> Our staff provided temporary no-action assurances last fall to certain funds facing extraordinary levels of redemption requests for affiliated persons of such funds to purchase eligible securities from the funds at the greater of amortized cost or market value (plus accrued and unpaid interest).<sup>390</sup> In these circumstances, money market funds may need to obtain cash quickly to avoid selling securities into the market at fire sale prices to meet shareholder redemption requests, to the detriment of remaining shareholders. The staff also provided no-action assurances to money market funds last fall for affiliated persons of the fund to purchase at the greater of amortized cost or market value (plus accrued and unpaid interest) certain distressed securities that were depressed in value due to market conditions potentially threatening the stable share price of the fund, but that remained eligible securities and had not defaulted.<sup>391</sup> Money market funds and their shareholders would benefit if affiliated persons were able to purchase

<sup>382</sup> This estimate is based on the following calculation: \$244/hour x 160 hours (senior systems analyst) = \$39,040.

<sup>383</sup> This is based on the following calculation: (171 (fund complexes) ÷ 3) x \$39,040 = \$2,225,280.

<sup>384</sup> This is based on the following calculation: \$4,000/hour (board time) x 0.25 hours = \$1,000.

<sup>385</sup> This is based on the following calculation: \$1,000 x 171 (fund complexes) = \$171,000.

<sup>386</sup> See proposed rule 17a-9(a).

<sup>387</sup> See *supra* Section II.H.1.

<sup>388</sup> Commission staff estimates that the costs to obtain staff no-action assurances range from \$50,000 to \$100,000.

<sup>389</sup> See proposed rule 17a-9(b)(2).

<sup>390</sup> Many of the no-action letters can be found on our website. See <http://www.sec.gov/divisions/investment/im-noaction.shtml#money>.

<sup>391</sup> *Id.*

securities from the fund at the greater of amortized cost or market value (plus accrued and unpaid interest) in such circumstances without the time, expense, and uncertainty of applying to Commission staff for no-action assurances.

Affiliated persons purchasing such securities would have costs in creating and implementing a system for tracking the purchased securities and remitting to the money market fund any profit ultimately received as a result. We estimate that creating such a system on average would require 5 hours of a senior programmer's time, at a cost of \$1,460 for each of the 171 fund complexes with money market funds and a total cost of \$249,660.<sup>392</sup> After the initial creation of this system, we expect that the time spent noting in this system that a security was purchased under rule 17a-9 would require a negligible amount of compliance personnel's time. Based on our experience, we do not anticipate that there would be many instances, if any, in which an affiliated person would be required to repay profits in excess of the purchase price paid to the fund. However, if there is a payment, it would be made to the fund. If the payment is sufficiently large, we believe that funds are likely to include it with the next distribution to shareholders, which would not result in any additional costs to the fund. We request comment on this analysis. Are our cost estimates accurate? Are there other costs in allowing an affiliated person of a money market fund to purchase portfolio securities from the fund? Are there incentives that might encourage an affiliated person to purchase securities that are not distressed in any way? If so, would such purchases result in any cost to the fund and its investors?

The Commission also is proposing a related amendment to rule 2a-7, which would require that funds report all transactions under rule 17a-9 to the Commission. We believe that this reporting requirement would benefit fund investors by allowing the Commission to monitor the purchases for possible abuses and conflicts of interest on the part of the affiliates. It also would allow the Commission to observe what types of securities are distressed and which money market funds are holding distressed securities or are subject to significant redemption pressures. This information would better enable the Commission to monitor emerging risks at money market funds. For purposes of the Paperwork Reduction Act analysis, we estimate this amendment would impose relatively small reporting costs on money market funds of \$7,625 per year.<sup>393</sup> We request comment on whether these cost estimates are reasonable. We also request comment on our analysis of the costs and benefits of this proposed rule amendment.

### C. Rule 22e-3

Proposed rule 22e-3 would permit money market funds that break the buck to suspend redemptions and postpone payment of proceeds pending board-approved liquidations. The rule would thus facilitate orderly liquidations, which would protect value for fund shareholders and minimize disruption to financial markets. The rule would also enable funds to avoid the expense and delay of obtaining an exemptive order from the Commission, which we estimate would otherwise cost about \$75,000,<sup>394</sup> and would provide legal certainty to funds that wish to suspend redemptions during a liquidation in the interest of fairness to all shareholders.

Proposed rule 22e-3 would impose certain minimal costs on funds relying on the rule by requiring them to provide prior notice to the Commission of their decision to suspend redemptions in connection with a liquidation. We estimate that, for the purposes of the PRA, the annual burden of the notification requirement would be 10 minutes for a cost of \$51.<sup>395</sup> The proposed rule may also impose costs on shareholders who seek to redeem their shares, but are unable to do so. In those circumstances, shareholders might have to borrow funds from another source, and thereby incur interest charges and other transactional fees. We believe the potential costs associated with proposed rule 22e-3 would be minimal, however, because the proposed rule would provide a limited exemption that is only triggered in the event of a fund breaking the buck and liquidating. We request comment on this analysis, and on any other potential costs and benefits of proposed rule 22e-3.

<sup>392</sup> This estimate is based on the following calculation: \$292/hour x 5 hours x 171 fund complexes = \$249,660.

<sup>393</sup> This estimate is based on the following calculations: 25 (notices) + \$305/hour (attorney) x 1 hour = \$7,625. *See supra* note 329 and accompanying text.

<sup>394</sup> *See* Exchange Traded Funds, Investment Company Act Release No. 28913 (Mar. 11, 2008) [73 FR 14618 (Mar. 18, 2008)] at n.301 (estimating a cost range between \$75,000 and \$350,000 to submit an application for relief to operate an ETF). We assume that the costs associated with an application for exemptive relief from section 22(e) would be on the low end of this range because section 22(e) exemptive applications are often less involved than ETF exemptive applications.

<sup>395</sup> This estimate is based on the following calculation: \$305/hour x 1 ÷ 6 hour = \$51.

#### D. Rule 30b1-6 and Form N-MFP: Monthly Reporting of Portfolio Holdings

Proposed rule 30b1-6 and Form N-MFP would require money market funds to file with the Commission interactive data-formatted portfolio holdings information on a monthly basis. We expect that the proposed rule would improve the efficiency and effectiveness of the Commission's oversight of money market funds by enabling Commission staff to manage and analyze money market fund portfolio information more quickly and at a lower cost than is currently possible. The interactive data would also facilitate the flow of information between money market funds and other users of this information, such as information services, academics, and investors. As the development of software products to analyze the data continues to grow, we expect these benefits would increase.

Money market funds may also realize cost savings from the proposed rule. Currently, money market funds provide portfolio holdings information in a variety of formats to different third-parties, such as information services and NRSROs. The proposed rule may encourage the industry to adopt a standardized format, thereby reducing the burdens on money market funds of having to produce this information in multiple formats. In addition, money market funds may also benefit from cost savings to the extent that we exempt them from filing certain information required to be disclosed in existing quarterly portfolio holdings reports.

The proposed reporting requirement would also impose certain costs. We estimate that, for the purposes of the PRA, these filing requirements (including collecting, tagging, and electronically filing the report) would impose 128 burden hours at a cost of \$35,968<sup>396</sup> per money market fund for the first year, and 96 burden hours at a cost of \$26,976<sup>397</sup> per money market fund in subsequent years.<sup>398</sup>

For the reasons outlined in the discussion on the monthly website posting requirement, we estimate that there would be minimal additional costs incurred in connection with the proposed reporting requirement. We request comment on our estimates, including whether our assumptions about the costs and benefits are correct. We also request comment on other potential costs and benefits of the proposed reporting requirement.

#### E. Request for Comments

The Commission requests comment on the potential costs and benefits of the proposed rules and rule amendments. We also request comment on the potential costs and benefits of any alternatives suggested by commenters. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Act of 1996,<sup>399</sup> the Commission also requests information regarding the potential annual effect of the proposals on the U.S. economy. Commenters are requested to provide empirical data to support their views.

### VI. COMPETITION, EFFICIENCY AND CAPITAL FORMATION

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>400</sup>

#### A. Rule 2a-7

##### 1. *Second Tier Securities, Portfolio Maturity, and Liquidity Limits*

We are proposing several amendments to rule 2a-7 to tighten the risk-limiting conditions of the rule. We are proposing to limit money market fund investments to only first tier securities, i.e., securities receiving the highest short-term ratings from the requisite NRSROs or unrated securities that the fund's board of directors or its delegate determines are of

<sup>396</sup> This estimate is based on the following calculation: \$281/hour x 128 hours (senior database administrator) = \$35,968.

<sup>397</sup> This estimate is based on the following calculation: \$281/hour x 96 hours (senior database administrator) = \$26,976.

<sup>398</sup> We understand that some money market funds may outsource all or a portion of these responsibilities to a filing agent, software consultant, or other third-party service provider. We believe, however, that a fund would engage third-party service providers only if the external costs were comparable, or less than, the estimated internal costs of compiling, tagging, and filing the Form N-MFP.

<sup>399</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

<sup>400</sup> 15 U.S.C. 80a-2(c).

comparable quality.<sup>401</sup> We also are proposing to limit money market funds to acquiring long-term securities that have received long-term ratings in the highest two ratings categories.<sup>402</sup>

The proposed amendments would reduce the maximum weighted average maturity of a money market fund permitted by rule 2a-7 from 90 days to 60 days.<sup>403</sup> They also would impose a new maturity limitation based on the weighted average “life” of fund securities that would limit the portion of a fund’s portfolio that could be held in longer term floating- or variable-rate securities.<sup>404</sup> We are proposing to delete a provision in rule 2a-7 that permits money market funds not relying on the amortized cost method of valuation to acquire Government securities with a remaining maturity of up to 762 calendar days.

Finally, we are proposing new liquidity requirements on money market funds. Under the proposed amendments, money market funds would be prohibited from acquiring illiquid securities<sup>405</sup> and money market funds would be required to comply with certain minimum daily and weekly liquidity requirements.<sup>406</sup> The amended rule also would require that a money market fund at all times hold highly liquid securities sufficient to meet reasonably foreseeable redemptions in light of its obligations under section 22(e) of the Act and any commitments the fund has made to shareholders.<sup>407</sup>

We believe that these changes would reduce money market funds’ sensitivity to interest rate, credit, and liquidity risks. These changes also would limit the credit spread risk and interest rate spread risk produced by longer term securities. A reduction of these risks would better enable money market funds to weather market turbulence and maintain a stable net asset value per share. We believe that the changes would reduce the risk that a money market fund will break the buck and therefore prevent losses to fund investors. To the extent that money market funds are more stable, the changes also would reduce systemic risk to the capital markets and ensure a stable source of financing for issuers of short-term credit instruments. We believe that these effects would encourage capital formation by encouraging investment in money market funds, thereby allowing them to expand as a source of short-term financing in the capital markets.

These changes also may reduce maturities of short-term credit securities that issuers offer, which may increase financing costs for these issuers who might have to go back more frequently to the market for financing. To the extent that some issuers are unwilling or unable to issue securities that match money market fund demand given these proposed restrictions, the amendments could have a negative impact on capital formation.

If the proposed amendments reduce yields that money market funds are able to offer, some investors may move their money to, among other places, offshore unregulated money market funds that do not follow rule 2a-7’s strictures and thus are able to offer a higher yield. Beyond the competitive impact, such a change could increase systemic risks to short-term credit markets and capital formation by increasing investment in less stable short-term instruments.

Precluding ownership of second tier securities also may have anticompetitive effects on some relatively small money market funds that may compete with larger funds on the basis of yield. The proposed elimination of the ability of money market funds to invest in second tier securities may affect the capital raising ability and strategies of the issuers of second tier securities or otherwise affect their financing arrangements, and may affect the flexibility of investing options for funds. As noted above, however, second tier securities represent only a very small percentage of money market fund portfolios today, which suggests that our proposed amendments would not have a material effect on capital formation. We solicit specific comment on whether the proposed amendments regarding second tier securities would promote efficiency, competition and capital formation.

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<sup>401</sup> See proposed rule 2a-7(a)(11)(iii); proposed rule 2a-7(a)(11)(iv).

<sup>402</sup> See proposed rule 2a-7(a)(11)(iv)(A).

<sup>403</sup> See proposed rule 2a-7(c)(2)(ii).

<sup>404</sup> See proposed rule 2a-7(c)(2)(iii).

<sup>405</sup> See proposed rule 2a-7(c)(5)(i).

<sup>406</sup> See proposed rule 2a-7(c)(5).

<sup>407</sup> See proposed rule 2a-7(c)(5)(ii).

## 2. Stress Testing

We are proposing to amend rule 2a-7 to require the board of directors of each money market fund to adopt procedures providing for periodic stress testing of the money market fund's portfolio, reporting the results of the testing to fund boards, and providing an assessment to the board.<sup>408</sup> We believe that stress testing could increase the efficiency of money market funds by enhancing their risk management and thus making it more likely that the fund will be better prepared for potential stress on the fund due to market events or shareholder behavior. Money market funds may become more stable as a result of the risk management benefits provided by stress testing, allowing them to expand and attract further investment. If so, this result will promote capital formation. We do not believe that stress testing would have an adverse impact on competition or capital formation. What effect would the proposed requirement have on competition, efficiency and capital formation?

## 3. Repurchase Agreements

We are proposing to allow money market funds to treat the acquisition of a repurchase agreement to be an acquisition of the collateral for purposes of rule 2a-7's diversification requirement only if the repurchase agreement is collateralized by cash items or Government securities<sup>409</sup> and after the board of directors or its delegate has evaluated the creditworthiness of the counterparty.<sup>410</sup>

We believe that these changes would limit money market funds' exposure to credit risk. The reduction of credit risk would increase money market funds' ability to maintain a stable net asset value per share, thereby preventing losses to fund investors, reducing systemic risk to the capital markets and ensuring a stable source of financing for issuers of short-term credit instruments. More stable money market funds may attract greater investments, thus promoting capital formation and providing a greater source of short-term financing in the capital markets.

The limitation on money market funds' ability to invest in repurchase agreements collateralized with securities other than cash items and Government securities may result in an increase in the short-term financing costs of the counterparties in such agreements, thereby reducing their willingness to invest in those securities. As a result, issuers of such securities could also be indirectly affected by our proposed change, which therefore could have a negative impact on capital formation. We request comment on what effect the proposed amendments would have on competition, efficiency, and capital formation.

## 4. Public Website Disclosure

We are proposing to require money market funds to disclose certain portfolio holdings information on their websites on a monthly basis.<sup>411</sup> The proposed rule amendment would provide greater transparency of the fund's investments for current and prospective shareholders, and may thus promote more efficient allocation of investments by investors. We believe the proposed rule amendment may also improve competition, as better-informed investors may prompt funds managers to provide better services and products. We do not anticipate that funds would be disadvantaged, with respect to competition, because so many already have chosen to provide the information more frequently than monthly. In addition, the investments selected by money market funds are less likely than, for example, equity funds, to be investments from which competing funds would obtain benefit by scrutinizing on a monthly basis. The proposed rule may also promote capital formation by making portfolio holdings information readily accessible to investors, who may thus be more inclined to allocate their investments in a particular fund or in money market funds instead of an alternative product. Alternatively, the proposed rule could have the reverse effect if the portfolio holdings information makes investors less confident regarding the risks associated with money market funds, including the risk that market participants may use the information obtained through the disclosures to the detriment of the fund and its investors, such as by trading along with the fund or ahead of the fund by anticipating future transactions based on past transactions. We request comment on what effect this proposed rule would have on competition, efficiency, and capital formation.

<sup>408</sup> Proposed rule 2a-7(c)(8)(ii)(D).

<sup>409</sup> Proposed rule 2a-7(a)(5).

<sup>410</sup> Proposed rule 2a-7(c)(4)(ii)(A).

<sup>411</sup> See *supra* Section II.F.1.



### 5. *Processing of Transactions*

We are proposing to require that each money market fund's board determine, at least once each calendar year, that the fund has the capability to redeem and sell its securities at prices other than the fund's stable net asset value per share.<sup>412</sup> This amendment would require money funds to have the operational capacity if they break the buck to continue to process investor transactions in an orderly manner. This amendment would increase efficiency at money market funds that break the buck by increasing the speed and minimizing the operational difficulties in satisfying shareholder redemption requests in such circumstances. It may also reduce investors' concerns that redemption would be unduly delayed if a money market fund were to break the buck. We do not believe that this amendment would have a material impact on competition or capital formation. We request comment on what effect this proposed amendment would have on competition, efficiency, and capital formation.

#### **B. Rule 17a-9**

The Commission is proposing to amend rule 17a-9 to expand the circumstances under which affiliated persons can purchase money market fund securities. Under the proposed amendments, a money market fund could sell a portfolio security that has defaulted (other than an immaterial default unrelated to the financial condition of the issuer) to an affiliated person for the greater of the security's amortized cost value or market value (plus accrued and unpaid interest), even though the security continued to be an eligible security.<sup>413</sup> In addition, the proposed amendment would permit affiliated persons, for any reason, to purchase other portfolio securities from an affiliated money market fund on the same terms provided that such person is required to promptly remit to the fund any profit it realizes from the later sale of the security.<sup>414</sup> These amendments would increase the efficiency of both the Commission and money market funds by allowing affiliated persons to purchase portfolio securities from money market funds under distress without having to seek no-action assurances from Commission staff. We do not believe that the proposed amendments will have any material impact on competition or capital formation. We request comment on our analysis. What effect would the proposed amendment to rule 17a-9 have on efficiency, competition and capital formation?

#### **C. Rule 22e-3**

Proposed rule 22e-3 would permit money market funds that break the buck to suspend redemptions and postpone the payment of proceeds pending board-approved liquidation proceedings. We anticipate that the rule would promote efficiency in the financial markets by facilitating orderly disposal of assets during liquidation. To the extent that investors choose money market funds over alternative investments because the proposed rule would provide reassurance as to the protection of their assets in the event the fund breaks the buck and minimize disruption in the financial markets, the rule also may promote capital formation. If, however, the possibility that redemptions can be suspended during a liquidation makes money market funds less appealing to investors, the rule may have a negative effect on capital formation. The proposed rule also could help make investors more confident that they would be able to receive the proceeds from their investment in the event of a liquidation of the fund. We do not believe that the proposed rule would have an adverse effect on competition. We request comment on what effect the proposed rule would have on competition, efficiency, and capital formation.

#### **D. Rule 30b1-6 and Form N-MFP: Monthly Reporting of Portfolio Holdings**

Proposed new rule 30b1-6 and Form N-MFP would mandate the monthly electronic filing of each money market fund's portfolio holdings information in XML-tagged format. As discussed above, we believe the new reporting requirement would improve the efficiency and effectiveness of the Commission's oversight of money market funds. The availability, and usability, of this data would also promote efficiency for other third-parties that may be interested in collecting and analyzing money market funds' portfolio holdings information. Money market funds currently are often required to provide this information to various third parties in different formats. To the extent that the proposal may encourage a standardized format for disclosure or transmission of portfolio holdings information, the proposal may promote efficiency for money market funds. We do not believe that the proposed rule would have an adverse effect on competition or capital

<sup>412</sup> Proposed rule 2a-7(c)(1).

<sup>413</sup> See proposed rule 17a-9(a).

<sup>414</sup> See proposed rule 17a-9(b).

formation. We request comment on what effect the proposed rule would have on competition, efficiency, and capital formation.

## VII. REGULATORY FLEXIBILITY ACT CERTIFICATION

Section 3(a) of the Regulatory Flexibility Act of 1980<sup>415</sup> (“RFA”) requires the Commission to undertake an initial regulatory flexibility analysis (“IRFA”) of the proposed rule amendments on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>416</sup> Pursuant to 5 U.S.C. section 605(b), the Commission hereby certifies that the proposed amendments to rules 2a-7, 17a-9, and 30b1-5, and proposed rules 30b1-6 and 22e-3 under the Investment Company Act, would not, if adopted, have a significant economic impact on a substantial number of small entities.

The proposal would amend rule 2a-7 under the Investment Company Act to:

- (i) Limit money market fund investments to first tier securities (i.e., securities that received the highest short-term ratings categories from the requisite NRSROs or unrated securities that the board of directors (or its delegate) determines are of comparable quality);
- (ii) Limit money market funds to acquiring long-term securities that have received long-term ratings in the highest two ratings categories from the requisite NRSROs;
- (iii) Reduce the maximum weighted average maturity of money market funds’ portfolio securities from 90 to 60 days;
- (iv) Require money market funds to maintain a maximum weighted average life to maturity of portfolio securities of no more than 120 days;
- (v) Eliminate a provision of the rule that permits a fund that relies exclusively on the penny-rounding method of pricing to acquire Government securities with remaining maturities of up to 762 days, rather than the 397-day limit otherwise provided by the rule;
- (vi) Prohibit money market funds from acquiring securities unless, at the time acquired, they are liquid, i.e., can be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund;
- (vii) Require that immediately after the acquisition of a security, a taxable “retail fund” hold no less than 5 percent of its total assets in cash, U.S. Treasury securities, or other securities (including repurchase agreements) that mature, or are subject to a demand feature exercisable in one business day, and (ii) an “institutional fund” hold no less than 10 percent of those instruments;
- (viii) Require that immediately after the acquisition of a security (i) a “retail fund” holds no less than 15 percent of its total assets in cash, U.S. Treasury securities, or other securities (including repurchase agreements) that are convertible to cash within five business days, and (ii) an “institutional fund” holds no less than 30 percent of those instruments;
- (ix) Require that a money market fund at all times hold cash, U.S. Treasury securities, or securities readily convertible to cash on a daily or weekly basis sufficient to meet reasonably foreseeable redemptions in light of its obligations under section 22(e) of the Act and any commitments the fund has made to shareholders;
- (x) Require the board of directors of each money market fund to adopt procedures providing for periodic stress testing of the money market fund’s ability to maintain a stable net asset value per share based on certain hypothetical events, a report of the testing results to the board, and an assessment by the fund’s adviser of the fund’s ability to withstand the events that are reasonably likely to occur within the following year;

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<sup>415</sup> 5 U.S.C. 603(a).

<sup>416</sup> 5 U.S.C. 605(b).

- (xi) Limit money market funds to investing in repurchase agreements collateralized by cash items or Government securities in order to obtain special treatment under the diversification provisions of rule 2a-7;
- (xii) Require that the money market fund's board of directors or its delegate evaluate the creditworthiness of the counterparty, regardless of whether the repurchase agreement is collateralized fully;
- (xiii) Require money market funds to post monthly portfolio information on their websites; and
- (xiv) Require that a money market fund's board determine, on an annual basis, that the fund (or its transfer agent) has the capacity to redeem and sell securities at prices that do not correspond to the fund's stable net asset value.

We also are proposing to amend rule 17a-9 to permit a money market fund to sell a portfolio security that has defaulted (other than an immaterial default unrelated to the financial condition of the issuer) to an affiliated person for the greater of the security's amortized cost value or market value (plus accrued and unpaid interest), even though the security continues to be an eligible security. In addition, we are proposing to permit an affiliated person, for any reason, to purchase any other portfolio security (e.g., an eligible security that has not defaulted) from an affiliated money market fund for cash at the greater of the security's amortized cost value or market value, provided that such person promptly remits to the fund any profit it realizes from the later sale of the security. Under the proposal, a money market fund whose portfolio securities are purchased in reliance on rule 17a-9 would be required to provide notice of the transaction to the Commission by e-mail.

We are also proposing to amend rule 30b1-5 to exempt money market funds from the requirement to file their schedules of investments pursuant to Item 1 of Form N-Q, a quarterly schedule of portfolio holdings of management investment companies. The proposed amendment is intended to avoid unnecessarily duplicative disclosure obligations.

Finally, we are proposing two new rules. Proposed rule 22e-3 would exempt money market funds from section 22(e) to permit them to suspend redemptions in order to facilitate an orderly liquidation of fund assets. Rule 30b1-6 would mandate the monthly electronic filing in XML-tagged format of valuation and other information about the risk characteristics of the money market fund and each security in its portfolio.

Based on information in filings submitted to the Commission, we believe that there are no money market funds that are small entities.<sup>417</sup> For this reason, the Commission believes the proposed amendments to rules 2a-7, 17a-9, and 30b1-5, and proposed rules 22e-3 and 30b1-6 under the Investment Company Act would not, if adopted, have a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to rules 2a-7, 17a-9, and 30b1-5, and proposed rules 22e-3 and 30b1-6 could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

## VIII. Statutory Authority

The Commission is proposing amendments to rule 2a-7 under the exemptive and rulemaking authority set forth in sections 6(c), 8(b), 22(c), and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-6(c), 80a-8(b), 80a-22(c), 80a-37(a)]. The Commission is proposing amendments to rule 17a-9 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-37(a)]. The Commission is proposing rule 22e-3 pursuant to the authority set forth in sections 6(c), 22(e) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-22(e), and 80a-37(a)]. The Commission is proposing amendments to rule 30b1-5 and new rule 30b1-6 and Form N-MFP pursuant to authority set forth in Sections 8(b), 30(b), 31(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-29(b), 80a-30(a), and 80a-37(a)].

### List of Subjects

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<sup>417</sup> Under rule 0-10 under the Investment Company Act, an investment company is considered a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

### **Text of Proposed Rules and Form**

For reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

#### **Part 270—Rules and Regulations, Investment Company Act of 1940**

1. The authority citation for Part 270 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

2. Section 270.2a-7 is revised to read as follows:

#### **§ 270.2a-7 Money market funds.**

(a) *Definitions.*

(1) *Acquisition (or Acquire)* means any purchase or subsequent rollover (but does not include the failure to exercise a Demand Feature).

(2) *Amortized Cost Method* of valuation means the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(3) *Asset Backed Security* means a fixed income security (other than a Government security) issued by a Special Purpose Entity (as defined in this paragraph), substantially all of the assets which consist of Qualifying Assets (as defined in this paragraph). *Special Purpose Entity* means a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from Qualifying Assets, but does not include a registered investment company. *Qualifying Assets* means financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(4) *Business Day* means any day, other than Saturday, Sunday, or any customary business holiday.

(5) *Collateralized Fully* means "Collateralized Fully" as defined in § 270.5b-3(c)(1) except that § 270.5b-3(c)(1)(iv)(C) and (D) shall not apply.

(6) *Conditional Demand Feature* means a Demand Feature that is not an Unconditional Demand Feature. A Conditional Demand Feature is not a Guarantee.

(7) *Conduit Security* means a security issued by a Municipal Issuer (as defined in this paragraph) involving an arrangement or agreement entered into, directly or indirectly, with a person other than a Municipal Issuer, which arrangement or agreement provides for or secures repayment of the security. *Municipal Issuer* means a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality of a state or territory of the United States. A Conduit Security does not include a security that is:

(i) Fully and unconditionally guaranteed by a Municipal Issuer;

(ii) Payable from the general revenues of the Municipal Issuer or other Municipal Issuers (other than those revenues derived from an agreement or arrangement with a person who is not a Municipal Issuer that provides for or secures repayment of the security issued by the Municipal Issuer);

(iii) Related to a project owned and operated by a Municipal Issuer; or

(iv) Related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a Municipal Issuer.

(8) *Daily Liquid Assets* means:

(i) Cash;

(ii) Direct obligations of the U.S. Government; or

(iii) Securities that will mature or are subject to a Demand Feature that is exercisable and payable within one Business Day.

(9) *Demand Feature* means:

(i) A feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise. A Demand Feature must be exercisable either:

(A) At any time on no more than 30 calendar days' notice;

(B) At specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice; or

(ii) A feature permitting the holder of an Asset Backed Security unconditionally to receive principal and interest within 397 calendar days of making demand.

(10) *Demand Feature Issued By A Non-Controlled Person* means a Demand Feature issued by:

(i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature (*control* means "control" as defined in section 2(a)(9) of the Act (15 U.S.C. 80a-2(a)(9)); or

(ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.

11) *Eligible Security* means:

(i) A security issued by a registered investment company that is a money market fund;

(ii) A Government Security;

(iii) A Rated Security with a remaining maturity of 397 calendar days or less that has received a rating from the Requisite NRSROs in the highest short-term rating category (within which there may be sub-categories or gradations indicating relative standing); or

(iv) An Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(11)(iii) of this section, as determined by the money market fund's board of directors; provided, however, that:

(A) A security that at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less and that is an Unrated Security is not an Eligible Security if the security has received a long-term rating from any NRSRO that is not within the NRSRO's two highest long-term ratings categories (within which there may be sub-categories or gradations indicating relative standing), unless the security has received a long-term rating from the Requisite NRSROs in one of the two highest rating categories;

(B) An Asset Backed Security (other than an Asset Backed Security substantially all of whose Qualifying Assets consist of obligations of one or more Municipal Issuers, as that term is defined in paragraph (a)(7) of this section) shall not be an Eligible Security unless it has received a rating from an NRSRO.

(v) In addition, in the case of a security that is subject to a Demand Feature or Guarantee:

(A) The Guarantee has received a rating from an NRSRO or the Guarantee is issued by a guarantor that has received a rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee, unless:

(1) The Guarantee is issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the Guarantee (other than a sponsor of a Special Purpose Entity with respect to an Asset Backed Security);

(2) The security subject to the Guarantee is a repurchase agreement that is Collateralized Fully; or

(3) The Guarantee is itself a Government Security; and

(B) The issuer of the Demand Feature or Guarantee, or another institution, has undertaken promptly to notify the holder of the security in the event the Demand Feature or Guarantee is substituted with another Demand Feature or Guarantee (if such substitution is permissible under the terms of the Demand Feature or Guarantee).

(12) *Event of Insolvency* means “Event of Insolvency” as defined in § 270.5b-3(c)(2).

(13) *Floating Rate Security* means a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and that, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(14) *Government Security* means any “Government security” as defined in section 2(a)(16) of the Act (15 U.S.C. 80a-2(a)(16)).

(15) *Guarantee* means an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the Guarantee (if required), the principal amount of the underlying security plus accrued interest when due or upon default, or, in the case of an Unconditional Demand Feature, an obligation that entitles the holder to receive upon exercise the approximate amortized cost of the underlying security or securities, plus accrued interest, if any. A Guarantee includes a letter of credit, financial guaranty (bond) insurance, and an Unconditional Demand Feature (other than an Unconditional Demand Feature provided by the issuer of the security).

(16) *Guarantee Issued By A Non-Controlled Person* means a Guarantee issued by:

(i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Guarantee (control means “control” as defined in section 2(a)(9) of the Act (15 U.S.C. 80a-2(a)(9))); or

(ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.

(17) *Institutional Fund* means a money market fund whose board of directors determines, no less frequently than once each calendar year, is intended to be offered primarily to institutional investors or has the characteristics of such a fund, based on the:

(i) Nature of the record owners of the fund’s shares;

(ii) Minimum initial investment requirements; and

(iii) Historical cash flows that have resulted or expected cash flows that would result from purchases and redemptions.

(18) *Liquid Security* means a security that can be sold or disposed of in the ordinary course of business within seven calendar days at approximately its amortized cost.

(19) *NRSRO* means any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(62)), that is not an “affiliated person,” as defined in section 2(a)(3)(C) of the Act (15 U.S.C. 80a-2(a)(3)(C)), of the issuer of, or any insurer or provider of credit support for, the security.

(20) *Penny-Rounding Method* of pricing means the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.

(21) *Rated Security* means a security that meets the requirements of paragraphs (a)(21)(i) or (ii) of this section, in each case subject to paragraph (a)(21)(iii) of this section:

(i) The security has received a short-term rating from an NRSRO, or has been issued by an issuer that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security; or

(ii) The security is subject to a Guarantee that has received a short-term rating from an NRSRO, or a Guarantee issued by a guarantor that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the Guarantee; but

(iii) A security is not a Rated Security if it is subject to an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement as provided in paragraph (a)(21)(i) of this section, or the credit support agreement with respect to the security has received a short-term rating as provided in paragraph (a)(21)(ii) of this section.

(22) *Refunded Security* means "Refunded Security" as defined in § 270.5b-3(c)(4).

(23) *Requisite NRSROs* means:

(i) Any two NRSROs that have issued a rating with respect to a security or class of (i) debt obligations of an issuer; or

(ii) If only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund acquires the security, that NRSRO.

(24) *Retail Fund* means any money market fund that the board of directors has not determined within the calendar year is an Institutional Fund under paragraph (c)(5)(v) of this section.

(25) *Single State Fund* means a Tax Exempt Fund that holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and, where applicable, subdivisions thereof.

(26) *Tax Exempt Fund* means any money market fund that holds itself out as distributing income exempt from regular federal income tax.

(27) *Total Assets* means, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.

(28) *Unconditional Demand Feature* means a Demand Feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

(29) *United States Dollar-Denominated* means, with reference to a security, that all principal and interest payments on such security are payable to security holders in United States dollars under all circumstances and that the interest rate of, the principal amount to be repaid, and the timing of payments related to such security do not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars.

(30) *Unrated Security* means a security that is not a Rated Security.

(31) *Variable Rate Security* means a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the

instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(32) *Weekly Liquid Assets* means:

(i) Cash;

(ii) Direct obligations of the U.S. Government; or

(iii) Securities that will mature or are subject to a Demand Feature that is exercisable and payable within five Business Days.

(b) *Holding Out and Use of Names and Titles*.

(1) It shall be an untrue statement of material fact within the meaning of section 34(b) of the Act (15 U.S.C. 80a-33(b)) for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by section 24(b) of the Act (15 U.S.C. 80a-24(b)), to hold itself out to investors as a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), (c)(4) and (c)(5) of this section.

(2) It shall constitute the use of a materially deceptive or misleading name or title within the meaning of section 35(d) of the Act (15 U.S.C. 80a-34(d)) for a registered investment company to adopt the term “money market” as part of its name or title or the name or title of any redeemable securities of which it is the issuer, or to adopt a name that suggests that it is a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), (c)(4), and (c)(5) of this section.

(3) For purposes of this paragraph, a name that suggests that a registered investment company is a money market fund or the equivalent thereof shall include one that uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) *Share Price Calculations*.

The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund” or “fund”), notwithstanding the requirements of section 2(a)(41) of the Act (15 U.S.C. 80a-2(a)(41)) and of §§ 270.2a-4 and 270.22c-1 thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; provided, however, that:

(1) *Board Findings*. The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share. The board shall annually determine in good faith that the fund (or its transfer agent) has the capacity to redeem and sell securities issued by the fund at a price based on the current net asset value per share pursuant to § 270.22c-1. Such capacity shall include the ability to redeem and sell securities at prices that do not correspond to a stable net asset value or price per share.

(2) *Portfolio Maturity*. The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; provided, however, that the money market fund will not:

(i) Acquire any instrument with a remaining maturity of greater than 397 calendar days;

(ii) Maintain a dollar-weighted average portfolio maturity that exceeds 60 calendar days; or



(iii) Maintain a dollar-weighted average portfolio maturity that exceeds 120 calendar days, determined without reference to the exceptions in paragraph (d) of this section regarding interest rate readjustments.

(3) *Portfolio Quality.*

(i) *General.* The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO) and that are at the time of Acquisition Eligible Securities.

(ii) *Securities Subject to Guarantees.* A security that is subject to a Guarantee may be determined to be an Eligible Security based solely on whether the Guarantee is an Eligible Security.

(iii) *Securities Subject to Conditional Demand Features.* A security that is subject to a Conditional Demand Feature ("Underlying Security") may be determined to be an Eligible Security only if:

(A) The Conditional Demand Feature is an Eligible Security;

(B) At the time of the Acquisition of the Underlying Security, the money market fund's board of directors has determined that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur; and

(1) The conditions limiting exercise either 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

(2) The terms of the Conditional Demand Feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand Feature in accordance with its terms; and

(C) The Underlying Security or any Guarantee of such security (or the debt securities of the issuer of the Underlying Security or Guarantee that are comparable in priority and security with the Underlying Security or Guarantee) has received either a short-term rating or a long-term rating, as the case may be, from the Requisite NRSROs within the NRSROs' highest short-term or long-term rating categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund's board of directors to a security that has received a rating from the Requisite NRSROs within the NRSROs' highest short-term or long-term rating categories, as the case may be.

(4) *Portfolio Diversification.*

(i) *Issuer Diversification.* The money market fund shall be diversified with respect to issuers of securities Acquired by the fund as provided in paragraphs (c)(4)(i) and (c)(4)(ii) of this section, other than with respect to Government Securities and securities subject to a Guarantee Issued By A Non-Controlled Person.

(A) *Taxable and National Funds.* Immediately after the Acquisition of any security, a money market fund other than a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security; provided, however, that such a fund may invest up to twenty-five percent of its Total Assets in the securities of a single issuer for a period of up to three Business Days after the Acquisition thereof; Provided, further, that the fund may not invest in the securities of more than one issuer in accordance with the foregoing proviso in this paragraph at any time.

(B) *Single State Funds.* With respect to seventy-five percent of its Total Assets, immediately after the Acquisition of any security, a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security.

(ii) *Issuer Diversification Calculations.* For purposes of making calculations under paragraph (c)(4)(i) of this section:

(A) *Repurchase Agreements.* The Acquisition of a repurchase agreement may be deemed to be an Acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully and the fund's board of directors has evaluated the seller's creditworthiness.

(B) *Refunded Securities.* The Acquisition of a Refunded Security shall be deemed to be an Acquisition of the escrowed Government Securities.

(C) *Conduit Securities.* A Conduit Security shall be deemed to be issued by the person (other than the Municipal Issuer) ultimately responsible for payments of interest and principal on the security.

(D) *Asset Backed Securities.*

(1) *General.* An Asset Backed Security Acquired by a fund ("Primary ABS") shall be deemed to be issued by the Special Purpose Entity that issued the Asset Backed Security; provided, however:

(i) *Holdings of Primary ABS.* Any person whose obligations constitute ten percent or more of the principal amount of the Qualifying Assets of the Primary ABS ("Ten Percent Obligor") shall be deemed to be an issuer of the portion of the Primary ABS such obligations represent; and

(ii) *Holdings of Secondary ABS.* If a Ten Percent Obligor of a Primary ABS is itself a Special Purpose Entity issuing Asset Backed Securities ("Secondary ABS"), any Ten Percent Obligor of such Secondary ABS also shall be deemed to be an issuer of the portion of the Primary ABS that such Ten Percent Obligor represents.

(2) *Restricted Special Purpose Entities.* A Ten Percent Obligor with respect to a Primary or Secondary ABS shall not be deemed to have issued any portion of the assets of a Primary ABS as provided in paragraph (c)(4)(ii)(D)(1) of this section if that Ten Percent Obligor is itself a Special Purpose Entity issuing Asset Backed Securities ("Restricted Special Purpose Entity"), and the securities that it issues (other than securities issued to a company that controls, or is controlled by or under common control with, the Restricted Special Purpose Entity and which is not itself a Special Purpose Entity issuing Asset Backed Securities) are held by only one other Special Purpose Entity.

(3) *Demand Features and Guarantees.* In the case of a Ten Percent Obligor deemed to be an issuer, the fund shall satisfy the diversification requirements of paragraph (c)(4)(iii) of this section with respect to any Demand Feature or Guarantee to which the Ten Percent Obligor's obligations are subject.

(E) *Shares of Other Money Market Funds.* A money market fund that Acquires shares issued by another money market fund in an amount that would otherwise be prohibited by paragraph (c)(4)(i) of this section shall nonetheless be deemed in compliance with this section if the board of directors of the Acquiring money market fund reasonably believes that the fund in which it has invested is in compliance with this section.

(iii) *Diversification Rules for Demand Features and Guarantees.* The money market fund shall be diversified with respect to Demand Features and Guarantees Acquired by the fund as provided in paragraphs (c)(4)(iii) and (c)(4)(iv) of this section, other than with respect to a Demand Feature issued by the same institution that issued the underlying security, or with respect to a Guarantee or Demand Feature that is itself a Government Security.

(A) *General.* Immediately after the Acquisition of any Demand Feature or Guarantee or security subject to a Demand Feature or Guarantee, a money market fund, with respect to seventy-five percent of its Total Assets, shall not have invested more than ten percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, subject to paragraph (c)(4)(iii) (B) of this section.

(B) *Demand Features or Guarantees Issued by Non-Controlled Persons.* Immediately after the Acquisition of any security subject to a Demand Feature or Guarantee, a money market fund shall not have invested more than ten percent of its Total Assets in securities issued by, or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, unless, with respect to any security subject to Demand Features or Guarantees from that institution (other than securities issued by such institution), the Demand Feature or Guarantee is a Demand Feature or Guarantee Issued By A Non-Controlled Person.

(iv) *Demand Feature and Guarantee Diversification Calculations.*

(A) *Fractional Demand Features or Guarantees.* In the case of a security subject to a Demand Feature or Guarantee from an institution by which the institution guarantees a specified portion of the value of the security, the institution shall be deemed to guarantee the specified portion thereof.

(B) *Layered Demand Features or Guarantees.* In the case of a security subject to Demand Features or Guarantees from multiple institutions that have not limited the extent of their obligations as described in paragraph (c)(4)(iv)(A) of this section, each institution shall be deemed to have provided the Demand Feature or Guarantee with respect to the entire principal amount of the security.

(v) *Diversification Safe Harbor.* A money market fund that satisfies the applicable diversification requirements of paragraphs (c)(4) and (c)(6) of this section shall be deemed to have satisfied the diversification requirements of section 5(b)(1) of the Act (15 U.S.C. 80a-5(b)(1)) and the rules adopted thereunder.

(5) *Portfolio Liquidity.*

(i) *Liquid Securities.* The money market fund shall limit its portfolio investments to cash and securities that at the time of Acquisition are Liquid Securities.

(ii) *General Liquidity Requirement.* The money market fund shall hold Daily Liquid Assets and Weekly Liquid Assets sufficient to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under section 22(e) of the Act (15 U.S.C. 80a-22(e)) and any commitments the fund has made to shareholders.

(iii) *Minimum Daily Liquidity Requirement.* A money market fund shall not Acquire any security other than a Daily Liquid Asset if, immediately after the Acquisition, a Retail Fund would have invested less than five percent of its Total Assets, and an Institutional Fund would have invested less than ten percent of its Total Assets, in Daily Liquid Assets. This provision shall not apply to Tax Exempt Funds.

(iv) *Minimum Weekly Liquidity Requirement.* A money market fund shall not Acquire any security if, immediately after the Acquisition, a Retail Fund would have invested less than fifteen percent of its Total Assets, and an Institutional Fund would have invested less than thirty percent of its Total Assets, in Weekly Liquid Assets.

(v) *Annual Board Determination.* The board of directors of each money market fund shall determine no less than once each calendar year whether the fund is an Institutional Fund for purposes of meeting the minimum liquidity requirements set forth in paragraphs (c)(5)(iii) and (iv) of this section.

(6) *Demand Features and Guarantees Not Relied Upon.* If the fund's board of directors has determined that the fund is not relying on a Demand Feature or Guarantee to determine the quality (pursuant to paragraph (c)(3) of this section), or maturity (pursuant to paragraph (d) of this section), or liquidity of a portfolio security, and maintains a record of this determination (pursuant to paragraphs (c)(10)(ii) and (c)(11)(vi) of this section), then the fund may disregard such Demand Feature or Guarantee for all purposes of this section.

(7) *Downgrades, Defaults and Other Events.*

(i) *Downgrades.*

(A) *General.* In the event that the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated Security held by the money market fund has, since the security was Acquired by the fund, been given a rating by any NRSRO below the NRSRO's highest short-term rating category, the board of directors of the money market fund shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders.

(B) The reassessment required by paragraph (c)(7)(i)(A) of this section shall not be required if the fund disposes of the security (or it matures) within five Business Days.

(ii) *Defaults and Other Events.* Upon the occurrence of any of the events specified in paragraphs (c)(7)(ii)(A) through (D) of this section with respect to a portfolio security, the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security):

(A) The default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(B) A portfolio security ceases to be an Eligible Security;

(C) A portfolio security has been determined to no longer present minimal credit risks; or

(D) An Event of Insolvency occurs with respect to the issuer of a portfolio security or the provider of any Demand Feature or Guarantee.

(iii) *Notice to the Commission.* The money market fund shall promptly notify the Commission by electronic mail directed to the Director of Investment Management or the Director's designee, of any:

(A) Default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Demand Feature or Guarantee to which it is subject, where immediately before default the securities (or the securities subject to the Demand Feature or Guarantee) accounted for  $\frac{1}{2}$  of 1 percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation; or

(B) Purchase of a security from the fund by an affiliated person in reliance on § 270.17a-9 of this section, and the reasons for such purchase.

(iv) *Defaults for Purposes of Paragraphs (c)(7)(ii) and (iii).* For purposes of paragraphs (c)(7)(ii) and (iii) of this section, an instrument subject to a Demand Feature or Guarantee shall not be deemed to be in default (and an Event of Insolvency with respect to the security shall not be deemed to have occurred) if:

(A) In the case of an instrument subject to a Demand Feature, the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest; or

(B) The provider of the Guarantee is continuing, without protest, to make payments as due on the instrument.

(8) *Required Procedures: Amortized Cost Method.* In the case of a money market fund using the Amortized Cost Method:

(i) *General.* In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) *Specific Procedures.* Included within the procedures adopted by the board of directors shall be the following:

(A) *Shadow Pricing.* Written procedures shall provide:

(1) That the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions;

(2) For the periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and

(3) For the maintenance of records of the determination of deviation and the board's review thereof.

(B) *Prompt Consideration of Deviation.* In the event such deviation from the money market fund's amortized cost price per share exceeds ½ of 1 percent, the board of directors shall promptly consider what action, if any, should be initiated by the board of directors.

(C) *Material Dilution or Unfair Results.* Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(D) *Stress Testing.* Written procedures shall provide for:

(1) The periodic testing, at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions, of the money market fund's ability to maintain a stable net asset value per share based upon specified hypothetical events, that include, but are not limited to, a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund;

(2) A report on the results of such testing to be provided to the board of directors at its next regularly scheduled meeting, which report shall include the date(s) on which the testing was performed and the magnitude of each hypothetical event that would cause the deviation of the money market fund's net asset value calculated using available market quotations (or appropriate substitutes which reflect current market conditions) from its net asset value per share calculated using amortized cost to exceed ½ of 1 percent; and

(3) An assessment by the fund's adviser of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.

(9) *Required Procedures: Penny-Rounding Method.* In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.

(10) *Specific Procedures: Amortized Cost and Penny-Rounding Methods.* Included within the procedures adopted by the board of directors for money market funds using either the Amortized Cost or Penny-Rounding Methods shall be the following:

(i) *Securities for Which Maturity Is Determined by Reference to Demand Features.* In the case of a security for which maturity is determined by reference to a Demand Feature, written procedures shall require ongoing review of the security's continued minimal credit risks, and that review must be based on, among other things, financial data for the most recent fiscal year of the issuer of the Demand Feature and, in the case of a security subject to a Conditional Demand Feature, the issuer of the security whose financial condition must be monitored under paragraph (c)(3)(iv) of this section, whether such data is publicly available or provided under the terms of the security's governing documentation.

(ii) *Securities Subject to Demand Features or Guarantees.* In the case of a security subject to one or more Demand Features or Guarantees that the fund's board of directors has determined that the fund is not relying on to determine the quality (pursuant to paragraph (c)(3) of this section), maturity (pursuant to paragraph (d) of this section) or liquidity of the security subject to the Demand Feature or Guarantee, written procedures shall require periodic evaluation of such determination.

(iii) *Adjustable Rate Securities Without Demand Features.* In the case of a Variable Rate or Floating Rate Security that is not subject to a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section, written procedures shall require periodic review of whether the interest rate formula, upon readjustment of its interest rate, can reasonably be expected to cause the security to have a market value that approximates its amortized cost value.

(iv) *Asset Backed Securities.* In the case of an Asset Backed Security, written procedures shall require the fund to periodically determine the number of Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section; Provided, however, written procedures need not require periodic determinations with respect to any Asset Backed Security that a fund's board of directors has determined, at the time of Acquisition, will not have, or is unlikely to have, Ten Percent Obligor that are deemed to be issuers of all or a portion of that Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section, and maintains a record of this determination.

(11) *Record Keeping and Reporting.*

(i) *Written Procedures.* For a period of not less than six years following the replacement of such procedures with new procedures (the first two years in an easily accessible place), a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(7) through (c)(10) and (e) of this section shall be maintained and preserved.

(ii) *Board Considerations and Actions.* For a period of not less than six years (the first two years in an easily accessible place) a written record shall be maintained and preserved of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth in this section, to be included in the minutes of the board of directors' meetings.

(iii) *Credit Risk Analysis.* For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks and the NRSRO ratings (if any) used to determine the status of the security as an Eligible Security shall be maintained and preserved in an easily accessible place.

(iv) *Determinations with Respect to Adjustable Rate Securities.* For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(10)(iii) of this section (that a Variable Rate or Floating Rate Security that is not subject to a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section can reasonably be expected, upon readjustment of its interest rate at all times during the life of the instrument, to have a market value that approximates its amortized cost).

(v) *Determinations with Respect to Asset Backed Securities.* For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determinations required by paragraph (c)(10)(iv) of this section (the number of Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section). The written record shall include:

(A) The identities of the Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section), the percentage of the Qualifying Assets constituted by the securities of each Ten Percent Obligor and the percentage of the fund's Total Assets that are invested in securities of each Ten Percent Obligor; and

(B) Any determination that an Asset Backed Security will not have, or is unlikely to have, Ten Percent Obligor deemed to be issuers of all or a portion of that Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section.

(vi) *Evaluations with Respect to Securities Subject to Demand Features or Guarantees.* For a period of not less than three years from the date when the evaluation was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the evaluation required by paragraph (c)(10)(ii) (regarding securities subject to one or more Demand Features or Guarantees) of this section.

(vii) *Reports and Assessments with Respect to Stress Testing.* For a period of not less than six years (the first two years in an easily accessible place), a written copy of the report required under paragraph (c)(8)(ii)(D)(2) of this section and a written record of the assessment required under paragraph (c)(8)(ii)(D)(3) of this section shall be maintained and preserved.

(viii) *Inspection of Records.* The documents preserved pursuant to this paragraph (c)(11) shall be subject to inspection by the Commission in accordance with section 31(b) of the Act (15 U.S.C. 80a-30(b)) as if such documents were records required to be maintained pursuant to rules adopted under section 31(a) of the Act (15 U.S.C. 80a-30(a)). If any action was taken under paragraphs (c)(7)(ii) (with respect to defaulted securities and events of insolvency) or (c)(8)(ii) (with respect to a deviation from the fund's share price of more than ½ of 1 percent) of this section, the money market fund will file an exhibit to the Form N-SAR (17 CFR 274.101) filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

(12) *Public Disclosure of Valuations.* The money market fund shall post on its website, for a period of not less than twelve months, beginning no later than the second business day of the month, the fund's schedule of investments, as prescribed by rules 12-12 – 12-14 of Regulation S-X [17 CFR 210.12-12 – 12-14], as of the last business day of the prior month.

(d) *Maturity of Portfolio Securities.*

For purposes of this section, the maturity of a portfolio security shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, except as provided in paragraphs (d)(1) through (d)(8) of this section:

(1) *Adjustable Rate Government Securities.* A Government Security that is a Variable Rate Security where the variable rate of interest is readjusted no less frequently than every 397 calendar days shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate. A Government Security that is a Floating Rate Security shall be deemed to have a remaining maturity of one day.

(2) *Short-Term Variable Rate Securities.* A Variable Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity equal to the earlier of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(3) *Long-Term Variable Rate Securities.* A Variable Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) *Short-Term Floating Rate Securities.* A Floating Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity of one day.

(5) *Long-Term Floating Rate Securities.* A Floating Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(6) *Repurchase Agreements.* A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.

(7) *Portfolio Lending Agreements.* A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(8) *Money Market Fund Securities*. An investment in a money market fund shall be treated as having a maturity equal to the period of time within which the Acquired money market fund is required to make payment upon redemption, unless the Acquired money market fund has agreed in writing to provide redemption proceeds to the investing money market fund within a shorter time period, in which case the maturity of such investment shall be deemed to be the shorter period.

(e) *Delegation*.

The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (c)(1) (board findings); (c)(7)(ii) (defaults and other events); (c)(8)(i) (general required procedures: Amortized Cost Method); (c)(8)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), and (C) (material dilution or unfair results); and (c)(9) (required procedures: Penny-Rounding Method) of this section) provided:

(1) *Written Guidelines*. The Board shall establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this section) and procedures under which the delegate makes such determinations:

(2) *Oversight*. The Board shall take any measures reasonably necessary (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security or Event of Insolvency with respect to the issuer of the security or any Guarantee to which it is subject that requires notification of the Commission under paragraph (c)(7)(iii) of this section) to assure that the guidelines and procedures are being followed.

3. Section 270.17a-9 is revised to read as follows:

**§ 270.17a-9 Purchase of certain securities from a money market fund by an affiliate, or an affiliate of an affiliate.**

The purchase of a security from the portfolio of an open-end investment company holding itself out as a money market fund by any affiliated person or promoter of or principal underwriter for the money market fund or any affiliated person of such person shall be exempt from Section 17(a) of the Act (15 U.S.C. 80a-17(a)); provided that:

(a) In the case of a portfolio security that has ceased to be an Eligible Security (as defined in § 270.2a-7 (a)(11), or has defaulted (other than an immaterial default unrelated to the financial condition of the issuer):

(1) The purchase price is paid in cash; and

(2) 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).

(b) In the case of any other portfolio security:

(1) The purchase price meets the requirements of paragraph (a)(1) and (2) of this section; and

(2) In the event that the purchaser thereafter sells the security for a higher price than the purchase price paid to the money market fund, the purchaser shall promptly pay to the fund the amount by which the subsequent sale price exceeds the purchase price paid to the fund.

4. Section 270.22e-3 is added to read as follows:

**§ 270.22e-3 Exemption for liquidation of money market funds.**

(a) A registered open-end management investment company or series thereof ("fund") that is regulated as a money market fund under § 270.2a-7 is exempt from the requirements of section 22(e) of the Act (15 U.S.C. 80a-22(e)) if:

(1) The fund's current price per share calculated pursuant to § 270.2a-7(c) is less than the fund's stable net asset value or price per share;



- (2) The fund's board of directors, including a majority of directors who are not interested persons of the fund, has approved the liquidation of the fund; and
- (3) The fund, prior to suspending redemptions, notifies the Commission of its decision to liquidate and suspend redemptions, by electronic mail directed to the attention of the Director of the Division of Investment Management or his designee.
- (b) Any fund that owns, pursuant to section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E)), shares of a money market fund that has suspended redemptions of shares pursuant to paragraph (a) of this section also is exempt from the requirements of section 22(e) of the Act. A fund relying on the exemption provided in this paragraph must promptly notify the Commission that it has suspended redemptions in reliance on this section. Notification under this paragraph shall be made by electronic mail directed to the attention of the Director of the Division of Investment Management or his designee.
- (c) For the protection of fund shareholders, the Commission may issue an order to rescind or modify the exemption provided by this section as to that fund, after appropriate notice and opportunity for hearing in accordance with section 40 of the Act (15 U.S.C. 80a-39).

5. Section 270.30b1-5 is revised to read as follows:

**§ 270.30b1-5 Quarterly report.**

Every registered management investment company, other than a small business investment company registered on Form N-5 (§§ 239.24 and 274.5 of this chapter), shall file a quarterly report on Form N-Q (§§ 249.332 and 274.130 of this chapter) not more than 60 days after the close of the first and third quarters of each fiscal year. A registered management investment company that has filed a registration statement with the Commission registering its securities for the first time under the Securities Act of 1933 is relieved of this reporting obligation with respect to any reporting period or portion thereof prior to the date on which that registration statement becomes effective or is withdrawn. A registered management investment company regulated as a money market fund under § 270.2a-7 is relieved of the reporting obligation required pursuant to Item 1 of Form N-Q.

6. Section 270.30b1-6 is added to read as follows:

**§ 270.30b1-6 Monthly report for money market funds.**

Every registered open-end management investment company, or series thereof, that is regulated as a money market fund under § 270.2a-7 must file with the Commission a monthly report of portfolio holdings on Form N-MFP no later than the second business day of each month.

**Part 274—Forms Prescribed Under the Investment Company Act of 1940**

7. The authority citation for Part 274 continues to read in part as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

8. Section 274.201 and Form N-MFP are added to read as follows:

**§ 274.201 Form N-MFP, Portfolio Holdings of Money Market Funds**

This form shall be used by registered management investment companies that are regulated as money market funds under § 270.2a-7 of this chapter to file reports pursuant to § 270.30b1-6 of this chapter not later than two business days after the end of each month.

**Note:** The text of Form N-MFP will not appear in the Code of Federal Regulations.

## Form N-MFP

### Monthly Schedule of Portfolio Holdings of Money Market Funds

Form N-MFP is to be used by open-end management investment companies, or series thereof, that are regulated as money market funds under § 270.2a-7 (“money market funds”), to file reports with the Commission, not later than the second business day of each month, pursuant to rule 30b1-6 under the Investment Company Act of 1940 (17 CFR 270.30b1-6). The Commission may use the information provided on Form N-MFP in its regulatory, disclosure review, inspection, and policymaking roles.

### GENERAL INSTRUCTIONS

#### A. Rule as to Use of Form N-MFP

Form N-MFP is the public reporting form that is to be used for monthly reports of money market funds under section 30(b) of the Investment Company Act of 1940 (the “Act”) and rule 30b1-6 of the Act (17 CFR 270.30b1-6). Form N-MFP must be filed no later than the second business day of each month, and will contain certain information about the money market fund and its portfolio holdings as of the last business day of the preceding month.

#### B. Application of General Rules and Regulations

The General Rules and Regulations under the Act contain certain general requirements that are applicable to reporting on any form under the Act. These general requirements should be carefully read and observed in the preparation and filing of reports on this form, except that any provision in the form or in these instruction shall be controlling.

#### C. Filing of Form N-MFP

A money market fund must file Form N-MFP no later than the second business day of each month, in accordance with rule 232.13 of Regulation S-T. Form N-MFP must be filed electronically using the Commission’s EDGAR system.

#### D. Paperwork Reduction Act Information

A registrant is not required to respond to the collection of information contained in Form N-MFP unless the Form displays a currently valid Office of Management and Budget (“OMB”) control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. 3507.

United States  
Securities and Exchange Commission  
Washington, DC 20549

Form N-MFP  
Monthly Schedule of Portfolio Holdings of Money Market Funds

Date of Filing:

Report for [Month, Day, Year]

Name and Address of Fund or Portfolio Filing This Report:

CIK Number:

SEC File Number:

EDGAR Series Identifier:

Number of share classes offered:

Check here if Amendment [ ]

Amendment Number:

Is this an Initial Filing? [Y/N] Is this a Final Filing? [Y/N]

## Releases

Is the fund liquidating? [Y/N] Is the fund merging with another fund? [Y/N]

If so, please identify the other fund by name, SEC File Number, and EDGAR Series Identifier.

Is the fund being acquired by another fund? [Y/N]

If so, please identify the acquiring fund by name, SEC File Number, and EDGAR Series Identifier.

### **Part 1: Information about the Fund**

Item 1. Name of Investment Adviser.

a. SEC file number of Investment Adviser.

Item 2. Name of Sub-Adviser. If a fund has multiple sub-advisers, disclose the name of all sub-advisers to the fund.

a. SEC file number of Sub-Adviser. Disclose the SEC file number of each sub-adviser to the fund.

Item 3. Independent Auditor.

Item 4. Administrator.

Item 5. Transfer Agent.

a. SEC file number of Transfer Agent.

Item 6. Minimum initial investment.

Item 7. Is this a feeder fund? [Y/N]

a. If this is a feeder fund, identify the master fund.

b. SEC File Number of the master fund.

Item 8. Is this a master fund? [Y/N]

a. If this is a master fund, identify all feeder funds.

b. SEC File Number of each feeder fund.

Item 9. Is this portfolio primarily used to invest cash collateral? [Y/N]

Item 10. Is this portfolio primarily used to fund variable accounts? [Y/N]

Item 11. Category. Indicate whether the money market fund is a Treasury, Government/Agency, Prime, Tax-Free National, or Tax-Free State Fund.

Item 12. Total value of the portfolio at cost, to the nearest hundredth of a cent.

Item 13. Net value of other assets and liabilities, to the nearest hundredth of a cent.

Item 14. Net asset value per share for purposes of distributions, redemptions, and repurchase, to the nearest hundredth of a cent.

Item 15. Net shareholder flow activity for the month ended (subscriptions less redemptions).

Item 16. Dollar weighted average maturity. Calculate the dollar weighted average maturity of portfolio securities, based on the time remaining until the next interest rate re-set.

Item 17. Dollar weighted average life maturity. Calculate the dollar weighted average maturity of portfolio securities based on final legal maturity or demand feature.

Item 18. 7-day gross yield. Based on the 7 days ended on the last day of the prior month, calculate the Fund's yield by determining the net change, exclusive of capital changes and income other than investment income, in the value of a hypothetical preexisting account having a balance of one share at the beginning of the period and dividing the difference by the value of the account at the beginning of the base period to obtain the base period return, and then multiplying the base period return by  $(365/7)$  with the resulting yield figure carried to at least the nearest hundredth of one percent. The 7-day gross yield should not reflect a deduction of shareholders fees and fund operating expenses.

**Part 2: Schedule of Portfolio Securities.** For each security held by the money market fund, please disclose the following:

Item 19. The name of the issuer.

Item 20. CIK number of the issuer.

Item 21. The title of the issue.

Item 22. The CUSIP.

Item 23. Other unique identifier (if the instrument does not have a CUSIP).

Item 24. The category of investment. Please indicate the category that most closely identifies the instrument from among the following: Treasury Debt; Government Agency Debt; Variable Rate Demand Notes; Other Municipal Debt; Financial Company Commercial Paper; Asset Backed Commercial Paper; Certificate of Deposit; Structured Investment Vehicle Notes; Other Notes; Treasury Repurchase Agreements; Government Agency Repurchase Agreements; Other Repurchase Agreements; Insurance Company Funding Agreements; Investment Company; Other Instrument.

Item 25. Rating. Please indicate whether the security is a 1st tier security, unrated, or no longer eligible. Requisite NRSROs.

Item 26. Requisite NRSROs.

a. Identify each Requisite NRSRO.

b. For each Requisite NRSRO, disclose the credit rating given by the Requisite NRSRO

Item 27. The maturity date as determined under rule 2a-7. Disclose the maturity date, taking into account the maturity shortening provisions of rule 2a-7.

Item 28. The final legal maturity date.

Item 29. Is the maturity date extendable? [Y/N]

Item 30. Does the security have a credit enhancement? [Y/N]

Item 31. For each credit enhancement, disclose:

a. The type of credit enhancement.

b. The identity of the credit enhancement provider.

c. The credit rating of the credit enhancement provider.

Item 32. Does the security have an insurance guarantee? [Y/N]

Item 33. For each insurance guarantee provider, disclose:

Releases

- a. The identity of the insurance guarantee provider.
- b. The credit rating of the insurance guarantee provider.

Item 34. Does the security have a liquidity provider? [Y/N]

Item 35. For each liquidity provider, disclose:

- a. The identity of the liquidity provider.
- b. The credit rating of the liquidity provider.

Item 36. The principal amount of the security.

Item 37. The current amortized cost, to the nearest hundredth of a cent.

Item 38. Is this a Level 1, Level 2, or Level 3 security, or Other? Please explain how the security was valued. Level 1 securities are valued based on quoted prices in active markets for identical securities. Level 2 securities are valued based on other significant observable inputs (including quoted prices for similar securities, interest rates, prepayment speeds, credit risks, etc.). Level 3 securities are valued based on significant unobservable inputs (including the fund's own assumptions in determining the fair value of investments). See Statement of Financial Accounting Standards Board No. 157, "Fair Value Measurement."

Item 39. The percentage of the money market fund's gross assets invested in the security, to the nearest hundredth of one percent.

Item 40. Explanatory notes. Please disclose any other information that may be material to other disclosure in the Form.

By the Commission.  
Elizabeth M. Murphy  
Secretary  
Dated: June 30, 2009

## 2010 MONEY MARKET FUND REFORM

Release No. IC-29132

February 23, 2010

AGENCY: Securities and Exchange Commission

ACTION: Final rule

**SUMMARY:** The Securities and Exchange Commission (“Commission” or “SEC”) is adopting amendments to certain rules that govern money market funds under the Investment Company Act of 1940. The amendments will tighten the risk-limiting conditions of rule 2a-7 by, among other things, requiring funds to maintain a portion of their portfolios in instruments that can be readily converted to cash, reducing the maximum weighted average maturity of portfolio holdings, and improving the quality of portfolio securities; require money market funds to report their portfolio holdings monthly to the Commission; and permit a money market fund that has “broken the buck” (i.e., re-priced its securities below \$1.00 per share), or is at imminent risk of breaking the buck, to suspend redemptions to allow for the orderly liquidation of fund assets. The amendments are designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share.

**DATES:** The rules, rule amendments, and form are effective May 5, 2010. The expiration date for 17 CFR 270.30b1-6T is extended from September 17, 2010, to December 1, 2010. Compliance dates are discussed in Section III of the Supplementary Information.

**FOR FURTHER INFORMATION CONTACT:** Office of Regulatory Policy, at (202)

551-6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

**SUPPLEMENTARY INFORMATION:** The Commission is adopting amendments to rules 2a-7 [17 CFR 270.2a-7], 17a-9 [17 CFR 270.17a-9] and 30b1-6T [17 CFR 270.30b1-6T], new rules 22e-3 [17 CFR 270.22e-3] and 30b1-7 [17 CFR 270.30b1-7], and new Form N-MFP [17 CFR 274.201] under the Investment Company Act of 1940 (“Investment Company Act” or “Act”).<sup>1</sup>

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<sup>1</sup> 15 U.S.C. 80a. Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act, including rule 2a-7, are to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270]. References to “current” rules relate to rules in their current form [17 CFR Part 270 (2009 version)], and references to “amended” rules relate to rules as they will be amended by this Release.

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### **I. BACKGROUND**

On June 30, 2009, the Commission issued a release proposing new rules and rule amendments governing the operation of money market funds.<sup>2</sup> Money market funds are open-end management investment companies that are registered under the Investment Company Act. They invest in high-quality, short-term debt instruments such as commercial paper, Treasury bills and repurchase agreements. Money market funds pay dividends that reflect prevailing short-term interest rates and, unlike other investment companies, maintain a stable net asset value per share (or “NAV”), typically \$1.00 per share. Money market funds have over \$3.3 trillion dollars in assets under management, and comprise over 30 percent of the assets of registered investment companies.<sup>3</sup>

All money market funds are subject to rule 2a-7 under the Investment Company Act. Rule 2a-7, among other things, facilitates money market funds’ ability to maintain a stable net asset value per share by permitting them to use the amortized cost method of valuation and the penny-rounding method of pricing.<sup>4</sup> But for rule 2a-7, the Investment

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<sup>2</sup> Money Market Fund Reform, Investment Company Act Release No. 28807 (June 30, 2009) [74 FR 32688 (July 8, 2009)] (“Proposing Release”). All references to “proposed” rules relate to rules as proposed in the Proposing Release.

<sup>3</sup> See Investment Company Institute, *Trends in Mutual Fund Investing*, Nov. 2009, available at [http://www.ici.org/research/stats/trends/trends\\_11\\_09](http://www.ici.org/research/stats/trends/trends_11_09).

<sup>4</sup> Current rule 2a-7(a)(2) defines the amortized cost method as the method of calculating an investment company’s net asset value per share (or “NAV”) whereby portfolio securities are valued at the fund’s acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors. The penny-rounding method of pricing means the method of computing a fund’s price per share for purposes of distribution, redemption, and repurchase whereby the current net asset value per share is rounded to the nearest one percent. See current rule 2a-7(a)(18).

Company Act and our rules would require a money market fund to calculate its current net asset value per share by valuing portfolio securities at their current value (“mark-to-market”).<sup>5</sup>

Under the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount. The basic premise underlying money market funds’ use of the amortized cost method of valuation is that high-quality, short-term debt securities held until maturity will eventually return to their amortized cost value, regardless of any current disparity between the amortized cost value and market value, and would not ordinarily be expected to fluctuate significantly in value.<sup>6</sup> Therefore, the rule permits money market funds to value portfolio securities at their amortized cost so long as the deviation between the portfolio’s amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current net asset value per share of the fund.<sup>7</sup>

To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, the rule contains several conditions (which we refer to as “risk-limiting conditions”) that limit the fund’s exposure to certain risks, such as credit, currency, and interest rate risks.<sup>8</sup> In addition, the rule includes certain procedural requirements overseen by the fund’s board of directors. One of the most important is the requirement that the fund periodically “shadow price” the amortized cost net asset value of the fund’s portfolio against the mark-to-market net asset value of the portfolio.<sup>9</sup> If there is a difference of more than one-half of one percent (or \$0.005 per share), the fund’s board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) \$1.00 per share, an event colloquially known as “breaking the buck.”<sup>10</sup>

As discussed in significant detail in the Proposing Release, during 2007-2008 money market funds were exposed to substantial losses, first as a result of exposure to debt securities issued by structured investment vehicles (“SIVs”), and then as a result of the default of debt securities issued by Lehman Brothers Holdings Inc. (“Lehman Brothers”). All but one of the funds that were exposed to losses from SIV and Lehman Brothers securities obtained support of some type from their advisers or other affiliated persons, which absorbed the losses or provided a guarantee covering a sufficient amount of losses to prevent the fund from breaking the buck. The Reserve Primary Fund, which held a \$785 million position in Lehman Brothers debt, ultimately did not have a sponsor with sufficient resources to support it, and on

<sup>5</sup> See section 2(a)(41) of the Act (defining “value” of fund assets); rule 2a-4 (defining “current net asset value” for use in computing the current price of a redeemable security); and rule 22c-1 (generally requiring open-end funds to sell and redeem their shares at a price based on the funds’ current net asset value as next computed after receipt of a redemption, purchase, or sale order).

<sup>6</sup> See Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] (“1983 Adopting Release”) at nn.3–7 and accompanying text; Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] at nn.3–4 and accompanying text.

<sup>7</sup> See amended rule 2a-7(c)(1), (c)(8)(ii)(B)–(C) (requiring, among other things, that the fund’s board of directors promptly consider what action, if any, should be taken if the deviation between the money market fund’s current market value and the fund’s amortized cost price per share exceeds ½ of 1%).

<sup>8</sup> For example, the current rule requires, among other things, that a money market fund’s portfolio securities meet certain credit quality requirements, such as being rated in the top one or two rating categories by nationally recognized statistical rating organizations (“NRSROs”). A fund, moreover, may only invest a limited portion of its portfolio in securities rated in the second highest rating category. See current rule 2a-7(c)(3). The current rule also places limits on the remaining maturity of securities in the fund’s portfolio. A fund generally may not acquire, for example, any securities with a remaining maturity greater than 397 days, and the dollar-weighted average maturity of the securities owned by the fund may not exceed 90 days. See current rule 2a-7(c)(2).

<sup>9</sup> See current rule 2a-7(c)(7) (requiring that such shadow pricing be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions).

<sup>10</sup> See current rule 2a-7(c)(7)(ii)(B). Regardless of the extent of the deviation, rule 2a-7 imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Current rule 2a-7(c)(7)(ii)(C). See 1983 Adopting Release, *supra* note 6, at nn.51–52 and accompanying text.



September 16, 2008, the fund announced that it would re-price its securities at \$0.97 per share.<sup>11</sup> It subsequently suspended redemptions as of September 17, 2008.<sup>12</sup>

The cumulative effect of these events, when combined with general turbulence in the financial markets, led to a run primarily on institutional taxable prime money market funds, which contributed to severe dislocations in short-term credit markets and strains on the businesses and institutions that obtain funding in those markets.<sup>13</sup> During the week of September 15, 2008, investors withdrew approximately \$300 billion from taxable prime money market funds, or 14 percent of the assets held in those funds.<sup>14</sup> In the final two weeks of September 2008, money market funds reduced their holdings of top-rated commercial paper by \$200.3 billion, or 29 percent.<sup>15</sup>

On September 19, 2008, the U.S. Department of the Treasury (“Treasury Department”) and the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) announced an unprecedented intervention in the short-term markets. The Treasury Department announced its Temporary Guarantee Program for Money Market Funds (“Guarantee Program”), which temporarily guaranteed certain investments in money market funds that decided to participate in the program.<sup>16</sup> This program has now expired.<sup>17</sup> The Federal Reserve Board announced the creation of its Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (“AMLF”), through which it extended credit to U.S. banks and bank holding companies to finance their purchases of high-quality asset backed commercial paper from money market funds.<sup>18</sup> These programs were effective in containing the run on institutional prime money market funds and providing additional liquidity to money market funds.<sup>19</sup>

<sup>11</sup> See Proposing Release, *supra* note 2, at n.44 and accompanying text. The Reserve Primary Fund distributed the bulk of its assets, and investors have received more than \$0.98 on the dollar. See Press Release, SEC, Reserve Primary Fund Distributes Assets to Investors (Jan. 29, 2010) available at <http://www.sec.gov/news/press/2010/2010-16.htm>.

<sup>12</sup> In response to a request by The Reserve Fund, the Commission issued an order permitting the suspension of redemptions in certain Reserve funds, to permit their orderly liquidation. See In the Matter of The Reserve Fund, Investment Company Act Release No. 28386 (Sept. 22, 2008) [73 FR55572(Sept.25,2008)](order). Several other Reserve funds also obtained an order from the Commission on October 24, 2008, permitting them to suspend redemptions to allow for their orderly liquidation. See Reserve Municipal Money-Market Trust, et al., Investment Company Act Release No. 28466 (Oct. 24, 2008) [73 FR 64993 (Oct. 31, 2008)] (order).

<sup>13</sup> See *Minutes of the Federal Open Market Committee*, Federal Reserve Board, Oct. 28–29, 2008, at 5, available at <http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20081029.pdf> (“*FRB Open Market Committee Oct. 28–29 Minutes*”). See also Press Release, Federal Reserve Board, Board Announces Creation of the Commercial Paper Funding Facility (CPFF) to Help Provide Liquidity to Term Funding Markets (Oct. 7, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm>.

<sup>14</sup> See Investment Company Institute, Report of the Money Market Working Group, at 62 (Mar. 17, 2009), available at [http://www.ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://www.ici.org/pdf/ppr_09_mmwg.pdf) (“ICI Report”) (analyzing data from iMoneyNet); see also Investment Company Institute, *Money Market Mutual Fund Assets Historical Data*, available at [http://www.ici.org/pdf/mm\\_data\\_2010.pdf](http://www.ici.org/pdf/mm_data_2010.pdf) (“ICI Mutual Fund Historical Data”).

<sup>15</sup> See Christopher Condon & Bryan Keogh, *Funds’ Flight from Commercial Paper Forced Fed Move*, Bloomberg, Oct. 7, 2008, available at [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5hvnKFCC\\_pQ](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5hvnKFCC_pQ).

<sup>16</sup> See Press Release, Treasury Department, Treasury Announces Guaranty Program for Money Market Funds (Sept. 19, 2008), available at <http://www.treas.gov/press/releases/hp1147.htm>. The Program insured investments in money market funds, to the extent of their shareholdings as of September 19, 2008, if the fund chose to participate in the Program. We adopted, on an interim final basis, a temporary rule, rule 22e-3T, to facilitate the ability of money market funds to participate in the Guarantee Program. The rule permitted a participating fund to suspend redemptions if it broke the buck and liquidated under the terms of the Program. See Temporary Exemption for Liquidation of Certain Money Market Funds, Investment Company Act Release No. 28487 (Nov. 20, 2008) [73 FR 71919 (Nov. 26, 2008)].

<sup>17</sup> See Press Release, U.S. Department of the Treasury, Treasury Announces Expiration of Guarantee Program for Money Market Funds (Sept. 18, 2009), available at <http://www.treas.gov/press/releases/tg293.htm>. The Program expired on September 19, 2009, and rule 22e-3T expired on October 18, 2009.

<sup>18</sup> See Press Release, Federal Reserve Board, Federal Reserve Board Announces Two Enhancements to its Programs to Provide Liquidity to Markets (Sept. 19, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20080919a.htm>. The AMLF expired on February 1, 2010. See Press Release, Federal Reserve Board, FOMC Statement (Jan. 27, 2010), available at <http://www.federalreserve.gov/newsevents/press/monetary/20100127a.htm>.

<sup>19</sup> During the week ending September 18, 2008, taxable institutional money market funds experienced net outflows of \$165 billion. See *Money Fund Assets Fell to \$3.4T in Latest Week*, Associated Press, Sept. 18, 2008. Almost \$80 billion was withdrawn from prime money market funds even after the announcement of the Guarantee Program on September 19, 2008. See Diana B. Henriques, *As Cash Leaves Money Funds, Financial Firms Sign Up for U.S. Protection*, N.Y. Times, Oct. 2, 2008, at C10. By the end of the week after the announcement, however, net outflows from taxable institutional money market funds had ceased. See *Money Fund Assets Fell to \$3.398T in Latest Week*, Associated Press, Sept. 25, 2008.

The severity of the problems experienced by money market funds during 2007 and 2008 prompted us to review our regulation of money market funds. We sought to better understand how we might revise rule 2a-7 to reduce the susceptibility of money market funds to runs and reduce the consequences of a run on fund shareholders. Our staff consulted extensively with staff from other members of the President's Working Group on Financial Markets. We talked to many market participants, and reviewed a report from a "Money Market Fund Working Group" assembled by the Investment Company Institute ("ICI Report"), which recommended a number of changes.<sup>20</sup>

Our June 2009 proposals were the product of that review and were, we explained, a first step to addressing regulatory concerns we identified. They were designed to make money market funds more resilient and less likely to break a buck as a result of disruptions such as those that occurred in the fall of 2008. They would give us better tools to oversee money market funds. If a money market fund did break a buck, they would facilitate an orderly liquidation in order to protect fund shareholders and help contain adverse effects on the capital markets and other money market funds. In addition, throughout the Proposing Release we requested comment on additional regulatory changes aimed at further strengthening the stability of money market funds.

We received approximately 120 comments on the rule, including approximately 45 comments from investment companies and their representatives, 22 from debt security issuers, and 30 from individuals, including investors and academics. The comment letters reflected a wide variety of views on most of the topics discussed in the Proposing Release. The investment companies generally supported those aspects of the proposal that were similar to those recommended in the ICI Report.<sup>21</sup> Most of them strongly objected to changes that would affect the stable net asset value that today is the principal characteristic of a money market fund.<sup>22</sup> Most debt security issuers who wrote to us objected to changes designed to increase the credit quality of money market fund portfolios by precluding funds from investing in second tier securities (as defined by the rule).<sup>23</sup> Many fund commenters pointed to the historical stability of funds and urged us to be modest in our changes to rule 2a-7.<sup>24</sup> Some others, however, pointed to the near-cataclysmic events of September 2008 in supporting more substantial changes.<sup>25</sup>

As we stated in the Proposing Release, we recognize that the events of 2007-2008 raise the question of whether further changes to the regulatory structure governing money market funds may be warranted. Accordingly, in the Proposing Release we requested comment on additional, more fundamental regulatory changes, some of which we recognized could transform the business and regulatory model on which money market funds have been operating for more than 30 years.<sup>26</sup> For example, we requested comment on whether money market funds should move to the "floating net asset value" used by other open-end investment companies.<sup>27</sup> We received over 75 comment letters addressing this issue. We have continued to explore possible more significant changes to the regulation of money market funds in light of these comments and through the staff's work with members of the President's Working Group. We expect to issue a release addressing these issues and proposing further reform to money market fund regulation.

<sup>20</sup> ICI Report, *supra* note 14.

<sup>21</sup> *See, e.g.*, Comment Letter of T. Rowe Price Associates, Inc. (Sept. 8, 2009) ("T. Rowe Price Comment Letter"); Comment Letter of UBS Global Asset Management (Americas) Inc. (Sept. 8, 2009); Comment Letter of The Vanguard Group, Inc. (Aug. 19, 2009) ("Vanguard Comment Letter").

<sup>22</sup> *See, e.g.*, Comment Letter of BlackRock Inc. (Sept. 4, 2009) ("BlackRock Comment Letter"); Comment Letter of the Dreyfus Corporation (Sept. 8, 2009) ("Dreyfus Comment Letter"); Comment Letter of Goldman Sachs Asset Management, L.P. (Sept. 8, 2009) ("Goldman Sachs Comment Letter").

<sup>23</sup> *See, e.g.*, Comment Letter of American Electric Power Company, Inc. (Sept. 8, 2009) ("Am. Elec. P. Comment Letter"); Comment Letters of the U.S. Chamber of Commerce and Joint Treasurer Signatories (Sept. 3 & Sept. 24, 2009) ("Chamber/Tier 2 Issuers Comment Letter"); Comment Letter of Dominion Resources Services, Inc. (Sept. 8, 2009) ("Dominion Res. Comment Letter").

<sup>24</sup> *See, e.g.*, Comment Letter of Fidelity Investments (Aug. 24, 2009) ("Fidelity Comment Letter"); T. Rowe Price Comment Letter; Comment Letter of USAA Investment Management Company (Sept. 8, 2009) ("USAA Comment Letter").

<sup>25</sup> *See, e.g.*, Comment Letter of Deutsche Investment Management Americas Inc. (Aug. 31, 2009) ("Deutsche Comment Letter"); Comment Letter of Jeffrey N. Gordon, Professor of Law, Columbia Law School (Sept. 9, 2009); Comment Letter of John R. Jay, CFA (Sept. 8, 2009).

<sup>26</sup> *See* Proposing Release, *supra* note 2, at Section III.

<sup>27</sup> *See id.* at Section III.A.

## II. DISCUSSION

Today we are adopting the amendments we proposed last June to the rules governing money market funds, with several changes made in response to the comments we received. As described below in more detail, we believe these amendments will make money market funds more resilient and less likely to break the buck. They will further limit the risks money market funds may assume by, among other things, requiring them to increase the credit quality of fund portfolios and to reduce the maximum weighted average maturity of their portfolios, and by requiring for the first time that all money market funds maintain liquidity buffers that will help them withstand sudden demands for redemptions. The rule amendments require fund managers to stress test their portfolios against potential economic shocks such as sudden increases in interest rates, heavy redemptions, and potential defaults. They provide investors with more timely, relevant information about fund portfolios to hold fund managers more accountable for the risks they take. They will improve our ability to oversee money market funds. And finally, they provide a means to wind down the operations of a fund that does break the buck or suffers a run, in an orderly way that is fair to the fund's investors and reduces the risk of market losses that could spread to other funds. We believe that these reforms collectively will better protect money market fund investors in times of financial market turmoil and lessen the possibility that the money market fund industry will not be able to withstand stresses similar to those experienced in 2007-08. Thus, we believe that each of the rules and rule amendments we are adopting is necessary or appropriate in the public interest and consistent with the protection of investors and the policies and purposes of the Investment Company Act.<sup>28</sup>

### A. Portfolio Quality

Rule 2a-7 limits a money market fund to investing in securities that are, at the time of their acquisition, “eligible securities,” which means that securities must have been rated in either of the two highest short-term debt ratings categories from the relevant NRSROs or are comparable to securities that have been so rated in these categories.<sup>29</sup> Before a fund may invest in an “eligible security,” a fund's board of directors (or its delegate) must also determine that the security presents minimal credit risks, which must be based on factors pertaining to credit quality in addition to any rating assigned to a security.<sup>30</sup> We are amending rule 2a-7 to reduce the amount of credit risk a money market fund may assume by limiting the securities in which money market funds may invest. We are also amending provisions of rule 2a-7 that address how NRSRO ratings are used in the rule.

#### 1. Second Tier Securities

We are amending rule 2a-7 to further limit money market funds' investments in “second tier securities.”<sup>31</sup> Under the amendments, we are reducing permissible money market fund investments in second tier securities by (i) lowering the permitted percentage of a fund's “total assets” that may be invested in second tier securities from five percent to three percent and (ii) lowering the permitted concentration of its total assets in second tier securities of a single issuer from the greater of one percent or \$1 million to one-half of one percent.<sup>32</sup> In addition, money market funds will not be permitted to acquire any second tier security with a remaining maturity in excess of 45 days.<sup>33</sup>

Last June, we proposed to prohibit money market funds from acquiring second tier securities, based on our analysis of the risks that these securities can pose to money market funds. We noted that second tier securities trade in thinner markets, generally have a weaker credit quality profile, and exhibited credit spreads that widened more dramatically than

<sup>28</sup> See section 6(c) of the Investment Company Act (under which rule 22e-3 and amendments to rules 2a-7 and 17a-9 are adopted).

<sup>29</sup> Amended rule 2a-7(a)(12) (eligible security).

<sup>30</sup> Amended rule 2a-7(c)(3)(i) (portfolio quality).

<sup>31</sup> Second tier securities are eligible securities that, if rated, have received other than the highest short-term term debt rating from the requisite NRSROs or, if unrated, have been determined by the fund's board of directors to be of comparable quality. See amended rule 2a-7(a)(24) (defining “second tier security”); amended rule 2a-7(a)(23) (defining “requisite NRSROs”).

<sup>32</sup> See amended rule 2a-7(c)(3)(ii) (portfolio quality—second tier securities); amended rule 2a-7(c)(4)(i)(C) (portfolio diversification—second tier securities); amended rule 2a-7(a)(27) (defining “total assets”).

<sup>33</sup> See amended rule 2a-7(c)(3)(ii) (portfolio quality—second tier securities).

those of first tier securities during the 2008 financial turmoil.<sup>34</sup> During times of financial market stress, we understand that these securities tend to become illiquid and sell in the secondary market, if at all, only at prices substantially discounted from their amortized cost value.<sup>35</sup> This additional risk created by the credit and liquidity profile of second tier securities increases the possibility that a fund holding these securities could break the buck in times of financial market turmoil, with a detrimental impact on fund investors.

Commenters were evenly divided between those supporting our proposed elimination of money market funds' ability to acquire second tier securities and those against our proposal. In general, most money market fund sponsors who commented supported elimination,<sup>36</sup> while most issuers of second tier securities who commented opposed elimination.<sup>37</sup> Those supporting elimination argued that it would be an effective way to increase the safety of money market funds and would reduce the likelihood that a fund would break the buck. Some commenters noted that the money market funds they manage have not acquired second tier securities historically<sup>38</sup> because of second tier issuers' weaker credit profiles, smaller issuer program sizes, and lower market liquidity.<sup>39</sup>

A few commenters noted that eliminating money market funds' ability to acquire second tier securities should result in minimal market disruption because money market funds currently hold small amounts of such securities.<sup>40</sup>

Commenters that opposed the proposal disagreed that second tier securities significantly increase risk at money market funds,<sup>41</sup> argued that a complete ban would not be justified on a cost-benefit basis,<sup>42</sup> and stated that a ban would have a material adverse impact on second tier security issuers.<sup>43</sup> Some commenters noted that in a report of default rates through 2006, second tier securities have default rates substantially similar to those of first tier securities.<sup>44</sup> These commenters also noted that rating agencies require that second tier security issuers establish backup liquidity lines of credit providing

<sup>34</sup> See Proposing Release, *supra* note 2, at Section II.A.1. See also Thomas K. Hahn, *Commercial Paper* (Federal Reserve Bank of Richmond, Economic Quarterly Vol. 79/2, Spring 1993), at Fig. 4 (showing historical spreads between A-1/P-1 commercial paper and A-2/P-2 commercial paper between 1974 and 1992, including the tendency of such spreads to spike shortly before and during recessions); Comment Letter of the Investment Company Institute (Sept. 8, 2009) ("ICI Comment Letter") (noting that the market for Tier 2 commercial paper is less deep with fewer issuers than the Tier 1 market).

<sup>35</sup> See, e.g., Comment Letter of Invesco AIM Advisors, Inc. (Sept. 4, 2009) ("Invesco Aim Comment Letter") (noting that it has historically avoided the second tier market due to, among other factors, the less overall market liquidity of second tier securities); ICI Comment Letter. See also Proposing Release, *supra* note 2, at Section II.A.1 for a discussion of the wider credit spreads of second tier securities during the fall of 2008, indicating the extent to which such securities traded at a discounted price.

<sup>36</sup> See, e.g., Comment Letter of Bankers Trust Company, N.A. (Aug. 28, 2009) ("Bankers Trust Comment Letter"); BlackRock Comment Letter; Comment Letter of Charles Schwab Investment Management, Inc. (Sept. 4, 2009) ("Charles Schwab Comment Letter"); Dreyfus Comment Letter; Vanguard Comment Letter. *But see* Comment Letter of Federated Investors, Inc. (Sept. 8, 2009) ("Federated Comment Letter"); Fidelity Comment Letter (opposing elimination).

<sup>37</sup> See, e.g., Comment Letter of the American Securitization Forum (Sept. 8, 2009) ("Am. Securit. Forum Comment Letter"); Comment Letter of the U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (Sept. 8, 2009) ("Chamber Comment Letter"); Dominion Res. Comment Letter; Comment Letter of XTO Energy Inc. (Sept. 3, 2009) ("XTO Energy Comment Letter").

<sup>38</sup> See, e.g., Dreyfus Comment Letter; Invesco Aim Comment Letter.

<sup>39</sup> See, e.g., Invesco Aim Comment Letter.

<sup>40</sup> See, e.g., ICI Comment Letter; Comment Letter of TD Asset Management (Sept. 8, 2009) ("TDAM Comment Letter").

<sup>41</sup> See, e.g., Comment Letter of the Association for Financial Professionals (Sept. 8, 2009) ("Assoc. Fin. Professionals Comment Letter"); Chamber/Tier 2 Issuers Comment Letter; Dominion Res. Comment Letter.

<sup>42</sup> See, e.g., Comment Letter of Fund Democracy and the Consumer Federation of America (Sept. 8, 2009) ("CFA/Fund Democracy Comment Letter"); Chamber Comment Letter; Dominion Res. Comment Letter. *But see* TDAM Comment Letter (stating that the benefits of eliminating second tier securities will far outweigh any disadvantages).

<sup>43</sup> See, e.g., Chamber Comment Letter; Dominion Res. Comment Letter; Comment Letter of Treasury Strategies, Inc. (Sept. 8, 2009) ("Treasury Strategies Comment Letter").

<sup>44</sup> Chamber Comment Letter; Chamber/Tier 2 Issuers Comment Letter. These commenters were citing the following study: Moody's Investors Service, *Short-Term Corporate and Structured Finance Rating Transition Rates, 1972–2006* (June 2007), available at [http://www.moodys.com/cust/content/content.ashx?source=staticcontent/free%20pages/regulator%20affairs/documents/st\\_corp\\_and\\_struc\\_transition\\_rates\\_06\\_07.pdf](http://www.moodys.com/cust/content/content.ashx?source=staticcontent/free%20pages/regulator%20affairs/documents/st_corp_and_struc_transition_rates_06_07.pdf) (showing, for example, a default rate for P-1 rated commercial paper over a 365 day time horizon of 0.02% versus a default rate for P-2 rated commercial paper of 0.10% over the same time horizon).

100 percent coverage for any issuance.<sup>45</sup> Several commenters agreed with our statement in the Proposing Release that second tier securities were not the direct cause of strains on money market funds during the 2007-2008 period.<sup>46</sup> A few stated that banning the acquisition of second tier securities would reduce diversification of money market fund portfolio holdings and thus increase risk, noting in particular that a greater percentage of second tier security issuers are not financial institutions, compared to first tier security issuers.<sup>47</sup>

Commenters also asserted that prohibiting the acquisition of second tier securities would have unintended consequences for the capital markets. They stated that it might discourage investors other than money market funds from investing in second tier securities, causing a more substantial reduction in the issuance of second tier securities.<sup>48</sup> Some argued that if second tier issuers are not able to issue sufficient commercial paper, they will be forced to borrow more from banks, which is a less flexible and more costly alternative that will increase borrowing costs.<sup>49</sup> Finally, two commenters stated that a complete ban on the acquisition of second tier securities by money market funds might have a negative effect on those issuers of first tier securities that are viewed as presenting a higher risk of being downgraded, because money

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<sup>45</sup> We note, however, that commenters did not discuss conditions under which those issuers would not be permitted to draw on those backup liquidity facilities. It is our understanding that such backup liquidity facilities typically do not provide a full backstop of liquidity support because they contain conditions limiting an issuer's ability to draw on the facility if the issuer has experienced a "material adverse change," which would often occur if the financial situation of the issuer had declined due to financial market or other economic turmoil. *See also* Hahn, *supra* note 34 (stating that backup lines of credit generally will not be useful for a firm whose operating and financial condition has deteriorated to the point where it is about to default on its short-term liabilities because credit agreements often contain "material adverse change" clauses that allow banks to cancel credit lines if the financial condition of the firm changes significantly); Pu Shen, *Why Has the Nonfinancial Commercial Paper Market Shrunk Recently?*, Federal Reserve Bank of Kansas City Economic Review, at 69 (First Quarter 2003) (stating that commercial paper backup facilities are only meant to provide emergency assistance for short-term liquidity difficulties and not to enhance the credit quality of issues); Standard & Poor's, *2008 Corporate Criteria: Commercial Paper*, at 3 (Apr. 15, 2008) ("Given the size of the CP market, backup facilities could not be relied on with a high degree of confidence in the event of widespread disruption.").

<sup>46</sup> *See, e.g.*, Chamber/Tier 2 Issuers Comment Letter; Federated Comment Letter; Fidelity Comment Letter.

<sup>47</sup> *See, e.g.*, Treasury Strategies Comment Letter; USAA Comment Letter; XTO Energy Comment Letter. We note that while a greater *percentage* of second tier security issuers do appear to be non-financial companies, there are a much greater *number* of non-financial first tier issuers and thus it is not clear that money market funds would not be able to achieve sufficient diversification in their portfolio holdings even if limited to acquiring first tier securities. The Chamber/Tier 2 Issuers Comment Letter also states that prohibiting money market funds from acquiring second tier securities would "cut the pool of *potential issuers* by 43%" (emphasis added). Any diversification is not driven only by the *number of potential* issuers, however. It is also determined by the amount of money market fund assets that can be *actually* allocated to different issuers. For example, while there are over 200 P-2 rated commercial paper programs, only approximately half of these programs are active in issuing *any* commercial paper and only 16 programs have an average quarterly outstanding issuance in excess of \$500 million. *See* American Securit. Forum Comment Letter. In addition, during the market turmoil of 2007 and 2008, second tier securities did not exhibit less risky or countervailing economic metrics relevant to money market funds maintaining a stable net asset value compared to first tier securities. *See* Proposing Release, *supra* note 2, at Section II.A.1, at n.98 and accompanying text and chart. In fact, AA-rated non-financial commercial paper did exhibit significantly greater price stability than A2/P2-rated non-financial commercial paper during the fall of 2008. *See* Federal Reserve Board, Commercial Paper Data, *available at* <http://www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP> ("Federal Reserve Commercial Paper Data"). *See also* V.V. Chari, L. Christiano & P. Kehoe, *Facts and Myths about the Financial Crisis of 2008*, Federal Reserve Bank of Minneapolis Working Paper 666, at Fig. 7B (Oct. 2008).

<sup>48</sup> *See, e.g.*, Chamber Comment Letter; Dominion Res. Comment Letter; Treasury Strategies Comment Letter. Commenters asserted that eliminating money market funds' ability to acquire second tier securities might have a substantially greater adverse impact on second tier issuers, and thus potentially on capital formation because other investors in second tier securities or lesser quality first tier securities might avoid investment in those securities as a result of our rule amendments. Investor behavior in this regard is difficult to predict. It is equally likely that investors in second tier paper would demand higher yields, increasing issuers' financing costs. As discussed below, however, we are not precluding money market funds from investing in second tier securities. Accordingly, we do not need to reach a conclusion on this matter.

<sup>49</sup> *See, e.g.*, Am. Elec. P. Comment Letter; Chamber/Tier 2 Issuers Comment Letter; Dominion Res. Comment Letter; XTO Energy Comment Letter. We note that money market funds hold a relatively low percentage of outstanding second tier commercial paper. *See* Bank of America Merrill Lynch, Tier-2 US Commercial Paper Market Update (Oct. 15, 2009) (attached to the Am. Securit. Forum Comment Letter) (indicating that over 75% of Tier-2 commercial paper is held by insurance firms, corporations and banks, and that only 11% is held by the asset management industry, which would include money market funds as well as other mutual funds and asset managers).

market funds may elect not to invest in those securities out of concern that the securities might soon become second tier securities.<sup>50</sup>

The focus of our concerns is and must be on the risk to money market funds and their shareholders from their investments in second tier securities. While, as commenters noted,<sup>51</sup> second tier securities do not appear to be subject to substantially greater default risk than first tier securities they present greater credit spread risk and trade in thinner markets,<sup>52</sup> all of which can lead to greater price volatility and illiquidity in times of market stress.<sup>53</sup> While these characteristics may not pose the same degree of risk to money market funds as the likelihood that a security could default and become worthless, they can adversely affect money market funds' ability to maintain a stable net asset value. This is particularly the case given money market funds' narrow margin for deviation between the mark-to-market value of their assets and the amortized cost value of those assets, and the significant negative impact on money market funds and their investors if a fund breaks the buck.

Several commenters asserted that there are high-quality second tier securities available and that money market funds conducting a thorough credit risk analysis may conclude that certain second tier securities provide a higher yield than first tier securities while still maintaining a risk profile consistent with investment objectives for money market fund investment.<sup>54</sup> In these circumstances, investment in higher yielding second tier securities may benefit fund investors. These commenters suggested that, given these benefits, it may be more appropriate for us to preserve money market funds' ability to invest in second tier securities, but to a reduced degree.<sup>55</sup>

In light of these considerations, we believe that it is not necessary to prohibit money market funds from acquiring second tier securities. Instead, we believe that a better approach is to further limit money market funds' exposure to the risks presented by second tier securities. We expect that this treatment will both satisfy our policy objectives, as further discussed below, while mitigating some of the possible negative consequences noted by commenters that could result from

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<sup>50</sup> Fidelity Comment Letter; USAA Comment Letter. Two other commenters suggested that the Commission should consider the effect of banning the acquisition of second tier securities on tax-exempt money market funds, and in particular single-state funds. *See* Dreyfus Comment Letter; Federated Comment Letter. As discussed further in the cost benefit analysis section of this Release, based on our review of money market fund portfolios in September 2008, very few money market funds, including tax-exempt funds, will be impacted by our amendments relating to second tier securities. The greatest potential impact on tax-exempt funds will be the 45-day maturity limitation for acquisition of second tier securities. Given the prevalence of variable rate demand notes among municipal securities, however, we believe that tax-exempt funds should be able to effectively manage the 45-day maturity limit without a substantial impact. Accordingly, we do not believe that a special accommodation for tax-exempt money market funds is required with respect to second tier securities.

<sup>51</sup> *See supra* note 44 and accompanying text.

<sup>52</sup> A few commenters argued that the increase in spreads of Tier 2 commercial paper over Tier 1 commercial paper during the fall of 2008 was due to the Federal Reserve Board's announcement of its creation of the Commercial Paper Funding Facility (CPFF) on October 7, 2008, which only supported issuance of 90-day Tier 1 commercial paper. *See* Chamber Comment Letter; Chamber/Tier 2 Issuers Comment Letter; Dominion Res. Comment Letter. We note, however, that spreads between Tier 1 and Tier 2 commercial paper widened significantly (by well over 300 basis points) immediately after the bankruptcy of Lehman Brothers was announced on September 14, 2008—well before the CPFF was announced on October 7. *See* Federal Reserve Commercial Paper Data, *supra* note 47 (comparing AA and A2/P2 rated 30-day and 60-day nonfinancial commercial paper rates).

<sup>53</sup> We note that second tier securities are also more likely to be downgraded than first tier securities. *See* Moody's Investors Service, *Short-Term Corporate and Structured Finance Rating Transition Rates*, *supra* note 44, cited in Chamber/Tier 2 Issuers Comment Letter (showing that for each time period, commercial paper with a P-2 rating had a greater percentage chance of being downgraded than commercial paper with a P-1 rating, and that this gap widened over time—for example, P-2 rated commercial paper had a 1.09% chance of being downgraded over a 60-day period compared to a 0.72% chance of P-1 commercial paper being downgraded (a 0.37% difference); P-2 rated commercial paper had a 2.07% chance of being downgraded over a 120-day period compared to a 1.46% chance of P-1 commercial paper being downgraded (a 0.61% difference); and P-2 rated commercial paper had a 4% chance of being downgraded over a 270-day period compared to a 3.18% chance of P-1 commercial paper being downgraded (a 0.82% difference)).

<sup>54</sup> *See, e.g.*, Fidelity Comment Letter; Comment Letter of Thrivent Mutual Funds (Sept. 8, 2009) (“Thrivent Comment Letter”).

<sup>55</sup> *See, e.g.*, Federated Comment Letter (suggesting, as an alternative to eliminating money market funds' ability to acquire second tier securities, further limitations including reducing the percentage of fund assets permitted to be invested in second tier securities and limiting the final maturity of permissible second tier securities). *See also, e.g.*, Am. Elec. P. Comment Letter; Fidelity Comment Letter; USAA Comment Letter (each suggesting, as an alternative to eliminating money market funds' ability to acquire second tier securities, limiting the final maturity of permissible second tier securities to 90 days).

eliminating money market funds' ability to acquire second tier securities. This approach is reflected in three amendments we are adopting to rule 2a-7.

First, as suggested by some commenters,<sup>56</sup> we are reducing the amount of second tier securities that money market funds can acquire from five to three percent of their total assets, in order to reduce money market funds' aggregate exposure to the risks posed by second tier securities.<sup>57</sup> We are concerned that a limit of less than three percent could be equivalent to eliminating money market funds' ability to acquire second tier securities because we understand that investing in second tier securities requires an additional amount of credit analysis.<sup>58</sup> Accordingly, money market funds may not be willing to incur the costs of this additional credit analysis if they could only acquire second tier securities in amounts unlikely to make a meaningful contribution to fund yields.

Second, we are reducing the amount of second tier securities of any one issuer that a money market fund can acquire from one percent of the fund's total assets or \$1 million (whichever is greater), to one-half of one percent of the fund's total assets.<sup>59</sup> We requested comment in the Proposing Release on whether the issuer diversification limitations under rule 2a-7 should be further reduced and, if so, to what level.<sup>60</sup> Most commenters focused their response on whether there should be a general increase in the diversification limits under rule 2a-7 for all eligible securities. Many argued against an increase because it would require funds to invest in securities of lower credit quality in order to increase the number of issuers of portfolio securities and satisfy the greater diversification requirement.<sup>61</sup> One commenter, however, recommended that funds not be able to acquire more than one-half of one percent of their assets in second tier securities of any particular issuer as a method of limiting money market funds' exposure to the risks of second tier securities.<sup>62</sup>

We are adopting this commenter's suggestion because we believe the limitation will enhance the resilience of money market funds. It should decrease the likelihood that the default of, or significant distress experienced by, any particular second tier issuer alone will cause a money market fund to break the buck. While a money market fund can break the buck due to simultaneous stresses across its portfolio, it also can break the buck due to a sudden decline in the market-

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<sup>56</sup> See Federated Comment Letter; Comment Letter of the Sargent Shriver National Center on Poverty Law (Jul. 13, 2009) ("Shriver Poverty Law Ctr. Comment Letter"). These commenters did not suggest a particular percentage level to which the permissible aggregate amount of second tier securities that could be acquired should be reduced.

<sup>57</sup> The amendments apply the new limit on second tier securities holdings to all money market funds, including tax-exempt funds. See amended rule 2a-7(c)(3). Current rule 2a-7 limits tax-exempt funds' holdings of second tier securities only with respect to conduit securities (i.e., securities issued by a municipal issuer involving an arrangement or agreement entered into with a person other than the issuer that provides for or secures repayment of the security). See current rule 2a-7(c)(3)(ii)(B).

<sup>58</sup> In light of our decision not to prohibit the acquisition of second tier securities and after review of comments we received, we are persuaded that the current requirements regarding the rating standards in rule 2a-7 for certain long-term securities with remaining maturities of less than 397 days ("stub securities") are sufficient. We proposed to permit money market funds to acquire only those stub securities that had received a long-term rating in the highest two categories rather than the highest three categories, as permitted under the current rule. See current rule 2a-7(a)(10)(ii)(A). Commenters largely opposed our proposal asserting that standards associated with long-term ratings referenced in the current rule generally are correlated with the standards associated with the highest categories of short-term ratings. See BlackRock Comment Letter; Charles Schwab Comment Letter; ICI Comment Letter.

<sup>59</sup> Amended rule 2a-7(c)(4)(i)(C). The limitation also applies to tax-exempt funds, which under the current rule are only subject to the issuer diversification requirement with respect to conduit securities that are second tier. We also are amending rule 2a-7(c)(4)(i)(B) to prohibit each "single state fund" from acquiring more than ½ of 1% of its total assets in second tier securities. We also discussed modification to the guarantor and demand feature diversification provisions under rule 2a-7 in Section II.D of the Proposing Release. In addition to the reduction in the ability of money market funds to acquire second tier securities of any particular issuer, we are proportionately reducing by half the ability of a money market fund to acquire "demand features" or "guarantees" of a single issuer that are second tier securities from 5% to 2.5% of the money market fund's total assets. See amended rule 2a-7(c)(4)(iii)(B). We believe that this reduction will provide appropriate protection to money market funds against exposure to any particular guarantor or demand feature provider. We do not believe that we need to reduce this limitation to ½ of 1%, as we are doing with other individual second tier issuer exposures, because in these cases a security holder has recourse to both the security issuer and the issuer of the demand feature or guarantee, and thus there is a lesser chance that an individual company's default or distress will adversely impact the security. We received no comments on this aspect of the Proposing Release.

<sup>60</sup> See Proposing Release, *supra* note 2, at Section II.D.

<sup>61</sup> See, e.g., Charles Schwab Comment Letter; Invesco Aim Comment Letter.

<sup>62</sup> See Comment Letter of James J. Angel, Professor of Finance, Georgetown University (Sept. 8, 2009). Two other commenters also generally supported greater restrictions on money market funds' ability to acquire securities of any particular issuer. See Shriver Poverty Law Ctr. Comment Letter; Comment Letter of C. Stephen Wesselkamper (Sept. 3, 2009) ("C. Wesselkamper Comment Letter").

based price of a particular security in its portfolio, as was the case with respect to securities of Lehman Brothers during September 2008.<sup>63</sup> In addition, unlike in the case of imposing a one-half of one percent diversification limitation on *all* issuers held in a money market fund's portfolio, given the other limitations on holdings of second tier securities that we are adopting today, a diversification limitation of one-half of one percent that applies only to second tier securities should not require money market funds to invest in a substantially greater number of issuers, and thus should not expose the fund to investing in securities of lower credit quality.<sup>64</sup> In sum, we believe this tightened limitation on exposure to any particular second tier security issuer will provide additional protection to the stability of money market funds.

Third, we are limiting money market funds to acquiring second tier securities with remaining maturities of 45 days or less.<sup>65</sup> Several commenters urged us to adopt this approach to limiting money market funds' exposure to risk from second tier securities.<sup>66</sup> The risks of second tier securities discussed above can be substantially limited by restricting the length of time that a money market fund is exposed to the risks of that particular security. Securities of shorter maturity will pose less credit spread risk and liquidity risk to the fund because there is a shorter period of credit exposure and a shorter period until the security will mature and pay cash. Moreover, second tier securities with shorter maturities are less likely to be downgraded.<sup>67</sup> In recognition of the role that a shorter maturity can play in reducing second tier securities' risk, the market typically has demanded that such securities be issued at shorter maturities than first tier securities.<sup>68</sup> We believe that limiting the risk arising out of second tier securities through limiting their permissible maturity is appropriate and that a 45-day maturity limit will provide additional protection to investors without causing undue market disruption.<sup>69</sup>

We believe that the above combination of limitations on money market funds' ability to acquire second tier securities will achieve an appropriate balance between reducing the risk that money market funds will not be able to maintain a stable price per share and allowing fund investors to benefit from the higher returns that limited exposure to second tier securities can provide.

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<sup>63</sup> See *supra* text accompanying note 11.

<sup>64</sup> Under the current rule, a taxable money market fund could invest the greater of 1% or \$1 million of its assets in second tier securities of a single issuer. Under the amendments we are adopting today, a money market fund maximizing its investment ability in second tier securities and trying to concentrate its holdings in as few issuers as possible would hold securities of six different second tier security issuers, rather than five second tier issuers under the current rule.

<sup>65</sup> Amended rule 2a-7(c)(3)(ii). We requested comment on this approach in the Proposing Release. See Proposing Release, *supra* note 2, at Section II.A.1.

<sup>66</sup> See, e.g., Am. Elec. P. Comment Letter; Fidelity Comment Letter; USAA Comment Letter (all suggesting that permissible second tier security maturities be limited to a 90-day maximum); Thrivent Comment Letter (suggesting that permissible second tier security maturities be limited to a 45-day maximum). Given the need for money market funds to adjust quickly to changes in market risk to avoid breaking the buck (and given that based on historical experience second tier securities are unlikely to be issued with a 90-day maturity limit), we believe that a 45-day maturity limit is more prudent than a 90-day maturity limit.

<sup>67</sup> See Moody's Investors Service, *Short-Term Corporate and Structured Finance Rating Transition Rates*, *supra* note 44 (showing that P-2 rated commercial paper had a 98.79% chance of being rated P-2 or higher over a 30-day period, but a 96.31% chance of being rated P-2 or higher over a 90-day period, and a 92.75% chance of maintaining this rating level over a 180-day period).

<sup>68</sup> For example, the average maturity of outstanding non-asset backed second tier commercial paper as of November 20, 2009, was 25.6 days compared to 52.2 days for non-asset backed first tier commercial paper. See Federal Reserve Board, Average Maturity by Category for Outstanding Commercial Paper, *available at* <http://www.federalreserve.gov/releases/cp/maturity.htm> (last visited Dec. 2009). The Federal Reserve Board also has reported that during each of 2007, 2008, and 2009, on average over 96% of non-financial A2/P2 commercial paper had a maturity of 40 days or less at issuance. See Federal Reserve Board, Volume Statistics for Commercial Paper, A2/P2 Nonfinancial, *available at* <http://www.federalreserve.gov/releases/cp/volumestats.htm> (last visited Dec. 2009).

<sup>69</sup> One commenter asserted that because so little of second tier commercial paper currently is issued with a maturity of greater than 45 days, imposing a maturity limitation of 45 days on second tier securities eligible for money market fund investment would have little effect on a fund's overall exposure to credit risk. See ICI Comment Letter. We disagree. It is true that in recent years, second tier commercial paper has been issued largely at maturities of less than 45 days. See *supra* note 68. This fact may mean that there will be less cost impact from our amendments limiting money market funds to acquiring second tier securities with maturities of 45 days or less. It does not mean, however, that this historical maturity distribution will hold true in the future, and that money market funds will not seek in the future to invest in longer term second tier securities to achieve a higher yield, which would expose money market funds to the higher risks associated with longer term second tier securities.



## 2. Eligible Securities

We are amending rule 2a-7 to require that the board of directors of each money market fund (i) designate four or more NRSROs, any one or more of whose short-term credit ratings the fund would look to under the rule in determining whether a security is an eligible security, and (ii) determine at least once each calendar year that the designated NRSROs issue credit ratings that are sufficiently reliable for that use.<sup>70</sup> In addition, funds must identify the designated NRSROs in the fund's statement of additional information ("SAI").<sup>71</sup> Under the amendments, funds may, but are not required to, consider (or monitor) the ratings of other NRSROs under other provisions of the rule.<sup>72</sup>

As we have stated on several occasions, we are concerned with the authority that references to NRSRO ratings in our rules have given certain rating agencies, and whether such references have inadvertently placed an "official seal of approval" on ratings that could adversely affect the quality of due diligence and investment analysis.<sup>73</sup> The debt crisis of 2007-2008 also has given us concern about the reliability of these ratings.<sup>74</sup> Accordingly, we asked in the Proposing Release and in 2008 in a separate release whether we should eliminate or alter our use of ratings by NRSROs in rule 2a-7.<sup>75</sup>

The Proposing Release requested comment on alternative approaches. One approach would have eliminated any references to ratings in rule 2a-7, the effect of which would be to eliminate the floor established by the "eligible security" requirement and rely entirely on fund boards (and their delegates) to determine whether investment in a security involved minimal credit risks. An alternative approach would have maintained references to credit ratings in the rule, but shifted responsibility to fund boards to determine at least annually which NRSROs were sufficiently reliable for the fund to use to determine whether a security is an eligible security that could be considered for investment. Among other things, we requested comment on the minimum number of credit rating agencies we should require that a board designate for this purpose.

Each time we have solicited comments, a substantial majority of commenters has strongly supported retaining the references to NRSRO ratings in the rule.<sup>76</sup> Among other reasons, commenters argued that using credit ratings as a floor for credit quality limits money market fund advisers from taking greater risks that could weaken the rule's risk limiting conditions and thus the protection of investors.<sup>77</sup> Many urged us instead to address the "root causes" of ratings failures

<sup>70</sup> Amended rule 2a-7(a)(11)(i). As under the definition of "NRSRO" in current rule 2a-7, a designated NRSRO may not be an affiliated person of the issuer of, or any insurer or provider of credit support for, the security. Amended rule 2a-7(a)(11)(ii). The definition of "designated NRSRO" incorporates the definition of NRSRO in section 3(a)(62) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. 78c(a)(62)]. Amended rule 2a-7(a)(11).

<sup>71</sup> Amended rule 2a-7(a)(11)(iii) (requiring the fund to disclose in its SAI its designated NRSROs and any limitations with respect to the fund's use of such designation). See Part B of Form N-1A. In addition, funds must identify designated NRSROs in Form N-MFP with respect to each of the fund's portfolio securities. See *infra* Section II.E.2.

<sup>72</sup> See *infra* notes 116–118, 121, and accompanying text.

<sup>73</sup> See, e.g., References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327 (July 1, 2008) [73 FR 40124 (July 11, 2008)] ("NRSRO References Proposing Release"); References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28939 (Oct. 5, 2009) [74 FR 52358 (Oct. 9, 2009)] ("NRSRO References Adopting Release").

<sup>74</sup> See NRSRO References Proposing Release, *supra* note 73, at text following n.6.

<sup>75</sup> See Proposing Release, *supra* note 2, at text following n.110; NRSRO References Proposing Release, *supra* note 73, at Section III.A.

<sup>76</sup> See, e.g., Comment Letter of Calvert Group, Ltd. (Sept. 8, 2009) ("Calvert Comment Letter"); Federated Comment Letter; ICI Comment Letter. See also Comment Letter of the American Bar Association (Committee on Federal Regulation of Securities and Committee on Securitization and Structured Finance) (Sept. 12, 2008) (available in File No. S7-19-08); Comment Letter of the Institutional Money Market Funds Association (Sept. 5, 2008) (available in File No. S7-19-08); Comment Letter of the Securities Industry and Financial Markets Association (Dec. 8, 2009) (available in File No. S7-19-08). Comment letters submitted in File No. S7-19-08 are available on the Commission's website at: <http://www.sec.gov/comments/s7-19-08/s71908.shtml>.

<sup>77</sup> See, e.g., Dreyfus Comment Letter; ICI Comment Letter; Comment Letter of J.P. Morgan Asset Management (Sept. 8, 2009) ("J.P. Morgan Asset Mgt. Comment Letter"). See also Proposing Release, *supra* note 2, at nn.108–110 and accompanying text.

rather than remove the safety net provided by the credit ratings requirements of the rule.<sup>78</sup> Some disputed suggestions that inclusion of ratings in rule 2a-7 encourages fund managers to over-rely on the ratings, pointing to provisions in the rule that specifically require independent analysis by fund managers.<sup>79</sup> One commenter argued that NRSRO ratings provide “an additional, independent check on the investment manager’s judgment.”<sup>80</sup> By acting as a floor, the commenter argued, these ratings keep all money market funds operating at or above the same level,<sup>81</sup> and they restrain any particular money market fund from taking (and exposing investors to) greater risks than other competing money market funds in order to gain a competitive advantage in a highly yield-sensitive market.<sup>82</sup>

Only a few commenters have supported removing references to NRSRO ratings.<sup>83</sup> These commenters principally asserted that removing credit ratings references would prevent fund boards and advisers from overreliance on NRSRO ratings and encourage advisers to make independent decisions about whether a security presents a credit risk.<sup>84</sup> Other commenters, however, countered that eliminating NRSRO ratings from the rule would do nothing to prevent a fund manager from being highly dependent upon NRSRO ratings in making its minimal credit risk determination.<sup>85</sup>

Commenters did, however, largely support the approach of allowing funds to designate a minimum number of NRSROs that the fund would look to under rule 2a-7 in determining whether a security is an eligible security. They asserted that NRSRO designation would encourage competition among NRSROs to achieve designation and reduce the cost of subscribing to all NRSROs’ ratings.<sup>86</sup> They also noted that this approach would permit funds to focus better on standards, methods, and current ratings levels developed by designated NRSROs.<sup>87</sup> Several commenters expressed concern, however, that requiring designation of only three NRSROs would result in funds designating the three largest NRSROs, which could further entrench their market dominance.<sup>88</sup> Other commenters stated that designating NRSROs

<sup>78</sup> See, e.g., Comment Letter of the Northern Funds and Northern Institutional Funds—Independent Trustees (Sept. 8, 2009) (“Northern Funds Indep. Trustees Comment Letter”); Comment Letter of the Tamarack Funds Trust (Sept. 8, 2009) (“Tamarack Funds Comment Letter”). See also Comment Letter of Charles Schwab & Co., Inc. (Sept. 5, 2008) (available in File No. S7-19-08); Comment Letter of Dechert LLP (Sept. 5, 2008) (available in File No. S7-19-08); Comment Letter of Realpoint (Aug. 14, 2008) (available in File No. S7-19-08). We have recently adopted rule amendments designed to improve our regulation and oversight of NRSROs, which help address the integrity of their rating procedures and methodologies. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009) [74 FR 63832 (Dec. 4, 2009)]; Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59342 (Feb. 2, 2009) [74 FR 6456 (Feb. 9, 2009)]; Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (June 5, 2007) [72 FR 33564 (June 18, 2007)].

<sup>79</sup> See ICI Comment Letter; TDAM Comment Letter.

<sup>80</sup> See ICI Comment Letter.

<sup>81</sup> See, e.g., Comment Letter of State Street Global Advisors (Sept. 8, 2009) (“State Street Comment Letter”); Vanguard Comment Letter.

<sup>82</sup> See ICI Comment Letter. See also J.P. Morgan Asset Mgt. Comment Letter; Comment Letter of Stradley Ronon Stevens & Young, LLP (Sept. 8, 2009) (“Stradley Ronon Comment Letter”).

<sup>83</sup> See Comment Letter of James B. Burnham, Business School Professor, Duquesne University (Aug. 27, 2009) (“J. Burnham Comment Letter”); Comment Letter of Moody’s Investors Service (Sept. 8, 2009) (“Moody’s Comment Letter”); Comment Letter of James L. Nesfield (Jul. 4, 2009) (“J. Nesfield Comment Letter”); Comment Letter of the Shadow Financial Regulatory Committee (Sept. 14, 2009) (“Shadow FRC Comment Letter”); Comment Letter of John M. Winters, CFA (Jul. 23, 2009). See also Comment Letter of Professor Lawrence J. White (Sept. 5, 2008) (available in File No. S7-19-08); Comment Letter of Professor Frank Partnoy (Sept. 5, 2008) (available in File No. S7-19-08); Comment Letter of the Government Finance Officers Association (Sept. 5, 2008) (available in File No. S7-19-08); Comment Letter of the Financial Economists Roundtable (Dec. 1, 2008) (available in File No. S7-19-08).

<sup>84</sup> See J. Burnham Comment Letter; Moody’s Comment Letter; J. Nesfield Comment Letter; Shadow FRC Comment Letter. One commenter asserted that transparency of portfolio holdings was a better approach than using references to NRSRO ratings. J. Nesfield Comment Letter. We note that we are amending rule 2a-7 to require money market funds to disclose information about their portfolio holdings each month on their websites. See *infra* Section II.E.1.

<sup>85</sup> Stradley Ronon Comment Letter (removing the references would not prevent advisers from relying too heavily on NRSRO ratings under their own internal credit risk analysis).

<sup>86</sup> See, e.g., Federated Comment Letter; Fidelity Comment Letter; ICI Comment Letter.

<sup>87</sup> See Am. Securit. Forum Comment Letter.

<sup>88</sup> See, e.g., Comment Letter of DBRS Limited (Sept. 8, 2009) (“DBRS Comment Letter”); Comment Letter of Wells Fargo Funds Management, LLC (Sept. 8, 2009) (“Wells Fargo Comment Letter”). Three of the 10 NRSROs registered with the Commission issued approximately 97% of all outstanding ratings across all categories reported to the Commission for 2008. See SEC, Annual Report on Nationally Recognized Statistical Rating Organizations (Sept. 2008) at 10.

could disadvantage small NRSROs with well-developed capabilities regarding certain investments and suggested that the fund should have flexibility to rely on the particular NRSROs it determines have the best expertise to evaluate a particular security.<sup>89</sup> Some commenters, while supporting designation of NRSROs, asserted that fund boards are unprepared to make such determinations and urged that fund advisers be given the responsibility.<sup>90</sup>

The Commission is committed to reevaluating the use of NRSRO ratings in our rules. Recently we eliminated references to NRSRO ratings in several rules where we concluded that they were no longer warranted as serving their intended purposes and where the elimination was consistent with the protection of investors.<sup>91</sup> Today, as discussed in more detail below, we are eliminating the only provision in rule 2a-7 that limits money market funds to investing in a type of security only if it is rated.<sup>92</sup> We continue to work to further the goals of the Credit Rating Agency Reform Act in order to improve the quality and reliability of securities ratings.<sup>93</sup>

We have found no evidence that suggests that over-reliance on NRSRO ratings contributed to the problems that money market funds faced during the debt crisis. Our staff closely examined, for example, why some money market funds held securities issued by certain SIVs that became distressed in 2007. The staff exams appear to indicate that the minimal creditworthiness evaluations of SIVs made by advisers to funds that held those SIVs differed from the evaluations made by advisers to funds that did not invest in those SIVs in the emphasis the advisers gave to particular elements of the analysis.<sup>94</sup> Had fund managers relied too heavily on credit rating agencies, we would have expected to see far more funds holding Lehman Brothers commercial paper when it defaulted than we did.<sup>95</sup>

The current provisions of rule 2a-7 were designed to prevent excess reliance on credit rating agencies.<sup>96</sup> Under rule 2a-7, adequate ratings alone do not provide a basis for eligibility. As we have noted before, a determination that a security is an eligible security is a necessary but not sufficient finding in order for a fund to acquire the security.<sup>97</sup> The rule also requires fund boards (which typically rely on the fund's adviser) to determine that the security presents minimal credit risks, and specifically requires that determination "be based on factors pertaining to credit quality in addition to any ratings assigned to such securities by an NRSRO."<sup>98</sup> Thus, credit ratings provide an important *but not exclusive* input into the investment decision-making process,<sup>99</sup> and the unreliability or low quality of ratings issued by one or more NRSROs can (and should) be addressed by an investment adviser providing a thorough analysis of the security to determine if it

<sup>89</sup> See Tamarack Funds Comment Letter; TDAM Comment Letter.

<sup>90</sup> See Comment Letter of the American Bar Association (Committee on Federal Regulation of Securities) (Sept. 9, 2009) ("ABA Comment Letter"); Comment Letter of the Mutual Fund Directors Forum (Sept. 8, 2009) ("MFDF Comment Letter"); Comment Letter of Northern Funds and Northern Institutional Funds (Sept. 8, 2009) ("Northern Funds Comment Letter").

<sup>91</sup> See NRSRO References Adopting Release, *supra* note 73.

<sup>92</sup> Compare amended rule 2a-7(a)(12) with current rule 2a-7(a)(10)(i)(B).

<sup>93</sup> See, e.g., Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61051 (Nov. 23, 2009) [74 FR 63866 (Dec. 4, 2009)] (proposing rule amendments and a new rule requiring each NRSRO to: (1) furnish an annual report describing the steps taken by the firm's designated compliance officer during the fiscal year with respect to certain compliance matters; (2) disclose additional information about sources of revenues on Form NRSRO; and (3) make publicly available information about revenues of the NRSRO attributable to persons paying the NRSRO for the issuance or maintenance of a credit rating).

<sup>94</sup> See Proposing Release, *supra* note 2, at note 135.

<sup>95</sup> See *Fitch: Market Challenges Offer 'Lessons' for Rated Money Market Funds*, Business Wire (Oct. 1, 2008) ("Most funds were able to eliminate or minimize their exposure to securities issued by SIVs and Lehman Brothers by limiting their absolute exposures and/or taking measures to scale back their risk as the credit picture deteriorated."). See Bloomberg Terminal Database, LEH <Equity> CRPR (historical short-term credit ratings for credit rating agencies, including Moody's and Fitch, indicate that these agencies did not downgrade their ratings of Lehman Brothers debt before the company filed for bankruptcy); Bob Ivry, Mark Pittman & Christine Harper, *Sleep-At-Night-Money Lost in Lehman Lesson Missing \$63 Billion*, Bloomberg (Sept. 8, 2009), available at [http://www.bloomberg.com/apps/news?pid=email\\_en&sid=aLhi.S5xkemY](http://www.bloomberg.com/apps/news?pid=email_en&sid=aLhi.S5xkemY) (historical short-term credit ratings for Moody's and Fitch indicate that these credit rating agencies did not downgrade their ratings of Lehman Brothers debt before the company filed for bankruptcy); David Segal, *The Silence of the Oracle*, New York Times (Mar. 18, 2009) (noting Moody's rated Lehman Brothers' debt A2 before the firm's bankruptcy).

<sup>96</sup> See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)] ("1991 Adopting Release") at Section II.A.

<sup>97</sup> See, e.g., *id.* at text accompanying n.18.

<sup>98</sup> Current rule 2a-7(c)(3)(i).

<sup>99</sup> See 1991 Adopting Release, *supra* note 96, at Section II.A.

involves minimal credit risks. The use of these ratings provides an independent perspective on the creditworthiness of short-term securities that we have considered, in part, when determining whether to exercise our exemptive authority to permit money market funds to use the amortized cost method of valuation.<sup>100</sup>

This is not to say, however, that we are content with the current approach of rule 2a-7. Any one of the growing number of NRSROs, regardless of its expertise in rating short-term securities of the type held by money market funds, could have deemed a security unfit for a money market fund to acquire or, conversely, deemed a security to be eligible for investment by a money market fund. To address this concern, we are adopting amendments to rule 2a-7 that shift responsibility to money market fund boards for deciding which NRSROs they will use in determining whether a security is an eligible security for purposes of the rule.

The amendments are designed, among other things, to foster greater competition among NRSROs to produce the most reliable ratings in order to obtain designation by money market fund boards. Accordingly, we believe this approach will improve the utility of the rule's use of NRSRO ratings as threshold investment criteria, and is consistent with the goals of Congress in passing the Credit Rating Agency Reform Act.<sup>101</sup>

#### *a. Number of Designated NRSROs*

Under amended rule 2a-7, each money market fund must designate in its registration statement<sup>102</sup> at least four NRSROs that the fund will use to determine, among other things, whether a security is an eligible security.<sup>103</sup> Several commenters expressed concern that permitting funds to designate only three NRSROs (which was recommended by the ICI Report) would simply embrace the current market for ratings, which is dominated by three rating agencies.<sup>104</sup> We share these commenters' concerns and thus are requiring funds to designate at least four NRSROs, an approach recommended by commenters as a way to foster competition among NRSROs to develop a specialized service of providing short-term

<sup>100</sup> See 1983 Adopting Release, *supra* note 6, at paragraphs following n.31.

<sup>101</sup> See Senate Committee on Banking, Housing, and Urban Affairs, Credit Rating Agency Reform Act of 2006, S. Rep. 109-326, at 1 (2006) ("Senate Report No. 109-326") ("The purpose of the 'Credit Rating Agency Reform Act'...is to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."). In 2007, pursuant to the Credit Rating Agency Reform Act, we adopted rules to implement a program for registration and Commission oversight of NRSROs ("NRSRO Rules"). Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (June 5, 2007) [72 FR 33564 (June 18, 2007)] ("NRSRO Rules Adopting Release"). Our rule amendments regarding NRSROs have been designed, among other things, to foster greater competition among NRSROs and to encourage more of them to enter the market. *See, e.g.*, Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009) [74 FR 63832 (Dec. 4, 2009)], at nn.1-3 and accompanying text (*citing* Senate Report No. 109-326, at 1).

<sup>102</sup> The fund must disclose the designated NRSROs, including any limitations with respect to the fund's use of such designation, in the fund's SAI. Amended rule 2a-7(a)(11)(iii). In response to our request for comment on whether to require disclosure of designated NRSROs in money market funds' SAI, *See* Proposing Release, *supra* note 2, at text accompanying n.115, several commenters suggested we require disclosure of designated NRSROs in the fund's registration statement. *See, e.g.*, Fidelity Comment Letter (recommending disclosure in the fund's SAI); Invesco Aim Comment Letter (same); ICI Comment Letter (recommending disclosure in the fund's prospectus or website). In contrast, one commenter objected to disclosure of designated NRSROs in the fund's registration statement on the grounds that investors do not consider this information to be material and sticking the fund's prospectus for each change in designation would be too costly. *See* Federated Comment Letter. We believe that the identity of each designated NRSRO is not essential information for investors, but that some investors may find it useful, and therefore are requiring it in the SAI. *See* generally Form N-1A at General Instruction C.2(b) (noting that the purpose of the SAI is to provide additional information about a fund that is not necessary to be in the prospectus but that some investors may find useful).

<sup>103</sup> Amended rule 2a-7(a)(11). A fund may designate only credit rating agencies that are registered as NRSROs with the Commission under the Exchange Act and the rules adopted under those provisions. *See* section 15E of the Exchange Act [15 U.S.C. 78o-7]; 17 CFR 240.17g-1. In response to our request for comment, one commenter recommended permitting designation of unregistered credit rating agencies on the grounds that this could promote competition. *See* Moody's Comment Letter. Two commenters opposed designation of an unregistered credit rating agency, and one of these commenters argued that the potential for introducing under-researched data into the marketplace could disrupt the orderly functioning of markets. *See* DBRS Comment Letter; Invesco Aim Comment Letter. In light of the enhanced disclosure obligations and ongoing rulemaking initiatives designed to improve the quality and reliability of ratings issued by registered NRSROs, we are maintaining the requirement that only credit rating agencies registered as NRSROs with the Commission may be designated under the rule. *See, e.g., supra* note 93.

<sup>104</sup> *See, e.g.*, DBRS Comment Letter; Wells Fargo Comment Letter; C. Wesselkamper Comment Letter.

ratings to money market funds and improve independent credit ratings for purposes of the rule.<sup>105</sup> We also believe that the designation of at least four NRSROs will allow funds to designate smaller NRSROs that specialize in rating particular investments.

Under the amendments, a fund could designate an NRSRO with respect to short-term credit ratings for only certain types of issuers or securities.<sup>106</sup> This would allow a fund, for example, to designate an NRSRO that specializes in securities issued by insurance companies or banks.<sup>107</sup> This approach, which was supported by several of the commenters,<sup>108</sup> may further encourage new entrants among NRSROs that fund managers might not otherwise consider designating due to lack of confidence in ratings outside the NRSROs' areas of expertise.

#### *b. Board Designation and Annual Determination*

The amendments require each money market fund's board of directors to designate the NRSROs on which the fund will rely for purposes of the rule. In addition, the board must determine at least once each calendar year that each designated NRSRO issues credit ratings that are sufficiently reliable for such use.<sup>109</sup> Before designating an NRSRO and before making its annual determination, a board should have the benefit of the adviser's evaluation regarding the quality of the NRSRO's short-term ratings.<sup>110</sup> We would anticipate that the board's designations and annual determinations would be based on recommendations of the fund adviser and its credit analysts, who would have evaluated each NRSRO based on their experiences in addition to any information provided by the NRSRO. We would expect the adviser's annual evaluation to be based, among other things, on an examination of the methodology an NRSRO uses to rate securities, including the risks they measure, and the NRSRO's record with respect to the types of securities in which the fund invests, including asset backed securities.<sup>111</sup> The reliability of a newly registered NRSRO could be evaluated based upon the quality and relevant experience of the personnel conducting the rating. Even with the recommendations of the fund adviser, we recognize that ultimately, a board's determination whether an NRSRO's ratings are "sufficiently reliable" for use in determining whether a security is an eligible security will be a matter of judgment.

<sup>105</sup> See DBRS Comment Letter; Fidelity Comment Letter. In response to our request for comment on the appropriate number of NRSROs a board should designate, another commenter requested we require funds to designate at least five NRSROs as a way to encourage new entrants to the market. See Federated Comment Letter. See also Proposing Release, *supra* note 2, at text following n.113 and at n.117 and accompanying text (requesting comment).

<sup>106</sup> Amended rule 2a-7(a)(11)(i)(A) (providing that a money market fund's board of directors may designate an NRSRO whose short-term credit ratings with respect to any obligor or security or particular obligors or securities will be used by the fund to determine whether a security is an eligible security).

<sup>107</sup> A fund that has designated an NRSRO to use in determining the eligibility of insurance company-issued securities need not review or monitor any class of ratings that the NRSRO issued with respect to other securities or their issuers in which the fund may invest. A fund adviser (under delegated authority) would be free (but not required) to consider these ratings in determining whether the non-insurance company-issued security (or its issuer) presents minimal credit risks. Amended rule 2a-7(c)(3)(i).

<sup>108</sup> See DBRS Comment Letter; Moody's Comment Letter; Wells Fargo Comment Letter.

<sup>109</sup> Amended rule 2a-7(a)(11)(i). We are requiring funds to perform the annual determination once each calendar year to simplify compliance so that a fund is not in violation of the rule if the board's determination occurs soon after the year anniversary of the previous determination.

<sup>110</sup> Fund boards may, however, also find an NRSRO's record with respect to long-term securities to be helpful in evaluating the overall quality of the organization.

<sup>111</sup> See Moody's Comment Letter (advocating that any board designation be "based on the board's assessment of ratings' attributes, such as quality, comparability and historical performance."). We have recently adopted rule amendments relating to NRSROs that should help fund advisers and their credit analysts in performing their evaluations. Our amendments require NRSROs, among other things, to disclose information about their ratings methodology, experience and performance. For example, NRSROs must disclose in their applications their ratings experience, performance in assessing the creditworthiness of securities and obligors, procedures and methodologies used in determining credit ratings, the types of conflicts NRSROs face and how they manage those conflicts, and the qualifications of the NRSRO's credit analysts. See Items 6, 7 and Exhibits 1, 2, 6, 7, 8 of Form NRSRO. In addition, NRSROs currently are required to disclose on a public web site a random sample of 10% of the ratings histories of issuer paid ratings in each class of credit ratings for which the NRSRO is registered and has issued 500 or more issuer paid credit ratings. Rule 17g-2(a)(8) and (d) [17 CFR 240.17g-2(a)(8) and (d)]. In June of this year, these public disclosures will have to include ratings action histories for *all* credit ratings initially determined on or after June 26, 2007. See Amendments to Rules for Nationally Recognized Statistical Ratings Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009) [74 Fed. Reg. 63832 (Dec. 4, 2009)] at text following n.19 and compliance date.

Many commenters expressed concern that a money market fund's board of directors does not have the necessary expertise to designate NRSROs, and urged that we delegate the authority to fund advisers to make the designation.<sup>112</sup> A number of these commenters seem to assume that we would require fund boards to engage in the type of analysis that we expect the adviser will provide the board for its consideration. We believe that it will be useful for boards to consider the designation of NRSROs, a role not unlike the role that many boards play in approving other matters of substantial significance to the operation of the fund.<sup>113</sup> Board designation and determination (at least once a calendar year) will serve as a check on fund managers that may have conflicts of interest in selecting an NRSRO from which the manager seeks a rating for the fund (in order to facilitate marketing the fund),<sup>114</sup> or an NRSRO that may accommodate the fund's investment in higher yielding, riskier securities.<sup>115</sup>

### *c. Operation of the Rule*

Once a board has designated the NRSROs, the fund could look to the designated NRSROs whenever it has to consider credit ratings under rule 2a-7 unless and until the board changes the designation.<sup>116</sup> A fund must look to only the designated NRSROs to determine whether the security is an eligible security, a rated security,<sup>117</sup> and whether it is a first tier or a second tier security.<sup>118</sup> Under the amendments, a security is an unrated security if neither the security nor its issuer has received a short-term rating from any of the designated NRSROs.<sup>119</sup> Accordingly, before investing in the security, the fund adviser must make a determination that the security is of comparable quality to a rated security.<sup>120</sup> After a money market fund acquires a security, the fund manager must monitor only the ratings of designated NRSROs

<sup>112</sup> See, e.g., ABA Comment Letter; MFDF Comment Letter; Northern Funds Comment Letter. These commenters responded to our discussion of this approach in the Proposing Release. See Proposing Release, *supra* note 2, at text following n.118.

<sup>113</sup> See, e.g., amended rule 2a-7(c)(8) (requiring the fund's board of directors to establish procedures to stabilize the fund's NAV, including procedures providing for, among other things, the board's periodic review of the fund's shadow price, the methods used for calculating shadow price, and what action, if any, the board should initiate if the fund's shadow price exceeds amortized cost by more than ½ of 1%).

<sup>114</sup> See Wells Fargo Comment Letter.

<sup>115</sup> See Moody's Comment Letter (noting that the more narrowly defined the categories of ratings for which a designation can be obtained, the "easier it could be for mutual funds to game the system, e.g., by dropping an NRSRO from its list of designated NRSROs for a particular class of ratings because the NRSRO has introduced a more conservative ratings methodology").

<sup>116</sup> We have changed the term from "NRSRO" to "designated NRSRO" throughout the rule each time it is used. As a consequence, changes in the fund's designated NRSROs may affect the ability of the fund to purchase a new security or rollover a current holding, and may require the fund to reassess promptly whether the security continues to present minimal creditworthiness and dispose of a current holding. This is because a new designation of an NRSRO (or a removal of a designated NRSRO) is now treated under the rule as the equivalent of a credit event requiring the fund board or adviser to consider the rating of the newly designated NRSRO (or preclude the consideration of a formerly designated NRSRO). For example, if a fund acquires an unrated security (i.e., a security (or its issuer) that does not have a short-term rating from a designated NRSRO) that the fund considered to be equivalent to a first tier security and the fund thereafter designates a new NRSRO that has rated the security as a second tier security, the fund must then treat the security as a second tier security. The fund would not be required to dispose of the security (although it would be required to perform a credit assessment, which might prompt it to dispose of the security) even if the position in the security exceeds the fund's limits on second tier securities, because compliance with the limits on second tier securities is determined immediately after the fund acquires the security. See amended rule 2a-7(c)(3)(ii); 2a-7(c)(4)(i)(C). The fund could only roll over the position to the extent that immediately after the rollover the fund would meet the rule's limits on second tier securities. See amended rule 2a-7(a)(1) (defining "acquisition" to include a rollover of a position in security).

<sup>117</sup> Amended rule 2a-7(a)(23) (defining the term "requisite NRSROs"). For purposes of determining whether a rated security is an eligible security and a first tier security, rule 2a-7 requires the fund to determine whether the security (or its issuer) has received a short-term rating from the requisite NRSROs. Amended rule 2a-7(a)(12)(i). Under the amended rule, the requisite NRSROs must be drawn from the designated NRSROs. Amended rule 2a-7(a)(23). Thus, for example, a security that is rated as a first tier security by two NRSROs, only one of which is a designated NRSRO, and as a second tier security by another designated NRSRO, is a split-rated security and thus a second tier security. *Id.*

<sup>118</sup> Amended rule 2a-7(a)(12) (defining "eligible security"); amended rule 2a-7(a)(14) (defining "first tier security"); and amended rule 2a-7(a)(24) (defining "second tier security").

<sup>119</sup> Amended rule 2a-7(a)(30) (defining "unrated security" by reference to amended rule 2a-7(a)(21), which defines a "rated security" as, among other things, a security that has received or been issued by an issuer that has received a short-term rating by a designated NRSRO).

<sup>120</sup> Amended rule 2a-7(a)(12) (defining "eligible security").

to determine whether a change in those ratings requires the board to reassess promptly whether the security continues to present minimal credit risks or to dispose of a portfolio security that is no longer an eligible security.<sup>121</sup>

### 3. Asset Backed Securities

We are amending rule 2a-7 to eliminate a requirement that an asset backed security (“ABS”) be rated by at least one NRSRO in order to be an eligible security that a money market fund may acquire.<sup>122</sup> As a consequence, funds may acquire an unrated asset backed security that otherwise meets the requirements of rule 2a-7, including those requirements that apply to unrated securities.<sup>123</sup>

In 1996, we limited funds to investing in rated ABSs because we thought that NRSROs played a beneficial role in assuring that assets underlying an ABS were properly valued and would support the cash flows required to fund the ABS, and we were concerned that fund advisers may not be in as good a position to perform the legal, structural, and credit analysis that the rating agencies performed.<sup>124</sup> As discussed in the Proposing Release, NRSROs rapidly downgraded ABSs from their status as first tier securities over a short time period during 2007–2008.<sup>125</sup> The NRSROs thus did not seem to play a role in buttressing the minimal credit risk analysis of fund management sufficient to warrant a requirement that *all* ABSs be rated to be eligible for money market fund investment. We would otherwise have expected a slower, more orderly downgrading process for these ABSs, which would have permitted money market funds to gradually roll off the paper.

We received only a few comments on this approach.<sup>126</sup> One NRSRO commenter supported removing this requirement.<sup>127</sup> Two urged us to keep the ratings requirement for ABSs,<sup>128</sup> and one of those asserted that ratings “under appropriate criteria” enhance the liquidity of ABSs and provide credit and structural expertise and research that benefit investors.<sup>129</sup> As noted above, we do not believe that NRSRO ratings of ABSs served this function during the 2007-2008 turmoil in the ABS marketplace, and we no longer believe that the provision of rule 2a-7 that has required such ratings for *all* ABSs is warranted as serving its intended purpose, and thus we are eliminating this requirement.<sup>130</sup>

<sup>121</sup> Amended rule 2a-7(c)(7)(i)(A) (requiring a fund’s board of directors to reassess promptly whether the security continues to present minimal credit risks and cause the fund to take action if: (i) the security ceases to be a first tier security because it no longer has the highest rating from the requisite NRSROs or, in the case of an unrated security, the board determines it is no longer of comparable quality to a first tier security, or (ii) the security is an unrated security or second tier security and the fund’s investment adviser (or portfolio manager) becomes aware since acquisition of the security that any designated NRSRO has given it a rating below the designated NRSRO’s second highest short-term rating); amended rule 2a-7(c)(7)(ii)(B) (requiring a fund to dispose of a security that ceases to be an eligible security as soon as practicable consistent with achieving an orderly disposition of the security, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund).

<sup>122</sup> We are thus amending current rule 2a-7(a)(10)(ii) to eliminate paragraph (B) and renumber paragraph 2a-7(a)(10)(ii)(A) as 2a-7(a)(12)(ii).

<sup>123</sup> See, e.g., amended rule 2a-7(a)(12)(ii); (c)(3)(iv)(C); (c)(7)(i)(A)(1). As under the current rule, if an asset backed security is a rated security, it will be required to satisfy the rule’s ratings criteria. Amended rule 2a-7(a)(12)(i).

<sup>124</sup> Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] at Section II.E.4; Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] (“1993 Proposing Release”) at nn.110–112 and accompanying text.

<sup>125</sup> See Proposing Release, *supra* note 2, at Section II.A.4. See also Standard & Poor’s, *Global Structured Finance Default and Transition Study—1978–2008: Credit Quality of Global Structured Securities Fell Sharply in 2008 amid Capital Market Turmoil* (Feb. 25, 2009), available at <http://www2.standardandpoors.com/portal/site/sp/en/ca/page.article/3,3,3,0,1204847668460.html> (showing greater default rate and significantly greater downgrades in structured finance securities).

<sup>126</sup> We also solicited comment generally on whether, and if so how, we should amend rule 2a-7 to generally address the risks presented by ABSs. We received a number of comments in response to this request, and will consider them in developing further amendments to rule 2a-7.

<sup>127</sup> See Moody’s Comment Letter.

<sup>128</sup> See Am. Securit. Forum Comment Letter; Shriver Poverty Law Ctr. Comment Letter.

<sup>129</sup> See Am. Securit. Forum Comment Letter.

<sup>130</sup> See Statement of Lawrence J. White, SEC Roundtable to Examine Oversight of Credit Rating Agencies at 2 (Apr. 15, 2009) (initial ratings on bonds securitized from subprime residential mortgages “proved to be excessively optimistic”—especially for the bonds based on mortgages originated in 2005 and 2006).

We do note, however, that as part of the minimal credit risk analysis that any money market fund must conduct before investing in an ABS, the board of directors (or its delegate) should: (i) analyze the underlying ABS assets to ensure that they are properly valued and provide adequate asset coverage for the cash flows required to fund the ABS under various market conditions; (ii) analyze the terms of any liquidity or other support provided by the sponsor of the ABS; and (iii) otherwise perform the legal, structural, and credit analyses required to determine that the particular ABS involves appropriate risks for the money market fund.<sup>131</sup>

## B. Portfolio Maturity

We are adopting amendments to rule 2a-7 to further restrict the maturity limitations on a money market fund's portfolio in order to reduce the exposure of money market fund investors to certain risks, including interest rate risk, spread risk, and liquidity risk. First, we are reducing the maximum weighted average portfolio maturity permitted by the rule from 90 days to 60 days. Second, we are adopting a 120-day limit on the weighted average life of a money market fund's portfolio, which will limit the portion of a fund's portfolio that could be held in longer term adjustable-rate securities. Finally, we are deleting a provision in the rule that permitted certain money market funds to acquire Government securities with extended maturities of up to 762 calendar days.

### 1. Weighted Average Maturity

We are amending rule 2a-7 to require that each money market fund maintain a dollar-weighted average portfolio maturity (WAM) appropriate to its objective of maintaining a stable net asset value or price per share, but in no case greater than 60 days.<sup>132</sup> We believe that such a limit on the maximum WAM will result in money market funds that are more resilient to changes in interest rates that may be accompanied by other market shocks, and thus reduce the likelihood of a run and better protect money market fund investors. As we explained in the Proposing Release, a portfolio weighted towards securities with longer maturities increases the fund's exposure to interest rate risk, amplifies spread risk, and decreases the ability of a fund to pay redeeming shareholders.<sup>133</sup>

Most commenters that addressed this proposal supported further reducing the maximum WAM of fund portfolios in order to reduce the funds' exposure to related risk. Those commenters were divided between those supporting the 60-day maximum WAM that we proposed<sup>134</sup> and those supporting a reduction to 75 days.<sup>135</sup> Other commenters argued for no reduction at all (i.e., leaving the limit at 90 days).<sup>136</sup> Commenters supporting a maximum WAM limitation of 60 days believed that such a reduction would be appropriate to increase the stability and liquidity of money market funds<sup>137</sup> and would reduce funds' exposure to interest rate risk.<sup>138</sup> One asserted that a 60-day limitation is appropriate as it prioritizes a money market fund's safety and liquidity over yield.<sup>139</sup>

Commenters supporting a maximum WAM of 75 days argued that such a limitation would achieve the Commission's goal of reducing funds' exposure to interest rate risk while providing funds with sufficient flexibility to invest in high quality securities when shorter term investments are scarce.<sup>140</sup> Some expressed concern about whether a 60-day WAM would reduce a money market fund's ability to generate sufficient yield.<sup>141</sup> Still others argued that a shorter WAM could

<sup>131</sup> See 1993 Proposing Release, *supra* note 124, at nn.108–111 and preceding and accompanying text.

<sup>132</sup> See amended rule 2a-7(c)(2).

<sup>133</sup> See Proposing Release, *supra* note 2, at Section II.B.1.

<sup>134</sup> See, e.g., Goldman Sachs Comment Letter; Comment Letter of the Institutional Money Market Funds Association (Sept. 8, 2009) ("IMMFA Comment Letter"); Northern Funds Indep. Trustees Comment Letter.

<sup>135</sup> See, e.g., Charles Schwab Comment Letter; Comment Letter of GE Asset Management Incorporated (Sept. 8, 2009) ("GE Asset Mgt. Comment Letter"); T. Rowe Price Comment Letter.

<sup>136</sup> See, e.g., State Street Comment Letter; Comment Letter of Victory Capital Management (Sept. 8, 2009) ("Victory Cap. Mgt. Comment Letter"); Wells Fargo Comment Letter.

<sup>137</sup> See Tamarack Funds Comment Letter.

<sup>138</sup> See TDAM Comment Letter.

<sup>139</sup> See Invesco Aim Comment Letter.

<sup>140</sup> See, e.g., Charles Schwab Comment Letter; GE Asset Mgt. Comment Letter; ICI Comment Letter.

<sup>141</sup> See, e.g., Charles Schwab Comment Letter; Comment Letter of Crane Data LLC and Money Fund Intelligence (Aug. 31, 2009) ("Crane Data Comment Letter"); T. Rowe Price Comment Letter.



make some money market funds more risky because of the alternative investment strategies they might employ as a result.<sup>142</sup> Finally, two commenters opposing any change in the maximum WAM permitted by rule 2a-7 argued that liquidity risk to funds is more appropriately limited by other aspects of our amendments to rule 2a-7, and that the resulting reduction in yield would “homogenize” money market funds to such an extent that investors may be driven to invest in unregulated funds, thus increasing systemic risk.<sup>143</sup>

We believe that the maximum WAM permissible for money market funds should be reduced to 60 days in order to reduce the likelihood of funds breaking the buck. The increased resilience to simultaneous stresses from interest rate and other risks that a money market fund would achieve through a maximum WAM of 60 days is significant. A fund with a 90-day WAM could withstand an instantaneous change in interest rates of 200 basis points before breaking the buck.<sup>144</sup> In contrast, a fund with a WAM of 60 days could withstand an interest rate change of 300 basis points without breaking the buck.<sup>145</sup> Although an interest rate change of such a magnitude may be unlikely to occur,<sup>146</sup> funds must also be able to withstand multiple shocks occurring simultaneously, such as those that occurred in September 2008 when there was a simultaneous increase in LIBOR rates and widening spreads due to credit deterioration and liquidity pressures, together with extraordinary redemptions.<sup>147</sup>

A fund with a lower WAM has significantly greater protection in the circumstances described above. For example, a fund with a 90-day WAM facing a change in credit spreads of 50 basis points and redemptions of 10 percent would break the buck with an interest rate change of a little more than 100 basis points.<sup>148</sup> Greater shocks from an even larger increase in spreads or redemptions would only lessen that interest rate cushion—last fall increases in spreads and redemptions were

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<sup>142</sup> One commenter noted that a WAM limitation longer than 60 days would allow a fund to improve the credit profile of its portfolio by substituting longer term Government securities for shorter term corporate securities. *See* BlackRock Comment Letter. Another commenter argued that a reduction would lead to fund portfolios with a “barbelled” maturity structure in which the fund balanced the low yield offered by the large amount of very short-term securities it would be required to hold with an offsetting amount of riskier longer term securities, which could increase the riskiness of fund portfolios. *See* Comment Letter of Waddell & Reed/Ivy Fund Portfolio Managers (Sept. 8, 2009) (“Waddell & Reed Comment Letter”). Another stated that higher risk issuers tend to be limited to issuing shorter maturity securities, so a shorter WAM limitation could increase a fund’s credit risk profile. *See* Wells Fargo Comment Letter.

<sup>143</sup> *See* Fidelity Comment Letter; State Street Comment Letter. Several commenters also asserted that any reduction in WAM would increase issuers’ reliance on short-term funding, also increasing systemic risk. *See, e.g.*, Am. Secur. Forum Comment Letter; State Street Comment Letter; Wells Fargo Comment Letter.

<sup>144</sup> *See* Fidelity Comment Letter.

<sup>145</sup> Our staff supplemented stress test analysis conducted by commenters with more data points and stress scenarios to illustrate the impact on a money market fund’s net asset value per share from multiple stresses on that fund’s portfolio. A fund with a 75-day WAM could withstand an interest rate change of less than 250 basis points without breaking the buck. We note that these scenarios also represent the most conservative scenarios because they assume that the money market fund started with a market-based net asset value of \$1.00. It is our understanding that at any point in time, a large number of money market funds will not start from a market-based net asset value of \$1.00—many will start with a market-based net asset value of less than a dollar and thus a smaller interest rate change will cause the funds to break the buck.

<sup>146</sup> Interest rate shocks of a 300 basis point magnitude over a relatively short period of time have occurred, although not since the late 1970s. *See* Federal Reserve Bank of New York, Historical Changes of the Target Federal Funds and Discount Rates, 1971 to present, *available at* <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html>. In low interest rate environments (such as today), a shock in interest rates could occur if the Federal Reserve determines to raise interest rates quickly, for example, to stave off inflation as the economy recovers or to strengthen the U.S. dollar.

<sup>147</sup> *See* Proposing Release, *supra* note 2, at nn.47–48, 53, 63, 66–67 and accompanying text. *See also infra* note 178 (discussing the increase in LIBOR during the financial crisis). Many money market fund portfolio holdings at the time were tied to LIBOR.

<sup>148</sup> This assumes a weighted average life limitation of 120 days. A fund with a 75-day WAM could withstand a 50 basis point increase in credit spreads across its portfolio, 10% redemptions, and an increase in interest rates of 125 basis points before breaking the buck, assuming a 120-day weighted average life.

considerably above this level.<sup>149</sup> A fund with a 60-day WAM would be in a better position to withstand multiple shocks without breaking the buck than if it maintained a 90-day or 75-day WAM.<sup>150</sup>

We disagree with those commenters that asserted that a reduction of maximum permissible WAM would have a significant adverse effect on money market funds' investment strategies or yield. We have not observed such adverse effect in funds with WAMs below 60 days or a greater tendency to invest in riskier short-term securities or to follow riskier portfolio strategies to increase yield. These funds do not appear to have had great difficulties in creating portfolios that generated competitive yields and attracted investors.<sup>151</sup> Indeed, many domestic money market funds currently limit their WAM to a maximum of 60 days voluntarily, a limit they likely would have discontinued if they had experienced the management or competitive difficulties suggested by commenters.<sup>152</sup> No commenter reported to us that any of these funds were doing so. We acknowledge that one consequence of our amendments may be to further "homogenize" fund portfolios as managers have fewer avenues to acquire yield by exposing the funds to risk, but we believe that the level of potential homogenization is justified to reduce the risk to investors that a money market fund will break the buck. In addition, we are not persuaded by comments that a likely consequence of a shortened maximum WAM will be riskier portfolios. Accordingly, we are adopting the 60-day WAM limitation as proposed.

## 2. Weighted Average Life

We are adopting, as proposed, a requirement that limits the dollar-weighted average life to maturity of a money market fund's portfolio to 120 calendar days.<sup>153</sup> Unlike weighted average maturity, the weighted average life (or "WAL") of a portfolio is measured without reference to any rule 2a-7 provision that otherwise permits a fund to shorten the maturity

<sup>149</sup> In addition, we note that spreads have widened to significant degrees in the past. See, e.g., Benjamin N. Friedman & Kenneth N. Kuttner, *Why Does the Paper-Bill Spread Predict Real Economic Activity?*, NBER Working Paper No. 3879, at Fig.1 (Oct. 1991) (showing historical spreads for 6-month commercial paper over 6-month Treasury bill rates from 1959 to 1990).

<sup>150</sup> Based on staff review of various stress test scenarios, a fund with a 60-day WAM could withstand a 50 basis point increase in credit spreads across its portfolio, 10% redemptions, and an increase in interest rates of over 150 basis points before breaking the buck, again assuming a weighted average life limitation of 120 days. Others have recognized that exposure to multiple stresses may call for a lower WAM. See, e.g., Standard & Poor's, *Fund Ratings Criteria: Market Price Exposure*, at 3 (2007), available at <http://www2.standardandpoors.com/spf/pdf/events/MMX709.pdf> (stating that money market funds with a greater liquidity risk due to a smaller asset size or shareholder composition may need to maintain a lower WAM than 60 days).

<sup>151</sup> Similarly, European stable value money market funds do not appear to have had these difficulties. As the Institutional Money Market Fund Association (IMMFA) notes in its comment letter, IMMFA funds (which manage a significant amount of stable value money market fund assets in Europe) have been required to maintain a maximum WAM of 60 days since 2002. The recent proposals by the European Union's Committee of European Securities Regulators to create common requirements for European money market funds would impose a maximum 60-day WAM for short-term money market funds. See Committee of European Securities Regulators Consultation Paper, *A Common Definition of European Money Market Funds*, CESR/09-850 (Oct. 20, 2009), available at [http://www.cesr.eu/index.php?page=consultation\\_details&id=151](http://www.cesr.eu/index.php?page=consultation_details&id=151).

<sup>152</sup> For some time and through various interest rate and market environments a large portion of domestic money market funds have maintained a maximum WAM of less than 60 days. According to data provided by the ICL, from January 1998 through April 2009, even the 75th percentile of prime money market funds has maintained an average WAM of 53 days and the 90th percentile of prime money market funds has maintained an average WAM of 65 days. Investment Company Institute, *Average Maturity of Taxable Prime Money Market Funds, 1998–2009*, available at <http://www.sec.gov/comments/s7-11-09/s71109-14.htm>. The 75th percentile of these funds only reported a WAM in excess of 60 days on 8 monthly occasions out of the 136 monthly time periods reported. We also note that to obtain a top rating from an NRSRO, money market funds must maintain a WAM of no greater than 60 days. According to the iMoneyNet Money Market Fund Analyzer Database, as of November 17, 2009, 61% of money market fund assets were held in funds that were top rated by at least one NRSRO and 34% of money market funds had a top rating from at least one NRSRO.

<sup>153</sup> See amended rule 2a-7(c)(2)(iii). This limitation will apply to all money market funds (including taxable and tax-exempt funds).

of an adjustable-rate security by reference to its interest rate reset dates.<sup>154</sup> The WAL limitation thus restricts the extent to which a fund can invest in longer term securities that may expose a fund to spread risk.<sup>155</sup>

We proposed the WAL limitation because we were concerned that the traditional WAM limitation of rule 2a-7 does not require that a manager of a money market fund limit the spread risk associated with longer term adjustable-rate securities.<sup>156</sup> These securities are more sensitive to credit spreads than short-term securities with final maturities equal to the reset date of the longer term security.<sup>157</sup> The WAL limitation will provide an extra layer of protection for funds and their shareholders against spread risk, particularly in volatile markets. We proposed a 120-day limit as a prudent limit recommended to us in the ICI Report and one that we understand is currently used by some money market fund managers.<sup>158</sup> We requested comment on whether a higher or lower WAL limitation would be more appropriate.

Twenty-one commenters supported adding a WAL limit to the rule.<sup>159</sup> One large money market fund manager, for example, described the WAL as “a very prudent addition to the rule that, combined with the minimum liquidity requirements...represents an important and substantive risk reduction in the permissible construction of a money fund portfolio.”<sup>160</sup> Another acknowledged that “the risk that such a security will begin to deviate significantly from its Amortized Cost increases with its maturity,” and agreed that “the new 120-day WAL limit should control this risk.”<sup>161</sup>

Two commenters generally opposed a WAL limitation.<sup>162</sup> One urged us to consider, instead, revising the maturity-shortening provisions of rule 2a-7 to require money market funds to measure the maturity of adjustable-rate securities

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<sup>154</sup> The Fidelity Comment Letter, the Comment Letter of HighMark Capital Management, Inc. (Sept. 8, 2009) (“HighMark Capital Comment Letter”), and the ICI Comment Letter requested that the Commission amend rule 2a-7 to specify how cash balances held by money market funds would be treated under the WAM and WAL limitations. For purposes of the WAM and WAL limitations, cash balances have a maturity of one day. The Tamarack Funds Comment Letter also suggested that the Commission address extendible notes. For purposes of the WAM and WAL limitations, in calculating the final legal maturity of a security extendible at the option of the issuer the security should be deemed fully extended. *See* amended rule 2a-7(d) (final maturity is determined with reference to the time at which a fund will unconditionally receive payment); *see also* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] at n.151 and accompanying text (discussing the unconditional right to receive payment with respect to demand features).

<sup>155</sup> *See* Morgan Stanley, Weighted Average Life: Enhancing Money Market Fund Transparency (2009), *available at* [http://www.morganstanley.com/msamg/msimintl/docs/en\\_US/common/comm/200907\\_mm\\_update.pdf](http://www.morganstanley.com/msamg/msimintl/docs/en_US/common/comm/200907_mm_update.pdf) (“[Morgan Stanley Investment Management is] introducing WAL to supplement our WAM reporting. The WAL calculation is based on a security’s stated final maturity date or, when relevant, the date of the next demand feature when the fund may receive payment of principal and interest (such as a put feature). Accordingly, WAL reflects how a portfolio would react to deteriorating credit (widening spreads) or tightening liquidity conditions. We believe that when viewed alongside WAM, the supplemental WAL disclosure will provide investors with a further degree of insight into our portfolios’ structure.”).

<sup>156</sup> For example, if the market perceived an issuer’s credit risk as deteriorating, the spreads on that issuer’s 30-day floating-rate securities would likely widen to a lesser extent than the spreads on that issuer’s 397-day floating-rate securities because the longer term securities have a much longer exposure to the issuer’s credit risk (assuming neither security had a Demand Feature). Because the WAM limitation allows the use of interest rate reset dates to shorten the maturity of a security, each of the 397-day floating-rate securities and the 30-day floating-rate securities would be considered to have a maturity of one day. In contrast, under the WAL limitation we are today adopting each adjustable-rate security without a Demand Feature would have a maturity equal to its final legal maturity. As a result, if spreads on these securities widen to different degrees due to changing market perceptions of credit risk or liquidity, the WAL limitation will capture these different risk exposures.

<sup>157</sup> *See* Proposing Release, *supra* note 2, at Section II.B.2.

<sup>158</sup> *See, e.g.*, HighMark Capital Comment Letter (“We have been calculating a WAL for years and believe it will more appropriately reflect the total interest rate and spread risk of a portfolio.”). *See also* JPMorgan Prime Money Market Fund Quarterly Fact Sheet (Dec. 31, 2009), *available at* <https://www.jpmorganfunds.com/cm/BlobServer/FS-PMM.PDF?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1158572105887&blobheader=application%2FPDF&blobheadername1=Content-Disposition&ssbinary=true&blobheadervalue1=inline;filename=FS-PMM-P.PDF> (showing the fund’s WAL over the previous year).

<sup>159</sup> *See, e.g.*, Bankers Trust Comment Letter; Goldman Sachs Comment Letter; Northern Funds Trustees Comment Letter.

<sup>160</sup> *See* BlackRock Comment Letter.

<sup>161</sup> *See* Federated Comment Letter.

<sup>162</sup> *See* Thrivent Comment Letter; USAA Comment Letter.

by reference to their final legal maturity date rather than the date at which the interest rate resets.<sup>163</sup> Such a change would dramatically reduce the ability of money market funds to invest in floating rate securities, and as we discuss below, such a reduction may be unnecessary.<sup>164</sup> Another commenter asserted that the WAL limitation was unnecessarily restrictive of prime retail funds and disagreed with our assessment of the spread risk posed by floating-rate Government securities.<sup>165</sup> The commenter, however, offered no explanation of why the exposure to spread risk would have less harmful consequences for a prime retail fund than for other types of funds and thus be of less concern.

Most commenters supported the proposed WAL limit of 120 days,<sup>166</sup> which the ICI comment letter described as “flexible enough even during ‘normal’ market conditions to not unduly restrict a fund’s ability to offer a diversified portfolio of short-term, high quality debt securities.”<sup>167</sup> Four commenters supported a WAL with a longer term, with two of these commenters suggesting a longer WAL for government money market funds than for other money market funds.<sup>168</sup> One of these commenters argued that the spread risk associated with Government floating-rate securities is different from the spread risk associated with non-Government securities.<sup>169</sup> Another commenter only supported a WAL limitation applicable to Government securities with maturities of more than two years, arguing that applying a 120 day WAL to all adjustable-rate Government securities would disrupt the short-term debt markets and hinder the ability of Government security issuers to meet internal funding needs.<sup>170</sup>

On balance, we conclude that 120 days is an appropriate length of time for the WAL limitation. A WAL limitation of, for example, 90 days appears to be unnecessarily restrictive to money market funds because it could significantly constrain the range of high-quality, short-term debt securities in which money market funds may invest, particularly when combined with our new minimum liquidity requirements.<sup>171</sup> Such a short WAL limitation also may provide spread risk protection beyond what is reasonably necessary to enhance the stability of money market funds. For a money market fund to break the buck while maintaining a WAL of 90 days, average spreads on all securities in the fund’s portfolio would have to widen beyond 200 basis points.<sup>172</sup> Other securities held by money market funds may not simultaneously

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<sup>163</sup> See USAA Comment Letter. Amended rule 2a-7(d) allows money market funds to shorten the maturity of an adjustable-rate portfolio security for purposes of the WAM limitation by referring to the security’s interest rate reset date, rather than the final legal maturity of the security, if the security has a final maturity of 397 days or less (for corporate securities) or an interest rate that adjusts no less frequently than every 397 days for Government securities.

<sup>164</sup> This comment also implies that rule 2a-7 should only have a WAL limitation (and not a separate WAM limitation). We believe that the WAM and WAL limitations address different risks (with the WAM primarily aimed at limiting interest rate risk and the WAL primarily aimed at limiting spread risk) and thus believe having both limitations in rule 2a-7 protects money market funds and their investors.

<sup>165</sup> See Thrivent Comment Letter.

<sup>166</sup> See, e.g., BlackRock Comment Letter; Invesco Aim Comment Letter; Comment Letter of Ridge Worth Capital Management, Inc. (“RidgeWorth Comment Letter”).

<sup>167</sup> ICI Comment Letter.

<sup>168</sup> See Fidelity Comment Letter (supporting a 150-day WAL for government money market funds and a 120-day WAL for all other money market funds); Victory Cap. Mgt. Comment Letter (supporting a 150-day WAL); C. Wesselkamper Comment Letter (supporting a 180-day WAL for government money market funds and a 150-day WAL for all other money market funds); Wells Fargo Comment Letter (supporting a 180-day WAL).

<sup>169</sup> See Fidelity Comment Letter.

<sup>170</sup> See Comment Letter of Fannie Mae (Sept. 3, 2009) (“Fannie Mae Comment Letter”). One commenter also argued that a 120-day WAL would limit Government security issuers’ ability to meet their funding needs. See Fidelity Comment Letter.

<sup>171</sup> One commenter stated that the Commission should not impose a WAL shorter than 120 days, asserting that a shorter limitation would be unnecessarily restrictive and limit a fund’s ability to maintain a diversified portfolio of high quality short-term debt securities. See Charles Schwab Comment Letter. No commenters supported a shorter WAL than 120 days.

<sup>172</sup> This assumes that there are no other simultaneous shocks to the fund’s portfolio from redemption pressures or otherwise. In order to evaluate commenters’ discussion about the appropriate length of time for a WAL limitation in the context of the shocks a money market fund might face, we again referred to stress test scenarios.

face such spread widening even if the commercial paper market is under stress.<sup>173</sup> Accordingly, protection across an entire money market fund portfolio against spread widening of the magnitude experienced in the commercial paper market during the fall of 2008 may be unnecessary.

On the other hand, we are not convinced that a WAL significantly longer than 120 days would be appropriate for a money market fund that is seeking to maintain a stable net asset value. For example, with a 150-day WAL, a money market fund would break the buck with a spread widening of just over 120 basis points (assuming no other simultaneous stresses on the fund's portfolio).<sup>174</sup> Historically, commercial paper spreads, for example, have widened to that extent fairly frequently.<sup>175</sup> Given this limited resilience to spread widening, and given that a money market fund would break the buck even earlier if any other shocks to the fund's portfolio occurred simultaneously, we have determined not to adopt a longer WAL, such as a 150- or 180-day WAL. We note that the European Union's Committee of European Securities Regulators has also recently proposed requiring that short-term money market funds adhere to a maximum 120-day WAL.<sup>176</sup>

Finally, we are not providing for a longer WAL for money market funds that primarily invest in Government securities. While some commenters asserted that adjustable-rate Government securities have a more benign credit risk profile,<sup>177</sup> they are still exposed to widening interest rate spreads to the same extent as non-Government securities and, as we noted in the Proposing Release, spreads on certain adjustable-rate Government securities did widen during the fall of 2008.<sup>178</sup> In addition, many prime money market funds also hold a sizeable portion of Government securities (and may hold even more Government securities after the adoption of rule 2a-7's new liquidity requirements). Given this fact, allowing government money market funds to have a longer WAL solely because they hold more Government securities than prime funds do, does not appear to us to be an approach that treats the risks attendant to longer term, adjustable-rate Government securities equally, and thus appears inappropriate.

### 3. Maturity Limit for Government Securities

The Commission is deleting a provision of rule 2a-7 that has permitted a fund that relied exclusively on the penny-rounding method of pricing to acquire Government securities with remaining maturities of up to 762 days, rather than

<sup>173</sup> Such spread widening even in commercial paper has been rare and commercial paper typically only comprises a portion of money market funds' portfolios. Spreads between 3-month commercial paper and the 3-month Treasury bill widened to approximately 300 basis points at the height of the financial crisis in the fall of 2008 and widened similarly in the mid-1970s, but otherwise have rarely widened by 200 basis points in the last 50 years. This analysis is based on commercial paper spread data contained in Bradley T. Ewing, Gerald J. Lynch & James E. Payne, *Monetary Volatility and the Paper-Bill Spread*, in *Progress in Economics Research* (2006), at p. 58, supplemented with data from Bloomberg on spreads between yields of 3-month commercial paper and the 3-month Treasury bill.

<sup>174</sup> This is based on our staff's analysis of stress test scenarios.

<sup>175</sup> See Ewing et al., *supra* note 173, at 58.

<sup>176</sup> See Committee of European Securities Regulators Consultation Paper, *A Common Definition of European Money Market Funds*, CESR/09-850 (Oct. 20, 2009), available at [http://www.cesr.eu/index.php?page=consultation\\_details&id=151](http://www.cesr.eu/index.php?page=consultation_details&id=151). In addition, Europe's Institutional Money Market Fund Association (IMMFA) recently has adopted changes to its code of conduct that will require IMMFA money market funds to adhere to a maximum 120-day WAL. See IMMFA Code of Practice, at Section 40, available at <http://www.immfa.org/About/Codefinal.pdf>.

We also note that the rating agencies have taken varied approaches to limiting the WAL of rated money market funds. Fitch has adopted revised ratings requirements limiting top-rated money market funds to a WAL of 120 days, but allowing longer WALs for lesser rated money market funds. See Fitch Ratings, *Global Money Market Fund Rating Criteria* (Oct. 5, 2009), available at [http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=470368](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=470368). Standard & Poor's has proposed more restrictive requirements that would limit top-rated money market funds to a WAL of 90 days, subject to upward adjustment to no more than 120 days depending on the extent of Government securities in the money market fund's portfolio. See Standard & Poor's, *Principal Stability Fund Rating Criteria* (Jan. 5, 2010), available at <http://www2.standardandpoors.com/spf/pdf/events/FITcon11410RFC.pdf>.

<sup>177</sup> See, e.g., Fidelity Comment Letter. *But see* BlackRock Comment Letter (recent events have shown that spread relationships can be variable for agency securities); Wells Fargo Comment Letter (credit spreads on Government securities widened to a significant degree in 2008).

<sup>178</sup> See Proposing Release, *supra* note 2, at Section II.B.2. We understand that many floating-rate securities issued by federal agencies and outstanding during the financial crisis had rates tied to LIBOR. As noted in the Proposing Release, the "TED" spread (the difference between the U.S. Treasury Bill rate and LIBOR) reached a high of 463 basis points on October 10, 2008. See *id.*, at n.67. We understand that most adjustable-rate Government securities held by money market funds had a final maturity of two years or less and thus limiting the WAL limitation to adjustable-rate Government securities with final maturities greater than two years would not address these securities' spread risk.

the 397-day limit otherwise provided by the rule.<sup>179</sup> As we noted in the Proposing Release,<sup>180</sup> we are unaware of any money market fund that currently relies solely on the penny-rounding method of pricing, and none that holds fixed-rate Government securities with remaining maturities of two years, which would involve the assumption of a substantial amount of interest rate risk. We received one comment on this topic, which supported the change.<sup>181</sup> Accordingly, we are adopting this change as proposed.<sup>182</sup>

### C. Portfolio Liquidity

We are amending rule 2a-7 to require that money market funds maintain a sufficient degree of liquidity necessary to meet reasonably foreseeable redemption requests and reduce the likelihood that a fund will have to meet redemptions by selling portfolio securities into a declining market. As discussed in the Proposing Release, money market funds generally have a higher and less predictable volume of redemptions than other open-end investment companies.<sup>183</sup> Their ability to maintain a stable net asset value will depend, in part, on their ability to convert portfolio holdings to cash to pay redeeming shareholders without having to sell them at a loss. The liquidity of fund portfolios became a critical factor in permitting them to absorb very heavy redemption demands in the fall of 2008 when the secondary markets for many short-term securities seized up.

Commenters generally agreed with our analysis of the liquidity needs of money market funds. They emphasized the importance of liquidity for money market funds and their ability to meet shareholder redemptions.<sup>184</sup> Several also acknowledged the need to place outside limits on the risks money market funds may take.<sup>185</sup> Most commenters supported amending the rule to impose more robust liquidity requirements, but many disagreed with our specific proposals.<sup>186</sup> Some asserted that the proposed requirements might negatively affect funds' ability to manage their portfolios, place excessive burdens on the board of directors, and affect the markets of some portfolio securities.<sup>187</sup> Others argued that the proposals are not sufficient to meet money market funds' liquidity concerns.<sup>188</sup>

<sup>179</sup> See current rule 2a-7(c)(2)(ii). In a conforming change, we also are amending as proposed the maturity-shortening provision of the rule for variable-rate Government securities to require that the variable rate of interest is readjusted no less frequently than every 397 days, instead of 762 days as the rule has permitted. See amended rule 2a-7(d)(1).

<sup>180</sup> See Proposing Release, *supra* note 2, at Section II.B.3.

<sup>181</sup> See BlackRock Comment Letter.

<sup>182</sup> We also requested comment in the Proposing Release on whether we should impose a limitation on the maximum final legal maturity of adjustable-rate Government securities that money market funds are permitted to acquire. We received only two comments on this proposal. One commenter encouraged us to constrain any limitation on adjustable-rate Government securities with a final legal maturity in excess of two years. See Fannie Mae Comment Letter. Another asserted that the WAL limitation provided a sufficient limitation on the risks posed by long-term adjustable-rate Government securities. See Federated Comment Letter. We are aware that WAL creates some limitation of this risk, but that even with a 120-day WAL limitation, a fund would still have some ability to acquire longer term adjustable-rate Government securities. No commenters provided us with any data on the extent of adjustable-rate Government securities outstanding from time to time. Two commenters indicated that these securities experienced variable spreads during the financial crisis. See BlackRock Comment Letter; Wells Fargo Comment Letter. In the future, we may reconsider whether to limit the maximum maturity of adjustable-rate Government securities that can be held by money market funds after obtaining additional data.

<sup>183</sup> See Proposing Release, *supra* note 2, at n.172 and accompanying text.

<sup>184</sup> See, e.g., Comment Letter of the Securities Industry and Financial Markets Association (Sept. 8, 2009) ("SIFMA Comment Letter"); State Street Comment Letter.

<sup>185</sup> See, e.g., Federated Comment Letter; Comment Letter of the Independent Directors Council (Sept. 8, 2009) ("IDC Comment Letter").

<sup>186</sup> See, e.g., State Street Comment Letter (opposing a general liquidity standard and different minimum liquidity thresholds for retail and institutional funds); Invesco Aim Comment Letter (same).

<sup>187</sup> See, e.g., Fidelity Comment Letter; ICI Comment Letter; Shadow FRC Comment Letter.

<sup>188</sup> See, e.g., Fund Democracy/CFA Comment Letter (requesting that the Commission mandate private liquidity insurance for money market funds); HighMark Capital Comment Letter (suggesting a private liquidity bank or that Treasury continue to provide emergency liquidity as possible solutions to address liquidity concerns); Vanguard Comment Letter (asserting that the proposed rule does not address liquidity risk arising from factors other than size of accounts, such as geographical concentration of the shareholders); Waddell & Reed Comment Letter (recommending some type of permanent backstop be available to money market funds); Wells Fargo Comment Letter (suggesting the Federal Reserve set up a secured lending facility to serve as a lender of last resort).

After reviewing the comments, and based on our analysis of redemption activity during the 2008 run on money market funds, we are amending rule 2a-7 to add three new provisions, substantially as proposed, which address different aspects of portfolio liquidity.<sup>189</sup> Together, we believe they will result in money market funds that are better able to absorb large amounts of redemptions.

### 1. General Liquidity Requirement

We are amending rule 2a-7, as proposed, to require that each money market fund hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of its obligations under section 22(e) of the Act and any commitments the fund has made to shareholders (the “general liquidity requirement”).<sup>190</sup> Depending upon the volatility of its cash flows (particularly shareholder redemptions), this new provision may require a fund to maintain greater liquidity than would be required by the daily and weekly minimum liquidity requirements set forth in the rule and discussed below.

Most commenters who addressed this proposal supported the addition of a general liquidity requirement.<sup>191</sup> They agreed that funds should be required to assess appropriate levels of liquidity above the minimums set forth in the rule.<sup>192</sup> Some commenters, however, expressed concerns that the proposed requirement was too vague,<sup>193</sup> or was unnecessary in light of the minimum daily and weekly liquidity requirements.<sup>194</sup> We disagree. Funds will have different liquidity needs that we cannot sufficiently anticipate and codify in a rule beyond the minimums we are adopting today.<sup>195</sup> Therefore, we believe it is incumbent upon the management of each fund and its board of directors to evaluate the fund’s liquidity needs and to protect the fund and its shareholders from the harm that can occur from failure to properly anticipate and provide for those needs.

To comply with this general liquidity requirement, we would expect money market fund managers to consider factors that could affect the fund’s liquidity needs, including characteristics of a money market fund’s investors and their likely redemptions.<sup>196</sup> For example, some shareholders may have regularly recurring liquidity needs, such as to meet monthly or more frequent payroll requirements. Others may have liquidity needs that are associated with particular annual events, such as holidays or tax payment deadlines. A fund also would need to consider the extent to which it may require greater liquidity at certain times when investors’ liquidity needs may coincide. In addition, a volatile or more concentrated shareholder base would require a fund to maintain greater liquidity than a stable shareholder base consisting of thousands of retail investors.<sup>197</sup>

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<sup>189</sup> See Proposing Release, *supra* note 2, at Section II.C.1-2.

<sup>190</sup> Amended rule 2a-7(c)(5).

<sup>191</sup> See, e.g., ICI Comment Letter; Northern Funds Indep. Trustees Comment Letter; Tamarack Funds Comment Letter.

<sup>192</sup> See, e.g., Federated Comment Letter; ICI Comment Letter;

<sup>193</sup> See, e.g., Charles Schwab Comment Letter; Dreyfus Comment Letter. We note, however, that similar general requirements in rule 2a-7 have not hampered fund managers. See, e.g., current rule 2a-7(c)(2) (requiring a money market fund to maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share). Thus, we do not share commenters’ concerns that the general liquidity standard could expose a money market fund to liability based on hindsight review of the fund’s subjective determinations and market events.

<sup>194</sup> See, e.g., TDAM Comment Letter. Another commenter asserted that money market funds are already subject to this requirement under section 22(e) of the Act. See State Street Comment Letter. The general liquidity requirement, together with rule 2a-7’s specific obligations related to illiquid securities and daily and weekly liquid assets, identifies the liquidity obligations that are specific to money market funds.

<sup>195</sup> For example, suggestions that we require each fund to maintain sufficient liquidity to meet redemptions by the largest shareholders seem inadequate because they assume that only those shareholders will redeem. See Stradley Ronon Comment Letter; SIFMA Comment Letter.

<sup>196</sup> See Proposing Release, *supra* note 2, at text following n.205.

<sup>197</sup> See Thrivent Comment Letter (suggesting that we approach portfolio liquidity on the basis of concentration among a fund’s shareholders). In determining the amount of liquidity available to meet the requirements of rule 2a-7, funds should not consider the fund’s ability to access overdraft protection, lines of credit, and inter-fund borrowing arrangements. See Federated Comment Letter (suggesting that we adopt the opposite approach). A fund that borrowed to satisfy redemptions would leverage its holdings, thus amplifying the risk of shareholder losses if the fund eventually broke the buck.

Thus, to comply with rule 2a-7, as amended, money market funds should adopt policies and procedures designed to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders.<sup>198</sup> In other words, fund boards should make sure that the adviser is monitoring and planning for “hot money.” In their consideration of these procedures and in the oversight of their implementation, fund boards should appreciate that, in some cases, fund managers’ interests in attracting additional fund assets may be in conflict with their overall duty to manage the fund in a manner consistent with maintaining a stable net asset value.<sup>199</sup> We urge directors to consider the need for establishing guidelines that address this conflict.

As some commenters noted, identification of these risks may be more challenging when share ownership is less transparent because the shares are held in omnibus accounts.<sup>200</sup> Funds may seek access to information about the investors who hold their interests through omnibus accounts in addition to considering information about the omnibus accounts, including their aggregate historical redemption patterns and the account record holder’s ability to redeem the entire account.<sup>201</sup>

## 2. Limitation on Acquisition of Illiquid Securities

We are amending rule 2a-7 to further limit a money market fund’s investments in illiquid securities (i.e., securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to them by the money market fund).<sup>202</sup> Under the amended rule, a money market fund cannot acquire illiquid securities if, immediately after the acquisition, the fund would have invested more than five percent of its total assets in illiquid securities.<sup>203</sup>

In light of the risk that liquid assets would become illiquid thereby impairing the ability of a money market fund to meet redemption demands, we proposed to prohibit funds from acquiring securities that were, at the time of their acquisition, already illiquid. Many fund commenters objected, arguing such a limitation could preclude them from investing in certain high quality illiquid securities in which money market funds have historically invested,<sup>204</sup> make it more difficult for tax-exempt funds to construct a well-diversified, high quality portfolio,<sup>205</sup> and prevent funds from investing in new

<sup>198</sup> Upon adoption of these amendments, such policies and procedures are, we believe, required under rule 38a-1 under the Investment Company Act (the “compliance rule”). Although two commenters suggested that the requirement to adopt the policies and procedures should be incorporated in rule 2a-7, we do not see a reason to duplicate the requirements for policies and procedures encompassed in the compliance rule. *See* Dreyfus Comment Letter; Comment Letter of Fifth Third Asset Management, Inc. (Sept. 8, 2009) (“Fifth Third Comment Letter”). One commenter recommended that “know your customer” policies apply only to shareholders whose redemptions (in their entirety) would have a material impact on the fund’s ability to satisfy redemptions. Stradley Ronon Comment Letter. *See also* SIFMA Comment Letter. Another commenter argued that the relevant shareholder characteristics should be limited to clearly defined parameters such as historical net flows. *See* RidgeWorth Comment Letter. We are not identifying specific characteristics that should be addressed in a fund’s policies and procedures because we believe that money market funds are in a better position to do so. For example, concurrent redemptions of several shareholders may have a material effect on a fund’s ability to satisfy redemptions even if the shareholders’ individual redemptions alone would not have such an effect. Nor are we setting limits as to the scope of the policies and procedures because different money market funds may have different needs in this regard.

<sup>199</sup> *See* Proposing Release, *supra* note 2, at n.180 and accompanying text.

<sup>200</sup> *See, e.g.*, Comment Letter of the Coalition of Mutual Fund Investors (Sept. 10, 2009) (“CMFI Comment Letter”); HighMark Capital Comment Letter.

<sup>201</sup> Some commenters argued that we should require greater transparency of investments held through financial intermediaries to allow funds to better monitor client profiles. *See, e.g.*, BlackRock Comment Letter; CMFI Comment Letter. Funds may seek to access this information in contractual arrangements with their financial intermediaries.

<sup>202</sup> We have construed section 22(e) of the Investment Company Act, which requires registered investment companies to satisfy redemption requests within seven days, to restrict a money market fund from investing more than 10% of its assets in illiquid securities. *See* 1983 Adopting Release, *supra* note 6, at nn.37–38 and accompanying text; Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)], at n.21 and accompanying text; Proposing Release, *supra* note 2, at n.171 and accompanying text.

<sup>203</sup> Amended rule 2a-7(c)(5)(i).

<sup>204</sup> These include, among other securities, term repurchase agreements, some time deposits, and insurance company funding agreements. *See, e.g.*, Am. Bankers Assoc. Comment Letter; Comment Letter of New York Life Investments (Sept. 14, 2009); Comment Letter of Promontory Interfinancial Network, LLC (Sept. 8, 2009); Wells Fargo Comment Letter.

<sup>205</sup> *See* Stradley Ronon Comment Letter; Wells Fargo Comment Letter.



types of securities that are illiquid until a market for them has been established.<sup>206</sup> Others asserted that a ban may be unnecessary in light of the new daily and weekly liquidity standards.<sup>207</sup>

These comments persuaded us that prohibiting funds from acquiring *any* illiquid securities may have undesirable consequences for money market funds. Instead, we are further limiting the circumstances under which a money market fund may acquire illiquid securities. Under the amended rule, a fund cannot acquire an illiquid security if, after the purchase, more than five percent of the fund's total assets would consist of illiquid securities.<sup>208</sup> Several commenters suggested that we lower the existing 10 percent limit as an alternative to our proposal.<sup>209</sup> We are reducing by half the existing limit in order to strike a balance between our concern regarding liquidity risk, i.e., a fund's ability to satisfy redemption demands if it is holding illiquid securities, and funds' concerns that they retain some ability to make investments in high quality illiquid securities.

We are also amending the rule to define the term "illiquid security" as a security cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund. At the suggestion of commenters, we would not treat as illiquid a security that could not be sold at amortized cost.<sup>210</sup>

### 3. Minimum Daily and Weekly Liquidity Requirements

The Commission is adopting new liquidity requirements that mandate each money market fund maintain a portion of its portfolio in cash and securities that can readily be converted into cash. More specifically, we are amending rule 2a-7 to require all taxable money market funds to hold at least 10 percent of their total assets in "daily liquid assets" and all money market funds to hold at least 30 percent of their total assets in "weekly liquid assets."<sup>211</sup> A money market fund must comply with the daily and weekly liquidity standards at the time each security is acquired.<sup>212</sup>

As we explained in the Proposing Release, current liquidity standards applicable to money market funds presume that a fund is able to find a buyer of its securities.<sup>213</sup> Our new approach would include as a "daily liquid asset" or "weekly liquid asset" only cash or securities that can readily be converted to cash (as discussed below). Thus, a fund should be able to use those assets to pay redeeming shareholders even in market conditions (such as those that occurred in September and October 2008) in which money market funds cannot rely on a secondary or dealer market to provide immediate liquidity.

<sup>206</sup> See, e.g., Deutsche Comment Letter; Stradley Ronon Comment Letter; USAA Comment Letter.

<sup>207</sup> See, e.g., Charles Schwab Comment Letter; TDAM Comment Letter.

<sup>208</sup> Amended rule 2a-7(c)(5)(i).

<sup>209</sup> See Federated Comment Letter; J.P. Morgan Asset Mgt. Comment Letter; Vanguard Comment Letter; Wells Fargo Comment Letter (all recommending a 5% percent limit). See also TDAM Comment Letter (recommending that we reduce the existing limit). Other commenters argued that we should maintain the 10% limit. See, e.g., Charles Schwab Comment Letter; Deutsche Comment Letter.

<sup>210</sup> See amended rule 2a-7(a)(19). See, e.g., Charles Schwab Comment Letter; Wells Fargo Comment Letter. The proposed rule defined "liquid security" with reference to the security's "amortized cost value." See proposed rule 2a-7(a)(18). Under the amended rule, a money market fund using the amortized cost method will be able to treat as liquid a security that the fund can sell at a price that deviates from the security's amortized cost value, as long as the price approximates the market-based value that the fund has ascribed to the security for purposes of determining its shadow price. Because the market-based value assigned by a money market fund to its securities is the measure that ultimately justifies the fund's use of a stable net asset value, a money market fund should *supra* treat as illiquid any security that cannot be sold at a price approximating such market-based value. See 1983 Adopting Release, *supra* note 6, at n.37 and paragraphs following n.39.

<sup>211</sup> See amended rule 2a-7(c)(5)(ii)-(iii). See also amended rule 2a-7(a)(8) (defining "daily liquid assets"); 2a-7(a)(32) (defining "weekly liquid assets"); *infra* notes 229–243 and accompanying text. "Total assets" means with respect to a money market fund using the amortized cost method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets. See amended rule 2a-7(a)(27).

<sup>212</sup> See amended rule 2a-7(a)(8); 2a-7(a)(32). One commenter recommended that the minimum liquidity standards apply on an ongoing basis, which could require money market funds with holdings that fall below the requirements to sell securities in order to meet the requisite daily and weekly liquid asset thresholds. See Fund Democracy/CFA Comment Letter. We do not agree with such an approach. A money market fund whose portfolio does not meet the minimum daily or weekly liquidity standards is not in violation of the rule, but may not acquire any assets other than daily or weekly liquid assets. See Dreyfus Comment Letter (requesting that the standards incorporate some flexibility to allow funds not to comply with them under unforeseeable circumstances).

<sup>213</sup> See Proposing Release, *supra* note 2, at Section II.C.2.

Commenters who addressed the issue largely supported the introduction of daily and weekly liquidity standards.<sup>214</sup> One large sponsor of money market funds asserted that it “recognize[d] that a meaningful and sustained level of liquidity has the potential to ease concerns of investors and may be useful for unforeseen events.”<sup>215</sup> Another agreed that “mandating liquidity requirements will bolster investor confidence in the ability of money market funds to sustain prolonged redemption pressures with increased levels of immediate cash on hand, both on a daily and weekly basis.”<sup>216</sup> One commenter, however, urged us to rely solely on the general liquidity requirement, arguing that requiring a minimum requirement would require unnecessary levels of liquidity at times that will not be sufficient during a severe market crisis.<sup>217</sup>

Markets can become illiquid very rapidly in response to events that money market fund managers may not anticipate. The failure of a single fund to anticipate such conditions may lead to a run of the sort we saw in September 2008 affecting all or many funds. We think it would be ill-advised to rely solely on the ability of managers to anticipate liquidity needs, which may arise from events the money market fund manager cannot anticipate or control. We acknowledge our minimum standards alone may not establish sufficient liquidity to allow funds to meet every liquidity crisis, which is why we also are adopting a general liquidity requirement (discussed above) to supplement the minimum requirements.

*Distinguishing between Retail and Institutional Funds.* In the Proposing Release, we observed that institutional money market funds need (and typically maintain) greater portfolio liquidity. These funds had substantially greater redemption pressure on them in the fall of 2008. During the four-week period ending October 8, 2008, prime institutional funds (or share classes) experienced 30 percent net outflows compared to only 4.6 percent outflows of prime retail funds, according to data compiled by the ICI.<sup>218</sup>

Consequently, we proposed to impose substantially lower liquidity requirements on retail funds because the higher thresholds appeared unnecessary and would have resulted in higher costs on them in terms of lower yields. For example, instead of 30 percent “weekly liquid assets,” we proposed to require that retail prime money market funds maintain 15 percent “weekly liquid assets.” We proposed to require that each money market fund’s board make an annual determination whether a fund was an institutional fund (and thus subject to the higher liquidity requirements) based on the nature of record owners of shares, minimum initial investment requirements, and cash flows from purchases and redemptions.<sup>219</sup>

Most commenters representing money market funds argued against drawing such a regulatory distinction, asserting that there are inherent difficulties in determining the difference between the two types of funds within a generally applicable definition.<sup>220</sup> Commenters asserted that many money market funds include both types of shareholders, and even if one could distinguish a fund with an institutional rather than a retail shareholder base, not all shareholders behave in the

<sup>214</sup> See, e.g., Calvert Comment Letter; Vanguard Comment Letter.

<sup>215</sup> J.P. Morgan Asset Mgmt. Comment Letter.

<sup>216</sup> Invesco Aim Comment Letter.

<sup>217</sup> See Wells Fargo Comment Letter. See also T. Rowe Price Comment Letter (the weekly liquidity standard is overly restrictive in light of the daily liquidity standard and other proposed changes to rule 2a-7).

<sup>218</sup> See ICI, *Money Market Mutual Fund Assets Historical Data*, available at [http://www.ici.org/pdf/mm\\_data\\_2010.pdf](http://www.ici.org/pdf/mm_data_2010.pdf). See also Proposing Release, *supra* note 2, at n.63 and accompanying text. The Proposing Release also noted that on September 17, 2008, approximately 4% of prime retail money market funds (or share classes) and 25% of prime institutional money market funds had outflows greater than 5%; on September 18, 2008, approximately 5% of prime retail funds and 30% of prime institutional funds had outflows greater than 5%; and on September 19, 2008, approximately 5% of prime retail funds and 22% of prime institutional funds had outflows greater than 5%. Proposing Release, *supra* note 2, at n.185.

<sup>219</sup> See proposed rule 2a-7(a)(17) (defining “institutional fund”); Proposing Release, *supra* note 2, at Section II.C.2.a-b.

<sup>220</sup> See, e.g., BlackRock Comment Letter; Goldman Sachs Comment Letter; ICI Comment Letter; Comment Letter of TCW Investment Management Company (Sept. 4, 2009); Vanguard Comment Letter. A few commenters expressed support for the distinction. See, e.g., Dreyfus Comment Letter; Fidelity Comment Letter; USAA Comment Letter.

same manner and present the same liquidity challenges as their peers.<sup>221</sup> Others expressed concern that the fund's board is not in the best position to make these determinations.<sup>222</sup> The difficulty in drawing bright lines led some commenters to express concern with the competitive consequences that might result when fund boards of directors come to different conclusions.<sup>223</sup>

We anticipated these concerns and requested comment on alternative approaches. One commenter suggested that we treat as institutional a fund that has any class which offers same day liquidity to shareholders.<sup>224</sup> We are uncertain, however, whether institutional investors will be willing to migrate to funds that offer next day liquidity in order to obtain additional yield, and if they did our purpose in drawing the distinction would be defeated. We have similar concerns that institutional investors might invest in retail funds that are defined with respect to minimum initial account sizes or maximum expense ratios, as suggested by other commenters.<sup>225</sup> The suggestion that the distinction be based on average account size raises different concerns, including the appropriate size for this measure and whether it should be based on total assets in omnibus accounts or in the accounts of the underlying shareholders.<sup>226</sup>

Taking into account the comments and after further consideration, we have not identified an effective way at this time to distinguish between types of money market funds to achieve our purpose. Therefore, we have determined to apply the same minimum liquidity standards to both institutional and retail money market funds.<sup>227</sup> We believe the compelling need to limit the liquidity risk of money market funds before another run occurs is reason not to further distinguish retail from institutional money market funds. We intend, however, to consider revisiting our determination to apply the same minimum liquidity standards to all money market funds and reevaluate whether there is a workable objective definition that would accurately identify funds with lower liquidity needs and thus justify applying lower minimum standards to them.<sup>228</sup>

*New Daily and Weekly Minimum Liquidity Requirements.* We are adopting the higher minimum liquidity thresholds we proposed for all money market funds. Under the final rule, (i) no taxable money market fund can acquire any security other than a daily liquid asset if, immediately after the acquisition, the fund would have invested less than 10 percent of its total assets in daily liquid assets, and (ii) no money market fund can acquire any security other than a weekly liquid asset if, immediately after the acquisition, the fund would have invested less than 30 percent of its total assets in weekly

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<sup>221</sup> See, e.g., GE Asset Mgt. Comment Letter; SIFMA Comment Letter; State Street Comment Letter. Many also argued that the nature of the financial intermediary record owner does not always correspond to the behavior of the ultimate investor. See, e.g., T. Rowe Price Comment Letter; Vanguard Comment Letter. A few commenters objected for other reasons. See Comment Letter of the Committee of Annuity Insurers (Sept. 8, 2009) ("Committee Ann. Insur. Comment Letter") (the characterization as retail or institutional would be confusing for investors); J.P. Morgan Asset Mgt. Comment Letter (retail investors would suffer if they invested in an institutional fund through an omnibus account or a money market fund lost its retail status because of institutional investments in the fund); Comment Letter of Russell Investment Management Company (Sept. 8, 2009) ("Russell Inv. Comment Letter") (money market funds would incur substantial costs to monitor and enforce the distinction); Waddell & Reed Comment Letter (the distinction is punitive for retail money market funds, which have a less concentrated shareholder base).

<sup>222</sup> See, e.g., IDC Comment Letter; Comment Letter of the New York City Bar Association (Sept. 8, 2009) ("NYC Bar Assoc. Comment Letter").

<sup>223</sup> See, e.g., Comment Letter of FAF Advisors (Sept. 9, 2009) ("FAF Advisors Comment Letter") (in the absence of clear guidelines, boards would likely characterize funds with largely the same shareholder base differently); Goldman Sachs Comment Letter (the distinction would create an incentive to characterize a fund as retail so that the fund would be subject to the lower standard); IDC Comment Letter (a board might take a conservative approach and identify more funds as institutional at the expense of the funds' shareholders).

<sup>224</sup> See Fidelity Comment Letter. See also Charles Schwab Comment Letter; Waddell & Reed Comment Letter.

<sup>225</sup> See HighMark Capital Comment Letter; T. Rowe Price Comment Letter.

<sup>226</sup> See Waddell & Reed Comment Letter. Similar concerns would arise if we used the definition the ICI uses for its analysis of retail money market share classes, i.e., those "offered primarily to individuals with moderate-sized accounts." See [http://www.ici.org/my\\_ici/mmf\\_developments/faqs\\_money\\_funds](http://www.ici.org/my_ici/mmf_developments/faqs_money_funds).

<sup>227</sup> See amended rule 2a-7(c)(5)(ii)-(iii).

<sup>228</sup> One commenter suggested that we impose different minimum liquidity standards for government and non-government money market funds. See C. Wesselkamper Comment Letter. We believe this is unnecessary, however, given that most Government money market funds have sufficient holdings of Treasury securities and Government agency discount notes to satisfy the rule's requirements for daily and weekly liquid assets. See amended rule 2a-7(a)(8) (defining "daily liquid assets"); 2a-7(a)(32) (defining "weekly liquid assets").

liquid assets.<sup>229</sup> We proposed these liquidity levels based on the levels of cash and overnight repurchase agreements that we believe reflect the liquidity needs of money market funds with institutional investors or other investors with similar liquidity needs.<sup>230</sup>

A few commenters supported our proposed levels for daily and weekly liquid assets, but most supported the lower levels recommended in the ICI Report of five percent of portfolios in daily liquid assets and 20 percent of portfolios in weekly liquid assets.<sup>231</sup> Commenters argued that when combined with our other proposals, these thresholds would provide sufficient protection to investors.<sup>232</sup> They also suggested that the lower levels strike an appropriate balance of improving funds' liquidity while providing sufficient flexibility to allow portfolio managers to meet the challenges of different market conditions.<sup>233</sup>

We are concerned that the lower minimum liquidity levels suggested by commenters would be insufficient to establish an adequate liquidity floor for money market funds in the event of a crisis such as we experienced in September 2008. The five percent daily liquidity level would have been insufficient to satisfy redemptions in one-fifth of prime institutional funds (or share classes) on each of three days during the week of September 15, and the 20 percent weekly liquidity level would have been insufficient to address outflows in more than a quarter of those funds during that week.<sup>234</sup> We would be concerned if such a large portion of money market funds had to increase their liquidity quickly in response to sudden market turmoil at the same time the overall market experiences a flight to liquidity.<sup>235</sup> As we noted above, one fund's inability to satisfy redemption requests may lead to a run on other money market funds.<sup>236</sup> Accordingly, we believe that the floor we establish for minimum liquidity requirements must be sufficiently high to allow most money market funds to manage their liquidity risk in a crisis, particularly when they may experience significant redemption requests on successive days.<sup>237</sup> For this reason, we have adopted the higher liquidity thresholds, under which we estimate that approximately 90 percent of retail and institutional funds would have been able to satisfy the level of redemption

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<sup>229</sup> Amended rule 2a-7(c)(5)(ii)-(iii).

<sup>230</sup> See Proposing Release, *supra* note 2, at n.191 and accompanying and following text.

<sup>231</sup> See, e.g., FAF Advisors Comment Letter; Invesco Aim Comment Letter. Others recommended different standards. See Crane Data Comment Letter (5% daily and 15% weekly liquidity for all money market funds); Fifth Third Comment Letter (10% daily liquidity and 25% weekly liquidity for all money market funds); J.P. Morgan Asset Mgt. Comment Letter (5% daily liquidity for taxable money market funds and 20% weekly liquidity for all money market funds); Vanguard Comment Letter (weekly liquidity requirement for institutional funds should not exceed 25%).

<sup>232</sup> See Dreyfus Comment Letter (\$119 billion redeemed in institutional funds during the week of September 17, 2008, represented 5% of institutional fund assets as reported by iMoneyNet on August 5, 2009); FAF Advisors Comment Letter; Goldman Sachs Comment Letter.

<sup>233</sup> See Invesco Aim Comment Letter.

<sup>234</sup> On September 17, 2008, approximately 25% of prime institutional money market funds experienced outflows greater than 5% of total assets; on September 18, 2008, approximately 30% of prime institutional money market funds experienced outflows greater than 5%; and on September 19, 2008, approximately 22% of prime institutional money market funds experienced outflows greater than 5%. As noted in the Proposing Release, during that week, approximately 27% of prime institutional money market funds experienced redemptions of more than 20% of assets, and 22% had outflows greater than 25%. This is based on analysis of data from the iMoneyNet Money Fund Analyzer Database. Proposing Release, *supra* note 2, at n.185.

<sup>235</sup> As of January 20, 2010, assets in taxable institutional share classes represented approximately 63% of the total assets of money market funds, and assets in prime institutional share classes represented approximately 37% of the total assets of money market assets. See ICI, *Money Market Mutual Fund Assets*, available at [http://www.ici.org/research/stats/mmf/mm\\_01\\_21\\_10](http://www.ici.org/research/stats/mmf/mm_01_21_10).

<sup>236</sup> See *supra* text following note 217.

<sup>237</sup> In support of its proposed lower liquidity levels, the ICI stated that the 5% daily and 20% weekly thresholds "would have met the demands of a large majority of the prime funds with at least one institutional share class" and noted that between September 10 through 24, 52% of these funds had outflows of less than 5 percent, and 22 percent experienced outflows of between 5% and 20% of assets, which would have been covered by the thresholds recommended by the ICI Report. Under the ICI's analysis, however, one quarter of prime money market funds would not have been covered by the thresholds recommended by the ICI Report, which as discussed above, we believe is too large a proportion that might have to increase liquidity quickly in response to sudden severe economic stress. We are not considering the redemption levels of the week following September 19, when the Treasury Department adopted the Guarantee Program, because we have no basis to estimate what the redemptions would have been had the Treasury not adopted the Program. We also note that another commenter that provided specific information on redemption flows, a large sponsor of money market funds, reported in its comment letter that on September 17, redemptions in its money market funds exceeded 5% and during the week of September 15, redemptions in the funds exceeded 20%. Federated Comment Letter.

demands during individual days as well as the week of greatest redemption pressure in the fall of 2008 (September 15–19).<sup>238</sup> At the same time, we appreciate commenters’ concerns that the proposed liquidity thresholds would limit funds’ flexibility to meet the challenges of different market conditions. In order to address those concerns as well as our concerns regarding liquidity risk, the amendments preserve funds’ ability to invest in a limited amount of illiquid securities, which is designed to permit funds some flexibility in dealing with varying market conditions.<sup>239</sup>

*Tax-Exempt Money Market Funds.* As proposed, the final rule excludes tax-exempt money market funds from the daily liquidity requirements.<sup>240</sup> Several commenters supported the proposal, noting that these funds cannot engage in repurchase agreements and the supply of tax-exempt securities with daily demand features is extremely limited.<sup>241</sup> One commenter, however, argued that tax-exempt funds are subject to daily redemptions and should be subject to the required minimum.<sup>242</sup> Based on the comments we received, we continue to believe that the different nature of the markets for tax-exempt securities justifies exempting tax-exempt money market funds from the daily liquidity requirements.<sup>243</sup>

*Definition of Daily and Weekly Liquid Assets.* As discussed above, the new daily and weekly liquidity requirements are designed to ensure that a money market fund has the legal right to receive cash within one or five business days so that a fund may more easily satisfy redemption requests during times of market stress.<sup>244</sup> Like our proposal, the final definition of “daily liquid assets” includes cash (including demand deposits), Treasury securities, and securities (including repurchase agreements) for which a money market fund has a legal right to receive cash in one business day.<sup>245</sup> Our proposed definition of “weekly liquid assets” included the same assets (except that the fund would have had to have the right to receive cash in five business days rather than one).<sup>246</sup> We proposed to include Treasury securities regardless of their maturity in the liquidity baskets because they have been the most liquid assets during times of market stress.<sup>247</sup> Indeed, we understand that the “flight to liquidity” that happens during times of uncertainty makes it easy to sell Treasury securities in even large quantities.<sup>248</sup>

Commenters supported our inclusion of Treasury securities, but many argued that we should include additional securities.<sup>249</sup> In particular, a number of commenters argued that we should also include agency notes (i.e., direct obligations of federal government agencies and government-sponsored enterprises) as daily or weekly liquid assets or

<sup>238</sup> See Proposing Release, *supra* note 2, at n.201 and accompanying text. The 9% of institutional money market funds that had redemptions exceeding 30% of assets in the week after The Reserve Fund broke the buck accounted for 10.9% of all institutional funds’ total assets as of September 15, 2008. We estimate that under the minimum liquidity standards we are adopting more retail funds would have been able to satisfy the level of redemption demands than would have institutional funds. During the week ending September 19, 2008, 3% of retail funds experienced outflows greater than 30%. This is based on analysis of data from the iMoneyNet Money Fund Analyzer Database

<sup>239</sup> See *supra* Section II.C.2 (limitations on illiquid securities).

<sup>240</sup> See Proposing Release, *supra* note 2, at nn.198–99 and accompanying text.

<sup>241</sup> See, e.g., Federated Comment Letter; ICI Comment Letter.

<sup>242</sup> See Fidelity Comment Letter.

<sup>243</sup> We understand that most of the portfolios consist of longer term floating and variable-rate securities with seven-day demand features from which the fund obtains much of its liquidity, and that they are unlikely to have investment alternatives that would permit them to meet a daily liquidity requirement. See Proposing Release, *supra* note 2, at n.199 and accompanying text.

<sup>244</sup> See *supra* note 213 and accompanying and following text.

<sup>245</sup> Amended rule 2a-7(a)(8) (defining “daily liquid asset” to mean (i) cash; (ii) direct obligations of the U.S. Government; and (iii) securities that will mature or are subject to a demand feature that is exercisable and payable within one business day).

<sup>246</sup> Proposed rule 2a-7(a)(32).

<sup>247</sup> U.S. Treasury securities were highly liquid during the market turmoil in 2008. See, e.g., *FRB Open Market Committee Oct. 28–29 Minutes*, *supra* note 13, at 5; *Minutes of the Federal Open Market Committee*, Federal Reserve Board, Dec. 15–16, 2008, at 4, available at <http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20081216.pdf>.

<sup>248</sup> See, e.g., Francis A. Longstaff, *The Flight-to-Liquidity Premium in U.S. Treasury Bond Prices*, 77 J. Bus. 511 (July 2004).

<sup>249</sup> See, e.g., Comment Letter of the Federal Home Loan Banks (Sept. 8, 2009) (“FHLB Comment Letter”) (include Federal Home Loan Bank discount notes); RidgeWorth Comment Letter (include fixed-rate agency discount notes with maturities of 95 days or less); Victory Cap. Mgmt. Comment Letter (include fixed-rate agency discount notes with maturities of 397 days or less). See also Dreyfus Comment Letter (include bank time deposits); Fidelity Comment Letter (include shares of other money market funds). Both shares of money market funds and bank time deposits, which some commenters advocated we specifically include in the rule text, fall within the definitions of daily and weekly liquid assets if they satisfy the applicable maturity terms.

in both liquid asset baskets.<sup>250</sup> We are persuaded, based on the comments we received, that the market for very short-term agency notes is likely to be sufficiently liquid under stressful market conditions to treat them as weekly liquid assets. Therefore, amended rule 2a-7 includes agency discount notes with remaining maturities of 60 days or less in the definition of weekly liquid assets.<sup>251</sup>

Our decision to include these securities is based on our consideration of the relative liquidity of agency discount notes during times of extreme market stress.<sup>252</sup> We compared average daily yields for the two weeks before and the two weeks after the Lehman Brothers bankruptcy on September 15, 2008. Between these periods, the yields for 30-day Treasury bills fell 75 percent while yields for 30-day and 60-day agency discount notes remained essentially the same.<sup>253</sup> The yields for other money market assets increased over the same periods. For example, the average daily yield for 90-day agency discount notes increased four percent; while the yield for 30-day first tier financial securities increased 23 percent.<sup>254</sup> Transaction volume in agency discount notes increased over this time period,<sup>255</sup> which suggests to us that money market funds were able to sell their shorter maturity agency discount notes at amortized cost or higher prices.

#### 4. Stress Testing

We are adopting amendments to rule 2a-7 to require the board of directors of each money market fund to adopt procedures providing for periodic stress testing of the money market fund's portfolio.<sup>256</sup> Almost all of the commenters who addressed this matter supported requiring stress testing of fund portfolios,<sup>257</sup> although several suggested changes from our proposal.<sup>258</sup>

<sup>250</sup> See, e.g., Comment Letter of the Capital Management of the Carolinas (Sept. 4, 2009) ("Cap. Mgt. Carolinas Comment Letter") (include discount notes with maturity of 397 days or less as daily liquid assets); Fidelity Comment Letter (include discount notes with maturity of 397 days or less as both daily and weekly liquid assets); ICI Comment Letter (include fixed-rate agency discount notes with maturity of 397 days or less as weekly liquid assets); C. Wesselkamper Comment Letter (include in daily and weekly liquid assets Government securities with fixed rates or fixed rate Government securities maturing in no more than 60 days). One commenter also expressed concern about the supply of assets that would qualify as daily or weekly liquid assets. See Fidelity Comment Letter.

<sup>251</sup> Amended rule 2a-7(a)(32) (defining "weekly liquid assets" to mean (i) cash; (ii) direct obligations of the U.S. Government; (iii) Government securities issued by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States, that are issued at a discount to the principal amount to be repaid at maturity and have a remaining maturity of 60 days or less; and (iv) securities that will mature or are subject to a demand feature that is exercisable and payable within five business days).

<sup>252</sup> Commenters who advocated including agency discount notes in the liquid asset baskets stressed the depth of liquidity in the secondary markets for these securities. See, e.g., Charles Schwab Comment Letter; ICI Comment Letter; SIFMA Comment Letter; FHLB Comment Letter (comment limited to Federal Home Loan Bank discount notes).

<sup>253</sup> Between these periods, 30-day Treasury bill average daily yields fell from 1.53% to 0.39%; 30 day agency discount note average daily yields held constant at 2.14%; and 60-day agency discount note average daily yields increased from 2.25% to 2.27%. See Bloomberg Terminal Database, US 30-Day T-Bill USGB030Y <Index>; Agency Discount Note 30 Day Yield AGDN030Y <Index>; Agency Discount Note 60 Day Yield AGDN060Y <Index>. We note that in September 2008, the Federal Reserve's Open Market Trading Desk purchased discount notes issued by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks in order to support market functioning. See Press Release, Federal Reserve Bank of New York, Statement Regarding Planned Purchases of Agency Debt (Sept. 19, 2008), available at [http://www.newyorkfed.org/markets/operating\\_policy\\_080919.html](http://www.newyorkfed.org/markets/operating_policy_080919.html). Data concerning the purchases are available at the Federal Reserve Bank of New York's Permanent Open Market Operations Historical Search webpage, available at <http://www.newyorkfed.org/markets/pomo/display/index.cfm?fuseaction=showSearchForm>.

<sup>254</sup> Average daily yields on 90-day agency discount notes increased from 2.35% to 2.45%. See Bloomberg, Agency Discount Note 90 Day Yield AGDN090Y <Index>. In addition, average daily yields on 30-day first tier financial securities increased from 2.40% to 2.96% and average daily yields on 30-day first tier non-financial securities increased from 2.03% to 2.16%. See Federal Reserve Commercial Paper Data, *supra* note 47 (select rates from the preformatted data package menu and follow the instructions to reformat the date range and download). Average daily yields on 60-day first tier financial securities increased from 2.57% to 2.99% and average daily yields on 60-day first tier non-financial securities increased from 2.03% to 2.19%. See *id.*

<sup>255</sup> See Federal Reserve Bank of New York, Primary Dealer Statistics, available at <http://www.newyorkfed.org/markets/gsds/search.cfm>.

<sup>256</sup> See amended rule 2a-7(c)(10)(v).

<sup>257</sup> See, e.g., J.P. Morgan Asset Mgt. Comment Letter; Tamarack Funds Comment Letter. *But see* C. Wesselkamper Comment Letter (stress testing should be an adviser's best practice).

<sup>258</sup> At the suggestions of some commenters, we have made the stress testing requirement applicable to all money market funds that employ either the amortized cost method of valuing portfolio securities or the penny-rounding method of pricing fund shares. See Federated Comment Letter; TDAM Comment Letter. We believe that few, if any, money market funds will be affected by this change.

Under the amended rule, a fund must adopt procedures that provide for the periodic testing of the fund's ability to maintain a stable net asset value per share based upon certain hypothetical events. These include an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund.<sup>259</sup> Commenters differed on whether we should specify details for stress testing in addition to these hypothetical events.<sup>260</sup> Because different tests may be appropriate for different market conditions and different money market funds, we believe that the funds are better positioned to design and modify their stress testing systems and have not included more specific criteria in the rule.<sup>261</sup>

The amendment requires the testing to be done at such intervals as the fund board of directors determines appropriate and reasonable in light of current market conditions.<sup>262</sup> This is the same approach that rule 2a-7 takes with respect to the frequency of shadow pricing.<sup>263</sup> The rule does not, however, specifically require the board to design the portfolio stress testing, as may have been suggested by our proposing release.<sup>264</sup> We agree with the many commenters that asserted that the board may not have sufficient expertise to construct appropriate stress tests for a fund.<sup>265</sup> Each board may, of course, consider the extent to which it wishes to become involved in design of the stress tests.

The rule also requires that the board receive a report of the results of the stress testing at its next regularly scheduled meeting, as proposed, and more frequently, if appropriate, in light of the results.<sup>266</sup> We have added the requirement for more frequent reporting in light of results because we believe that the board should be apprised of test results when they indicate that the magnitude of hypothetical events required to cause the fund to break a buck (such as changes in interest rates or shareholder redemptions or a combination of factors) is slight when compared with actual conditions.

As proposed, the report must include: (i) the date(s) on which the fund portfolio was tested; and (ii) the magnitude of each hypothetical event that would cause the money market fund to break the buck.<sup>267</sup> The report also must include an assessment by the fund's adviser of the fund's ability to withstand the events (and concurrent occurrences of those events)

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<sup>259</sup> Amended rule 2a-7(c)(10)(v)(A).

<sup>260</sup> See, e.g., Charles Schwab Comment Letter (opposing more specific tests in the rule); State Street Comment Letter (same); RidgeWorth Comment Letter (requesting that the Commission more clearly define feasible stress testing requirements); TDAM Comment Letter (same).

<sup>261</sup> See Federated Comment Letter (different types of money market funds should have different stress testing procedures); Invesco Aim Comment Letter ("each investment adviser should have the discretion to determine the appropriate assumptions and hypothetical events for which to test."). As discussed above, amended rule 2a-7's new liquidity requirements require money market funds to evaluate their liquidity needs based on their shareholder base. See *supra* note 195 and preceding and accompanying text. Money market funds should also incorporate this element in their stress testing procedures as appropriate. See Thrivent Comment Letter.

<sup>262</sup> Amended rule 2a-7(c)(10)(v)(A). Commenters differed in their views on the appropriate intervals for testing. See, e.g., J.P. Morgan Asset Mgt. Comment Letter (monthly or even more frequently); HighMark Comment Letter (quarterly under normal market conditions); Shriver Poverty Law Ctr. Comment Letter (same). We believe that a fund's board of directors is best positioned to choose the appropriate frequency under different conditions. We urge funds to adopt thresholds for testing frequency based, in part, on the amount of the deviation of the funds market-based net asset value per share from its amortized cost value per share similar to many funds' thresholds for more frequent shadow pricing. Thus, we would expect that if a fund's shadow net asset value per share decreased to less than \$0.9975, the fund would conduct stress tests at least every week, even if the fund stress tests less frequently under normal conditions. More frequent testing would likely allow the fund to better understand and manage the risks to which the fund and its shareholders are exposed.

<sup>263</sup> Amended rule 2a-7(c)(8)(ii)(A)(I).

<sup>264</sup> See Proposing Release, *supra* note 2, at text following n.209.

<sup>265</sup> See, e.g., ABA Comment Letter; HighMark Capital Comment Letter; IDC Comment Letter.

<sup>266</sup> Amended rule 2a-7(c)(10)(v)(B). We disagree with commenters that recommended that the adviser report to the board only annually and on an exception basis. See, e.g., Stradley Ronon Comment Letter; Tamarack Funds Comment Letter; T. Rowe Price Comment Letter. We believe that regular reports will allow the board more effectively to monitor the fund's ability to withstand hypothetical events that alone or in combination would cause the fund to break the buck. In the Proposing Release, we asked whether we should impose minimum liquidity requirements based on the results of a particular stress test. See Proposing Release, *supra* note 2, at text following n.216. Commenters were divided on this issue. See Fidelity Comment Letter (against); Bankers Trust Comment Letter (in favor); Shriver Poverty Law Ctr. (same). As discussed above, we expect that money market funds take into consideration the results of their stress testing in assessing their liquidity needs under the general liquidity requirement of rule 2a-7(c)(5). See *supra* note 261.

<sup>267</sup> Amended rule 2a-7(c)(10)(v)(B)(I).

that are reasonably likely to occur within the following year.<sup>268</sup> Finally, as proposed, funds are required to maintain records of the stress testing for six years, the first two years in an easily accessible place.<sup>269</sup>

#### D. Repurchase Agreements

Money market funds typically invest a significant portion of their assets in repurchase agreements, many of which mature the following day and provide an immediate source of liquidity. We are adopting, as proposed, two amendments to rule 2a-7 that affect fund investments in repurchase agreements for purposes of rule 2a-7's diversification provisions.<sup>270</sup>

First, we are limiting money market funds to investing in repurchase agreements collateralized by cash items or Government securities in order to obtain special treatment of those investments under the diversification provisions of rule 2a-7.<sup>271</sup> This change is designed to reduce the risk that a money market fund would experience losses upon the sale of collateral in the event of a counterparty's default.<sup>272</sup> Most commenters who addressed our proposal supported it.<sup>273</sup> Commenters also confirmed our understanding that many managers of money market funds already look through only those repurchase agreements that are collateralized by Government securities or cash instruments.<sup>274</sup>

Second, we are reinstating the requirement that the money market fund's board of directors or its delegate evaluate the creditworthiness of the repurchase agreement's counterparty in order for the fund to take advantage of the special look-through treatment under rule 2a-7's diversification provisions.<sup>275</sup> The effect of this amendment is to require a fund

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<sup>268</sup> Amended rule 2a-7(c)(10)(v)(B)(2). We do not agree with commenters who argued that advisers should not be required to provide an assessment of a fund's ability to withstand events that are reasonably likely to occur within the following year. See Charles Schwab Comment Letter; Federated Comment Letter; Stradley Ronon Comment Letter; Vanguard Comment Letter. The rule does not require advisers to predict the future in order to determine which hypothetical events to use in stress testing (and we recognize that advisers will not always be correct in their assessments of which events are reasonably likely to occur within the following year). Instead, the provision is designed to provide to the board some context within which to evaluate the assessment on the magnitude of each hypothetical event that would cause the fund to break the buck. See Proposing Release, *supra* note 2, at text following n.211.

<sup>269</sup> Amended rule 2a-7(c)(11)(vii).

<sup>270</sup> Amended rule 2a-7(c)(4)(ii)(A); Proposing Release, *supra* note 2, at Section II.E.

<sup>271</sup> Amended rule 2a-7(a)(5) (defining the term "collateralized fully"). The special treatment allows money market funds to consider the acquisition of the repurchase agreement as an acquisition of the underlying collateral for diversification purposes. See Proposing Release, *supra* note 2, at n.228 and accompanying text. Under the new rule, securities with the highest rating, or unrated securities of comparable credit quality, will no longer be acceptable collateral. Compare amended rule 2a-7(a)(5) with current rule 2a-7(a)(5).

<sup>272</sup> See Proposing Release, *supra* note 2, at n.229 and accompanying text.

<sup>273</sup> See Bankers Trust Comment Letter; BlackRock Comment Letter; HighMark Capital Comment Letter; RidgeWorth Comment Letter. Two commenters opposed the proposal. Wells Fargo made a number of arguments based on the premise that the change will prevent money market funds from investing in repurchase agreements collateralized by non-government securities. The rule, however, does not restrict funds from investing in repurchase agreements. Instead, it limits the circumstances under which a fund may look through the repurchase agreement to the underlying collateral for diversification purposes. A money market fund will continue to be able to invest in repurchase agreements collateralized by other types of assets, although the securities will not be eligible for special treatment under the diversification provisions. Another commenter asserted that the limitation is unnecessary if a fund evaluates the creditworthiness of the counterparty or if it adequately values the collateral in light of rule 2a-7(c)'s minimal credit risk determination. See Am. Securit. Forum Comment Letter. As discussed above and in the Proposing Release, we are adopting this provision to protect against circumstances in which the fund may be unable to obtain its collateral or the full value of that collateral.

<sup>274</sup> See Federated Comment Letter (Federated has never relied on the diversification look-through approach for repurchase agreements collateralized by non-government securities); ICI Comment Letter (ICI members typically adopt the look-through approach only for repurchase agreements collateralized by cash items and government securities). See also Fitch Ratings, *Money Market Funds Special Report, U.S. Prime Money Market Funds: Managing Portfolio Competition to Address Credit and Liquidity Risks* (Aug. 14, 2009) ("Fitch Report"), at 6 available at [http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=462366](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=462366) (reporting that after the end of 2008 "a number of advisors to Fitch-rated U.S. prime money market funds...significantly amended their investment policies with respect to repurchase agreements counterparties and collateral schedules"; the amendments include, among others, "[r]educed acceptance of repurchase agreement collateral other than U.S. Treasury and agency securities").

<sup>275</sup> See amended rule 2a-7(c)(4)(ii)(A). We eliminated the requirement in 2001. See Proposing Release, *supra* note 2, at nn.230–33 and accompanying text. Three commenters specifically supported the change. See BlackRock Comment Letter; HighMark Capital Comment Letter; Shriver Poverty Law Ctr. Comment Letter.



adviser to determine that the counterparty is a creditworthy institution, separate and apart from the value of the collateral supporting the counterparty's obligation under the repurchase agreement.<sup>276</sup>

We are not adopting an approach suggested by some of the commenters that the evaluation of a repurchase agreement should be limited to the credit risk determination already required by rule 2a-7(c)(3) with regard to the purchase of any security.<sup>277</sup> That approach would not require a fund to evaluate separately the creditworthiness of the counterparty in order to take advantage of the special look-through treatment for diversification purposes. Under that approach, the fund's evaluation of a repurchase agreement could be based primarily or exclusively on the quality of the *collateral*. As we explained in the Proposing Release, in the midst of a market disruption caused by the default of a counterparty, a money market fund may find it difficult to protect fully its collateral without incurring losses.<sup>278</sup> The amendment is designed to avoid such losses by requiring money market funds to evaluate the creditworthiness of the counterparty in order to limit exposure to less creditworthy institutions.

## E. Disclosure of Portfolio Information

### 1. Public Website Posting

We are amending rule 2a-7 to require money market funds to disclose information about their portfolio holdings each month on their websites. The disclosure will provide greater transparency of portfolio information in a manner convenient for most investors. The amendment is designed to give investors a better understanding of the current risks to which the fund is exposed, strengthening their ability to exert influence on risk-taking by fund advisers.

Commenters generally supported requiring money market funds to post portfolio information monthly, although several urged us to revise the amendments in certain ways.<sup>279</sup> The amendments we are today adopting are substantially similar to those we proposed, with modifications to (i) the information required to be disclosed, (ii) the time within which a fund must post its portfolio holdings information, and (iii) the length of time a fund must maintain the information on its website. We discuss each of these modifications below.

*Information Required to be Disclosed.* As proposed, the amendments to rule 2a-7 would have required a fund to disclose the fund's schedule of investments, as prescribed by rules 12-12 through 12-14 of Regulation S-X,<sup>280</sup> identifying, among other things, the issuer, the title of the issue, the principal amount, the interest rate, the maturity date, and the current amortized cost of the security.<sup>281</sup> Several commenters asserted that requiring the information specified in rules 12-12 through 12-14 of Regulation S-X would include information that would not be helpful to investors. They urged us instead to require information about money market fund portfolios that would better fit the needs of investors seeking information relevant to their investment decisions.<sup>282</sup> For example, some commenters noted that under the proposed amendments a fund would be required to classify and subtotal securities by industry, provide detailed restricted securities disclosures, and provide detailed information regarding repurchase agreement counterparties and collateral. One also noted that under the proposal funds may be required to provide certain notes required by generally accepted accounting principles ("GAAP"), as many funds do for filings on Form N-Q.<sup>283</sup> Commenters asserted that these requirements would unnecessarily complicate the disclosure, be of little interest or benefit to investors, be difficult to comply with, and would

<sup>276</sup> A number of commenters argued that the evaluation should not be the board's responsibility. *See, e.g.*, IDC Comment Letter; Comment Letter of the North Carolina Capital Management Trust—Independent Trustees (Sept. 8, 2009). We note that rule 2a-7(e) allows a board to delegate the creditworthiness evaluation to the fund's investment adviser or officers, under guidelines and procedures that the board establishes and reviews.

<sup>277</sup> Three commenters argued that the proposed creditworthiness evaluation is unnecessary because it is already an element of the minimal credit risk determination that a fund makes pursuant to rule 2a-7(c)(3). *See* Federated Comment Letter; ICI Comment Letter; IDC Comment Letter. Two other commenters recommended that the applicable standard be the minimal credit risk evaluation. *See* Fidelity Comment Letter; Stradley Ronon Comment Letter.

<sup>278</sup> Proposing Release, *supra* note 2, at n.233 and accompanying text.

<sup>279</sup> *See, e.g.*, Assoc. for Fin. Professionals Comment Letter; SIFMA Comment Letter; Vanguard Comment Letter.

<sup>280</sup> 17 CFR 210.12-12–12-14.

<sup>281</sup> *See, e.g.*, BlackRock Comment Letter; GE Asset Mgt. Comment Letter; Invesco Aim Comment Letter.

<sup>282</sup> *See, e.g.*, BlackRock Comment Letter; GE Asset Mgt. Comment Letter; Invesco Aim Comment Letter.

<sup>283</sup> *See* ICI Comment Letter.

impose a significant additional burden on money market funds. They suggested modifying the disclosure requirements to exclude some of the detail.<sup>284</sup>

We are revising the information about portfolio holdings that funds must disclose on their websites. Instead of referring to Regulation S-X as we proposed, we are listing in rule 2a-7(c)(12) the information that funds must disclose.<sup>285</sup> These revisions more closely tailor the required information to the needs of money market fund investors and others who seek information about fund holdings through internet websites. For example, rule 12-12 of Regulation S-X requires funds to disclose the *subtotal* of each category of investments, *subdivided* by business grouping or investment type. We agree with commenters who argued that this level of detail, although appropriate for financial statements, is unnecessary in a fund's website disclosures to investors.<sup>286</sup> For investors who may prefer to obtain the more detailed information, it will continue to be available in money market funds' quarterly Form N-CSR and Form N-Q filings.<sup>287</sup> As discussed below, detailed information also will be available on a fund's filings on Form N-MFP.<sup>288</sup>

As amended, rule 2a-7(c)(12) will require funds to disclose monthly with respect to each security held: (i) the name of the issuer; (ii) the category of investment (e.g., Treasury debt, government agency debt, asset backed commercial paper, structured investment vehicle note); (iii) the CUSIP number (if any); (iv) the principal amount; (v) the maturity date as determined under rule 2a-7 for purposes of calculating weighted average maturity; (vi) the final maturity date, if different from the maturity date previously described; (vii) coupon or yield; and (viii) the amortized cost value.<sup>289</sup> In addition, the amendments require funds to disclose their overall weighted average maturity and weighted average life maturity of their portfolios.<sup>290</sup> The information required is substantially the same as was proposed but eliminates some of the details required by Regulation S-X, to which investors will continue to have access in the fund's quarterly filings.<sup>291</sup>

<sup>284</sup> See, e.g., BlackRock Comment Letter; Fidelity Comment Letter; ICI Comment Letter.

<sup>285</sup> Rules 12-12 through 12-14 of Regulation S-X require, and the proposed rule amendments would have required, in addition to the information required by rule 2a-7(c)(12), the following information, which we believe is not critical to be made available to investors on money market fund websites: (i) the subtotals for each category of investments, subdivided by business grouping or investment type, with their percentage value compared to net assets; (ii) for repurchase agreements, showing for each, among other things, the date of the agreement, the total amount to be received upon repurchase, the repurchase date, and a description of the securities that are subject to the repurchase agreement; (iii) for restricted securities (1) as to each such issue (a) the acquisition date, (b) the carrying value per unit of investment at date of related balance sheet, and (c) the cost of such securities, (2) as to each issue acquired during the year preceding the date of the related balance sheet, the carrying value per unit of investment of unrestricted securities of the same issuer at (a) the day the purchase price was agreed to, (b) the day on which an enforceable right to acquire such securities was obtained, and (c) the aggregate value of all restricted securities and the percentage which the aggregate value bears to net assets; (iv) the aggregate gross unrealized appreciation for all securities in which there is an excess of value over tax cost; (v) the aggregate gross unrealized depreciation for all securities in which there is an excess of tax cost over value; (vi) the net unrealized appreciation or depreciation; (vii) the aggregate cost of securities for federal income tax purposes; (viii) disclosure of investments in non-securities; (ix) the amount of equity in net profit and loss for the period; and (x) the dollar amount of dividends or interest in investments in affiliates.

<sup>286</sup> See *supra* note 282.

<sup>287</sup> Money market funds must provide a full schedule of their portfolio holdings in quarterly filings to the Commission, within 60 days after the end of the quarter. See Form N-CSR [17 CFR 274.128] (form used by registered management investment companies to file shareholder reports); Form N-Q [17 CFR 274.130] (form used by registered management investment companies to file quarterly reports of portfolio holdings after the first and third quarters).

<sup>288</sup> See *infra* Section II.E.2.

<sup>289</sup> Amended rule 2a-7(c)(12)(ii). We have added disclosure of the security's CUSIP number as an item of the web disclosure, which is designed to help users identify the securities in the fund's portfolio. We proposed and are adopting CUSIP number reporting on Form N-MFP, and commenters did not object to this reporting. See *infra* note 306 and accompanying text.

<sup>290</sup> Amended rule 2a-7(c)(12)(i). We proposed to require that funds disclose this information on Form N-MFP, which we indicated we intended to make public. Some commenters also recommended we include these disclosure items in funds' website disclosures. See Assoc. Fin. Professionals Comment Letter; BlackRock Comment Letter; Fidelity Comment Letter.

<sup>291</sup> As discussed above, the proposed amendments to rule 2a-7 would have required money market funds to disclose on their websites their monthly schedule of investments in accordance with rules 12-12 to 12-14 of Regulation S-X. To avoid unnecessarily duplicative disclosure obligations, we also proposed to amend rule 30b1-5 to exempt money market funds from Item 1 of Form N-Q, which similarly requires funds to disclose their schedule of investments in accordance with rules 12-12 to 12-14 of Regulation S-X in quarterly filings with the Commission. Because we have revised the website disclosure requirement not to include certain items in rules 12-12 to 12-14 of Regulation S-X, the disclosure requirements of rule 2a-7 and Item 1 of Form N-Q are no longer duplicative. As a result, we are not adopting the proposed amendments to rule 30b1-5.

*Time of Posting Information on Website.* The amended rule requires funds to post the portfolio information, current as of the last business day of the previous month, no later than the *fifth* business day of the month.<sup>292</sup> Under the proposed amendments, a fund would have been required to post the portfolio information on its website no later than the *second* business day of the month.<sup>293</sup> We have extended the time in response to commenters that asserted that the second business day deadline would not provide funds with enough time to compile, review, and post the required portfolio information accurately.<sup>294</sup>

*Maintenance of Information on the Website.* Portfolio information must be maintained on the fund's website for no less than six months after posting.<sup>295</sup> We have reduced the maintenance period from the proposed twelve months in response to commenters.<sup>296</sup> Many commenters stated that the proposed twelve-month maintenance period was too long.<sup>297</sup> Half of these commenters recommended a six-month period, asserting that historical portfolio holdings information could be obtained from publicly available semiannual filings with the Commission.<sup>298</sup> Other commenters recommended that no historical data be maintained on a fund's website at all.<sup>299</sup> We believe that it is important for investors to be able to compare current holdings information with previous holdings information from which they (or others analyzing the data) may discern trends. However, because historical portfolio holdings information is available to investors in semiannual filings to the Commission, we have determined to reduce the maintenance period to six months.<sup>300</sup>

## 2. Reporting to the Commission

We are adopting a new rule requiring money market funds to provide the Commission a monthly electronic filing of more detailed portfolio holdings information. The information will permit us to create a central database of money market fund portfolio holdings, which will enhance our oversight of money market funds and our ability to respond to market events.<sup>301</sup> As discussed further below, the information will also be made public on a delayed basis.

New rule 30b1-7 requires money market funds to report portfolio information on new Form N-MFP. We received 49 comment letters on the proposed rule and form, most of which supported enhancing our oversight capabilities. Many of

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<sup>292</sup> Amended rule 2a-7(c)(12).

<sup>293</sup> Proposed rule 2a-7(c)(12).

<sup>294</sup> See, e.g., BlackRock Comment Letter; Charles Schwab Comment Letter; T. Rowe Price Comment Letter; Vanguard Comment Letter. One commenter estimated that compliance with the proposed second business day deadline would cost \$1.5 million initially and \$220,000 annually. See Fidelity Comment Letter. The recommended deadlines submitted by commenters ranged from 5 business days to 15 or 30 business days after the end of each month. In light of the modifications we are making to the information that must be posted on the fund's website, as discussed above, we believe that lengthening the deadline to five business days should provide funds sufficient time to compile, review, and post the portfolio holding information accurately. We also note that a five business day deadline will typically mean seven calendar days and, when holidays intervene, eight calendar days.

<sup>295</sup> Amended rule 2a-7(c)(12). The amended rule also requires funds to provide a link to a Securities and Exchange Commission webpage where a user may obtain access to the fund's most recent 12 months of publicly available filings on Form N-MFP. Amended rule 2a-7(c)(12)(iii).

<sup>296</sup> Proposed rule 2a-7(c)(12).

<sup>297</sup> See Comment Letter of Clearwater Analytics, LLC (Sept. 7, 2009) ("Clearwater Comment Letter"); Comment Letter of Data Communiqué (Sept. 8, 2009) ("Data Communiqué Comment Letter"); Dreyfus Comment Letter; Fidelity Comment Letter; Fifth Third Comment Letter; GE Asset Mgt. Comment Letter; SIFMA Comment Letter; T. Rowe Price Comment Letter.

<sup>298</sup> See Dreyfus Comment Letter; Fifth Third Comment Letter; SIFMA Comment Letter; T. Rowe Price Comment Letter.

<sup>299</sup> See Clearwater Comment Letter; Data Communiqué Comment Letter (investors "only interested in the most recent data"); Fidelity Comment Letter; GE Asset Mgt. Comment Letter.

<sup>300</sup> Two commenters stated that retaining portfolio holdings information on a fund's website for no more than six months would be consistent with the current requirements for portfolio holdings of open-end management investment companies. See Fifth Third Comment Letter; T. Rowe Price Comment Letter.

<sup>301</sup> As we explained in the Proposing Release, our current information on money market portfolio holdings is limited to quarterly reports filed with us which, due to the high turnover rate of portfolio securities, quickly become stale. See Proposing Release, *supra* note 2, at Section II.F.2.

these commenters suggested technical modifications, a number of which we are adopting, as discussed below.<sup>302</sup> The rule and form that we are adopting today are substantially similar to what we proposed.<sup>303</sup>

*Information.* Money market funds must report on Form N-MFP, with respect to each portfolio security held on the last business day of the prior month, the following items:<sup>304</sup> (i) the name of the issuer; (ii) the title of the issue, including the coupon or yield;<sup>305</sup> (iii) the CUSIP number;<sup>306</sup> (iv) the category of investment (e.g., Treasury debt, government agency debt, asset backed commercial paper, structured investment vehicle note, repurchase agreement<sup>307</sup>); (v) the NRSROs designated by the fund, the credit ratings given by each NRSRO, and whether each security is first tier, second tier, unrated, or no longer eligible; (vi) the maturity date as determined under rule 2a-7, taking into account the maturity shortening provisions of rule 2a-7(d); (vii) the final legal maturity date, taking into account any maturity date extensions that may be effected at the option of the issuer; (viii) whether the instrument has certain enhancement features;<sup>308</sup> (ix) the principal amount; (x) the current amortized cost value;<sup>309</sup> (xi) the percentage of the money market fund's assets

<sup>302</sup> See, e.g., Charles Schwab Comment Letter; Stradley Ronon Comment Letter; Tamarack Funds Comment Letter.

<sup>303</sup> In September 2009, we adopted interim final temporary rule 30b1-6T. Disclosure of Certain Money Market Fund Portfolio Holdings, Investment Company Act Release No. 28903 (Sept. 18, 2009) [74 FR 48376 (Sept. 23, 2009)] (“Rule 30b1-6T Release”). We therefore have adopted proposed rule 30b1-6 as rule 30b1-7. The portfolio securities information that money market funds currently must report each quarter (pursuant to rule 30b1-5) is less timely and more limited in scope, and includes information about the issuer, the title of the issue, the balance held at the close of the period, and the value of each item at the close of the period. See Item 1 of Form N-Q [17 CFR 274.130] and Item 6 of Form N-CSR [17 CFR 274.128] (requiring funds to include a schedule of investments as set forth in rule 12-12 through 12-14 of Regulation S-X [17 CFR 210.12-12–12-14]).

<sup>304</sup> We have revised the form's general instructions to clarify that a filer may amend the form at any time. See Form N-MFP at General Instruction A.

<sup>305</sup> We understand that the title of an issue typically includes the coupon or yield of the instrument, and we have revised Item 27 to require this information, if applicable.

<sup>306</sup> Item 20 of proposed Form N-MFP would have required a fund to disclose the CIK of the issuer. Several commenters suggested that the form not require the issuer's CIK because the CIK is not a widely used identifier for money market instruments and is not generally maintained by money market funds. See, e.g., Dreyfus Comment Letter; Federated Comment Letter; SIFMA Comment Letter. Form N-MFP, as adopted, only requires the issuer's CIK number if the security does not have a CUSIP number and the issuer has a CIK. Item 28 and Item 30 of Form N-MFP. If the security does not have a CUSIP number, the fund must provide a unique identifier for the security if there is one. Item 29 of Form N-MFP.

<sup>307</sup> For repurchase agreements we are also requiring funds to provide additional information regarding the underlying collateral. Item 32 of Form N-MFP. This information would have been required under our proposed amendments to rule 2a-7 regarding the website disclosure of portfolio holdings. Although we continue to believe that the information is important to understanding the risks associated with a repurchase agreement and should be readily available to investors who seek it, we agree with commenters who asserted that that level of detail may not be necessary on the website disclosure. Fidelity Comment Letter (“detailed information regarding repurchase agreement counterparties and collateral” is contained across multiple systems); ICI Comment Letter. Accordingly, we have added the disclosure requirement to Form N-MFP.

<sup>308</sup> At the suggestion of one commenter, we are incorporating defined terms from amended rule 2a-7 into Form N-MFP. See Federated Comment Letter. The form requires a fund to report: (i) whether the instrument has a “demand feature” (as defined in amended rule 2a-7(a)(9)); (ii) the identity of the issuer of the demand feature; (iii) the designated NRSRO(s) for the demand feature or its provider; (iv) the credit rating provided by each designated NRSRO, if any; (v) whether the instrument has a “guarantee” (as defined in amended rule 2a-7(a)(17)); (vi) the identity of the guarantor; (vii) the designated NRSRO(s) for the guarantee or guarantor; (viii) the credit rating provided by each designated NRSRO, if any; (ix) whether the instrument has any other enhancements (i.e., other than a demand feature or guarantee); (x) the type of enhancement; (xi) the identity of the enhancement provider; (xii) the designated NRSRO(s) for the enhancement or enhancement provider; and (xiii) the credit rating provided by each designated NRSRO, if any. See Items 37-39 of Form N-MFP.

<sup>309</sup> Under Item 37 of proposed Form N-MFP, a fund would have had to provide the amortized cost of a security to the nearest hundredth of a cent. Commenters pointed out that fund accounting systems carry costs of securities in whole cents, and recommended that funds therefore be required to report the amortized cost to the nearest cent. See, e.g., Dreyfus Comment Letter; ICI Comment Letter; State Street Comment Letter. We therefore have revised the form to require the amortized cost of each portfolio security to the nearest cent. Item 41 of Form N-MFP.

invested in the security;<sup>310</sup> (xii) whether the security is an illiquid security (as defined in amended rule 2a-7(a)(19));<sup>311</sup> and (xiii) “Explanatory notes.”<sup>312</sup> Form N-MFP also requires funds to report to us information about the fund,<sup>313</sup> including information about the fund’s risk characteristics such as the dollar weighted average maturity of the fund’s portfolio and its seven-day gross yield.<sup>314</sup>

Money market funds also must report on Form N-MFP the market-based values of each portfolio security<sup>315</sup> and the fund’s market-based net asset value per share, with separate entries for values that do and do not take into account any capital support agreements into which the fund may have entered.<sup>316</sup> When we proposed Form N-MFP, we solicited comment on requiring funds to report market-based values, including the value of any capital support agreement, on the form.<sup>317</sup> Two commenters supported requiring money market funds to report market-based values to the Commission.<sup>318</sup> Other commenters objected to the public disclosure of market-based values.<sup>319</sup> We have decided to require market-based information in the monthly reports, because it will assist us in our understanding of fund portfolio valuation practices as well as the potential risks associated with a fund, e.g., a fund that has a market-based net asset value that suggests that it

<sup>310</sup> Under Item 39 of proposed Form N-MFP, a fund would have had to disclose the percentage of gross assets invested in the security. We have revised the form to require that funds disclose the percentage of net assets invested in the security (Item 42 of Form N-MFP) to conform to existing disclosure requirements. *See* rule 12-12 of Regulation S-X.

<sup>311</sup> *See* Item 44 of Form N-MFP. We have added this disclosure requirement at the suggestion of one commenter who believed that it would be useful for us to know if different funds have taken different positions regarding the liquidity of a commonly held security. *See* Federated Comment Letter. Conversely, we are not adopting proposed Item 38, which would have required funds to disclose whether the inputs used in determining the value of the securities are Level 1, Level 2, or Level 3, if applicable. *See* Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 157, “Fair Value Measurement,”* available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818754924&blobheader=application%2Fpdf>. Commenters explained that industry practice is to categorize all securities valued through reference to amortized cost as Level 2. *See, e.g.*, Dreyfus Comment Letter; ICI Comment Letter. We understand that industry practice is to determine the value of an illiquid security using Level 3 inputs. Requiring funds to disclose whether a security is illiquid will provide comparable information regarding the classification of the security.

<sup>312</sup> *See* Item 43 of Form N-MFP. This item permits funds to add miscellaneous information that may be material to other disclosure in the form.

<sup>313</sup> As proposed, many of the items would have been disclosed with regard to each *series* of the fund. As adopted, however, we are requiring that funds provide some of this information with regard to each class of the fund, where relevant (e.g., minimum initial investment and flow activity). We believe that class-specific information about these items will be more useful for analysis. We also understand that funds typically maintain this information with regard to each class of the fund. For example, funds are required to disclose class-specific information about net assets and flow activities in financial statements. *See* Rules 6-04 and 6-09 of Regulation S-X. Therefore we do not believe that requiring certain information on a class-basis will be any more burdensome than what we proposed. *See also* Clearwater Comment Letter (suggesting that total net asset value should be disclosed on a class-level basis).

<sup>314</sup> We also have revised or augmented some of the disclosure items of Form N-MFP. In addition to the seven-day gross yield, the form as adopted requires the fund’s seven-day net yield for each class as calculated under Item 26(a)(1) of Form N-1A. Item 24 of Form N-MFP. Item 15 of proposed Form N-MFP would have required that a fund provide its net shareholder flow activity for the month ended. As adopted, Form N-MFP requires the net shareholder flow information for each class and also requires the fund to provide the gross subscriptions and redemptions for the month from which the net shareholder flow is calculated. Item 23 of Form N-MFP. Item 9 of proposed Form N-MFP would have required a fund to indicate if the fund was primarily used to invest cash collateral. One commenter stated that the term “cash collateral” is ambiguous (it could include corporate trust accounts and escrows as well as collateral for securities loans or over-the-counter derivatives) and that it would be difficult for a fund to know when it is being used “primarily” for these investments. *See* Federated Comment Letter. As adopted, Form N-MFP does not require this information. Items 12-14 of proposed Form N-MFP would have required certain assets and liabilities information to the nearest hundredth of a cent. We have slightly revised these items to conform to accounting conventions and added an item for the net assets of the class. Items 13-16 and 21-22 of Form N-MFP. In addition, in response to commenters’ assertion that fund accounting systems only carry costs in whole cents, Form N-MFP as adopted requires this information to the nearest cent. *Id.*

<sup>315</sup> *See* Items 45–46 of Form N-MFP. It should be noted that Form N-MFP requires the total market-based value of each portfolio security, not the per-unit price of the security.

<sup>316</sup> *See* Item 18 (shadow NAV of the series) and Item 25 of Form N-MFP (shadow NAV of each class).

<sup>317</sup> *See* Proposing Release, *supra* note 2, at paragraph accompanying n.253.

<sup>318</sup> *See* Fund Democracy/CFA Comment Letter (“We strongly support the SEC’s proposal to require that additional information be filed with the Commission on a temporarily confidential basis. It is critical that the Commission be able to gauge the stability of the MMF industry on an ongoing basis....We believe strongly that the values at which MMFs are carrying portfolio securities is the most important piece of information for monitoring potential liquidity problems.”); Tamarack Funds Comment Letter.

<sup>319</sup> *See, e.g.*, ABA Comment Letter; Dreyfus Comment Letter; Goldman Sachs Comment Letter; Tamarack Funds Comment Letter.

may be at risk of breaking the buck. The information regarding capital support agreements will help show the extent to which the funds' valuations depend on external support agreements.

*Public availability.* Under rule 30b1-7, the information contained in the portfolio reports that money market funds file with the Commission on Form N-MFP will be available to the public 60 days after the end of the month to which the information pertains.<sup>320</sup> Although the portfolio information and other information reported to the Commission on Form N-MFP is not primarily designed for individual investors, we anticipate that many investors, as well as academic researchers, financial analysts, and economic research firms, will use this information to study money market fund holdings and evaluate their risk. Their analyses may help other investors and regulators better understand risks in money market fund portfolios.<sup>321</sup> Therefore we believe that it is important to make this information publicly available.

In the Proposing Release, we stated that we expected to make the information filed on Form N-MFP available to the public on a delayed basis, and we also requested comment on whether the rule should require funds to report, and therefore disclose to the public, the market-based valuations of the portfolio securities and of the net asset value of the fund.<sup>322</sup> As discussed further below, commenters' objections to public availability of the information collected on Form N-MFP generally fell into two categories—the competitive effects of portfolio information and the potentially destabilizing effects of market-based value information. We address each objection in turn.

First, some commenters objected to the disclosure of information filed on Form N-MFP because of its competitive effects on funds or fund managers. Three commenters argued that the information to be provided on the form is proprietary, sensitive, or confidential in nature.<sup>323</sup> Others expressed concern that making the information public could result in “investor confusion.”<sup>324</sup> Two other commenters, however, supported making Form N-MFP information available to the public on a delayed basis.<sup>325</sup> One of them emphasized the positive effect that public disclosure can have on portfolio management practices.<sup>326</sup>

We believe commenters overstated the *competitive* risks for money market funds of public access to the fund's information. As we discussed in the Proposing Release, the risks of trading ahead of funds are severely curtailed in the context of money market funds, because of the short-term nature of money market fund investments and the restricted universe of eligible portfolio securities.<sup>327</sup> For similar reasons, we believe that the potential for “free riding” on a money market fund's investment strategies, i.e., obtaining for free the benefits of fund research and investment strategies, is minimal. Because shares of money market funds are ordinarily purchased and redeemed at the stable price per share, we believe that there would be relatively few opportunities for profitable arbitrage by investors. Moreover, most funds

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<sup>320</sup> Rule 30b1-7(b). As discussed above, money market fund portfolio information will be required to be posted on fund websites within five business days after the end of the month. *See supra* notes 292–294 and accompanying text.

<sup>321</sup> *See* Proposing Release, *supra* note 2, at paragraph accompanying n.245. *See also* Clearwater Comment Letter (“[R]egular disclosure will also allow third-party analytics and reporting providers to make meaningful comparisons of money funds and highlight certain characteristics that are of interest to investors and the market generally.”).

<sup>322</sup> We stated that we intended to make Form N-MFP information public two weeks after the filing of the form. *See* Proposing Release, *supra* note 2, at paragraph accompanying n.245.

<sup>323</sup> *See* BlackRock Comment Letter; Federated Comment Letter; T. Rowe Price Comment Letter.

<sup>324</sup> *See, e.g.*, Fidelity Comment Letter; GE Asset Mgt. Comment Letter; Vanguard Comment Letter. Some commenters stated that the monthly fund website postings would provide sufficient transparency for investors. *See, e.g.*, Fifth Third Comment Letter; ICI Comment Letter; Vanguard Comment Letter.

<sup>325</sup> *See* Fund Democracy/CFA Comment Letter; Comment Letter of J.P. Morgan Investor Services Co. (Sept. 4, 2009).

<sup>326</sup> *See* Fund Democracy/CFA Comment Letter.

<sup>327</sup> *See* Proposing Release, *supra* note 2, at n.379 and accompanying and following text; ICI Report, *supra* note 14, at 93 (“Because of the specific characteristics of money market funds and their holdings...the frontrunning concerns are far less significant for this type of fund. For example, money market funds' holdings are by definition very short-term in nature and therefore would not lend themselves to frontrunning by those who may want to profit by trading in a money market fund's particular holdings. Rule 2a-7 also restricts the universe of Eligible Securities to such an extent that frontrunning, to the extent it exists at all, tends to be immaterial to money market fund performance.”).

currently disclose their *current* portfolios on their websites, and much of the information contained in Form N-MFP is already available through other publicly available filings with the Commission, albeit on a less frequent basis.<sup>328</sup>

Second, many commenters objected to the disclosure of the *market-based* values of portfolio securities and of fund net asset value per share, because of the possible destabilizing effects on money market funds. These commenters stated that disclosure of market-based values would result in investor confusion and alarm that could result in redemption requests that exacerbate pricing deviations.<sup>329</sup> One commenter supported the disclosure of market-based net asset values, stating that the disclosure could provide discipline to managers operating their funds near the level of breaking the buck, and would level the informational playing field for less sophisticated investors.<sup>330</sup> Another commenter supported only the public disclosure of market-based *portfolio securities* values.<sup>331</sup> We appreciate the risks that are involved with the real-time public disclosure of a fund's market-based portfolio and net asset values. Money market funds normally pay redeeming shareholders \$1.00 per share even if their market-based net asset value is less than \$1.00. These redemptions can hurt the fund's remaining shareholders because the realized and unrealized losses are spread across fewer shares, further depressing the fund's market-based net asset value. If enough shareholders redeem shares under these conditions, the fund, absent a capital contribution by its investment adviser or another person, can break the buck, causing remaining shareholders to receive less than \$1.00 per share. We believe that many institutional investors are currently well aware of this dynamic. If more shareholders understand the mechanical relationship between shareholder redemptions and market-based net asset value, the disclosure of a market-based net asset value below \$1.00 might precipitate a run on the fund. If one fund were to fail for this reason, runs might develop in other money market funds, even those with relatively high market-based net asset values.

Notwithstanding these risks, we believe that shareholders will benefit from knowing the monthly market-based net asset values of money market funds.<sup>332</sup> We anticipate that the public availability of these values will help investors make better informed decisions about whether to invest, or maintain their investments, in money market funds. This disclosure will indicate the extent to which the fund is managing its portfolio to achieve its fundamental objective of maintaining a stable net asset value. In addition, if market-based prices indicate significant risks in a fund's portfolio, investors, advisers and others can have a more meaningful dialogue with the fund's manager about such risks and any plans the fund manager may have to address any discounts between the market-based net asset value and the stable net asset value. This type of dialogue already takes place between sophisticated investors and funds that disclose portfolio information on a current basis. These sophisticated, often institutional, investors have the resources to estimate current market values and make purchase and redemption decisions on the basis of information that, in the past, has been beyond the reach of most retail investors.

As a collateral effect, we expect that the public disclosure of monthly market-based net asset values may have the effect of discouraging a fund's portfolio manager from taking risks that might reduce the fund's market-based net asset value.<sup>333</sup> We also anticipate that such disclosure may lead to greater cash flows into funds that have a smaller discount from the \$1.00 NAV (or less historical volatility in that discount). This disclosure, which will provide values that include and exclude the effect of any capital support agreements, might also have the effect of encouraging funds that have affiliates to request financial support or other appropriate measures as soon as problems develop. Such support or other measures could provide greater stability to money market funds.

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<sup>328</sup> As noted above, money market funds must provide a full schedule of their portfolio holdings in quarterly filings to the Commission. See *supra* note 287.

<sup>329</sup> See, e.g., ABA Comment Letter; T. Rowe Price Comment Letter; USAA Comment Letter (redemptions might lead to greater volatility in cash flows and increase the instability of the fund). In addition, one commenter stated that the investor confusion might result in additional costs for funds due to the need to answer investor inquiries. See Dreyfus Comment Letter.

<sup>330</sup> See Shadow FRC Comment Letter.

<sup>331</sup> See Clearwater Comment Letter.

<sup>332</sup> Adequate disclosure to investors is a fundamental principle of the Commission's regulatory mandate. See, e.g., section 1(b), 1(b)(1) of the Investment Company Act ("[N]ational public interest and the interests of investors are adversely affected...when investors purchase, pay for, exchange...sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information...").

<sup>333</sup> See Fund Democracy/CFA Comment Letter ("[G]reater transparency should provide a strong incentive for funds to avoid the excessively risky practices that lead to instability and encourage redemption.").

Nevertheless, we understand commenters' concerns that the disclosure of certain fund information, including market-based values, might result in investor confusion and alarm, at least in the short term, that could result in redemption requests that exacerbate pricing deviations.<sup>334</sup> In response to these and other concerns discussed above, we are delaying the public availability of the information filed on Form N-MFP for 60 days after the end of the reporting period.<sup>335</sup> This 60-day delay in public availability mirrors the current 60-day lag under other rules between the end of a fund's reporting period and the public filing of portfolio information with the Commission.<sup>336</sup> In addition, funds currently are required to file twice a year a public report that includes the fund's market-based net asset value, within 60 days after the end of the reporting period.<sup>337</sup>

We anticipate that, during the 60 days between the end of the reporting period and public availability of the information, funds will take steps to resolve issues that may raise concerns with investors and analysts. In addition, because money market fund portfolios have a limited maturity, many of the portfolio securities will have matured by the time the information is released to the public. Thus we expect that the 60-day delay will ameliorate many of the risks associated with public disclosure. We also expect that, over time, investors and analysts will become more accustomed to the information disclosed about fund portfolios, and thus there may be less need in the future to require a 60-day delay between the end of the reporting period and the public availability of the information. We therefore may revisit in a subsequent release whether to retain the same (or any) delay in public availability of this information.

*Timing.* Each money market fund must submit Form N-MFP electronically to the Commission within five business days after the end of each month.<sup>338</sup> Under the proposed rule, a fund would have been required to file Form N-MFP with the Commission no later than two business days after the end of each month. Commenters asserted that the second business day deadline would not have provided funds enough time to compile, review, and file the requested portfolio information accurately.<sup>339</sup>

In response to commenters, we are delaying the mandatory filing date for several months after the effective date of the amendments, to permit money market funds to develop systems necessary to collect and submit the portfolio information on Form N-MFP.<sup>340</sup> Thus, the first mandatory filing will be due on December 7, 2010, for holdings as of the end of November 2010. For approximately two months before the first mandatory filing, our staff will accept the submission of trial data so that money market funds may voluntarily make (non-public) electronic submissions with us. We anticipate that these submissions will help money market funds gain experience collecting and submitting the information, and we will use these submissions and the experiences of the funds to make technical adjustments to our systems and provide any guidance. Because of the possibility of errors or mistakes in the information submitted, we do not intend to make the trial data public.

<sup>334</sup> See *supra* note 329 and accompanying text.

<sup>335</sup> Rule 30b1-7(b).

<sup>336</sup> Funds are required to file each quarter with the Commission portfolio holdings reports, which are available to the public, within 60 days after the end of the quarter. See *supra* note 287.

<sup>337</sup> Money market funds currently must disclose their mark-to-market net asset value per share, to four decimals, twice a year in their Form N-SAR filings [17 CFR 274.101]. See Sub-Item 74W of Form N-SAR. Form N-SAR must be filed with the Commission no later than the 60th day after the end of the fiscal period for which the report is being prepared. See General Instruction C to Form N-SAR. Information supplied on Form N-SAR is publicly available on EDGAR and in the public files of the Commission. See General Instruction A to Form N-SAR.

<sup>338</sup> See rule 30b1-7.

<sup>339</sup> See, e.g., BlackRock Comment Letter; Dreyfus Comment Letter; Vanguard Comment Letter. The recommended deadlines submitted by commenters ranged from five business days to 15 to 30 business days. We are providing for an extended implementation period before compliance with rule 30b1-7 is required, as discussed below, during which time funds will be able to build or update systems to compile the data and file the new form, test those systems, and possibly participate in the voluntary compliance program. Therefore, we believe that lengthening the deadline to five business days should provide funds sufficient time to compile, review, and file Form N-MFP accurately.

<sup>340</sup> Several commenters requested that the Commission allow funds at least six months before mandatory compliance with the new reporting requirement on Form N-MFP. See, e.g., FAF Advisors Comment Letter; ICI Comment Letter; J.P. Morgan Asset Mgt. Comment Letter.



*Method of filing.* As proposed, Form N-MFP must be filed electronically through the Commission's EDGAR system in an eXtensible Markup Language ("XML") tagged data format.<sup>341</sup> We understand that money market funds already maintain most of the information that will be filed on the form, and therefore the main requirement for funds will be the tagging of the data and filing of the reports with the Commission.<sup>342</sup> Some commenters recommended that the Commission require that Form N-MFP be filed in an eXtensible Business Reporting Language ("XBRL") format.<sup>343</sup> Although XBRL may allow for more comparative analysis or more opportunities for manipulation of data than XML allows, we believe that the data required by Form N-MFP will be clearly defined and often repetitive from one month to the next, and therefore the XML format will provide us with the necessary information in the most timely and cost-effective manner.<sup>344</sup> Over time we expect these filings will become highly automated and involve minimal costs.

### 3. Phase-out of Weekly Reporting by Certain Funds

We are adopting as final rule 30b1-6T, the temporary rule that requires the weekly filing of portfolio information by money market funds in certain circumstances. As adopted, the only change to the rule is the expiration date. Rule 30b1-6T will expire on December 1, 2010, which corresponds with the first filing of portfolio information required by new rule 30b1-7.

In September 2009, we adopted rule 30b1-6T.<sup>345</sup> The rule requires any money market fund that has a market-based net asset value per share below \$0.9975 to provide the Commission with weekly portfolio and valuation information. The information required by the rule is similar to the information money market funds participating in the Treasury Department's Guarantee Program were required to provide under similar circumstances.<sup>346</sup> We requested comments on the rule when we adopted it, but received none.<sup>347</sup>

Rule 30b1-6T originally would have expired one year after we adopted it, i.e., on September 17, 2010.<sup>348</sup> The information that rule 30b1-7, which we are adopting today, will require *all* money market funds to file on a monthly basis subsumes the information that funds with lower market-based NAVs were required to file under rule 30b1-6T. Therefore we are phasing out the latter rule, but are extending its expiration date so that we will continue to receive weekly reports until the monthly reporting requirements of rule 30b1-7 are mandatory. After that time, our monitoring of information filed by money market funds on Form N-MFP, as well as notifications of purchases of certain assets from funds in reliance on rule 17a-9 should enable our staff to identify, and analyze information from, money market funds that exhibit signs of distress and the need for further monitoring.<sup>349</sup>

<sup>341</sup> We anticipate that the XML interactive data file will be compatible with a wide range of open source and proprietary information management software applications. Continued advances in interactive data software, search engines, and other web-based tools may further enhance the accessibility and usability of the data.

<sup>342</sup> We understand that many funds often provide this type of information in different formats to various information services and third-parties, including NRSROs. Standardizing the data format in Form N-MFP may encourage standardization across the industry, resulting in cost savings for money market funds.

<sup>343</sup> See, e.g., Comment Letter of the American Institute of Certified Public Accountants (Sept. 8, 2009); Comment Letter of EDGAR Online, Inc. (July 23, 2009); Comment Letter of XBRL US (Sept. 8, 2009). Most commenters were neutral on the submission format for Form N-MFP. See, e.g., Clearwater Comment Letter; Fund Democracy/CFA Comment Letter; ICI Comment Letter.

<sup>344</sup> The XBRL format would require a longer period for implementation by the Commission and funds, and would entail additional costs. However, the XBRL format derives from and is compatible with the XML format. Moreover, to the extent possible, we intend to follow the naming convention for the XBRL-tagging of the Schedule of Investments in the voluntary filer program. See Interactive Data for Mutual Fund Risk/Return Summary, Investment Company Act Release No. 28617 (Feb. 11, 2009) [74 Fed. Reg. 7748 (Feb. 19, 2009)]. If the Commission determines at a future date to require the filing of Form N-MFP in an XBRL format, the Commission and funds might benefit from their experience with their existing XML technology.

<sup>345</sup> See Rule 30b1-6T Release, *supra* note 303. We adopted the rule on an interim final basis. See *id.* at Section II.C.

<sup>346</sup> See rule 30b1-6T(b)(3). See also *supra* note 16.

<sup>347</sup> See Rule 30b1-6T Release, *supra* note 303, at Section III.

<sup>348</sup> Rule 30b1-6T(d).

<sup>349</sup> See *infra* Section II.G.2 (notification provision under amended rule 2a-7 concerning purchases undertaken in reliance on rule 17a-9).

Because the compliance date for filing monthly portfolio information on Form N-MFP is December 7, 2010, we are amending rule 30b1-6T so that it expires on December 1, 2010. The last date that funds will be required to file information under rule 30b1-6T therefore will be on November 30, 2010.

#### F. Processing of Transactions

We are amending rule 2a-7, substantially as proposed, to require that a fund (or its transfer agent) have the capacity to redeem and sell its securities at a price based on the fund's current net asset value per share, including the capacity to sell and redeem shares at prices that do not correspond to the stable net asset value or price per share.<sup>350</sup> This amendment will require that shareholder transactions be processed in an orderly manner, even under circumstances that require a fund to "break a dollar."<sup>351</sup> Other types of mutual funds already have this ability to process transactions at varying prices.

Several commenters supported the proposed amendment, noting that it is important that funds be able to redeem shareholders at prices based on the current net asset value of the fund.<sup>352</sup> Some commenters expressed concerns about the costs for funds to modify their systems under the amendment.<sup>353</sup> We noted when we proposed the amendment that, because funds are already obligated to redeem at a price other than the stable net asset value per share, there should be no new cost associated with the requirement that funds (or their transfer agents) have systems that can meet these requirements.<sup>354</sup> It is the responsibility of money market funds, as issuers of redeemable securities, to be able to satisfy redemption requests within seven days after tender of the securities, even if a fund has re-priced its net asset value at a price other than its stable net asset value per share.<sup>355</sup> Based on our recent experience, we believe it is unlikely that a fund that breaks the dollar would be able to satisfy redemption requests within seven days if it did not already have the capacity to process redemptions at prices other than the stable net asset value.<sup>356</sup> To the extent that funds incur costs in meeting the new requirement, we believe the benefits to shareholders justify those costs, which we discuss in detail in the cost benefit section below.<sup>357</sup>

When we proposed the amendment, we proposed to require that the fund's *board of directors determine* that the fund has the capacity to sell and redeem securities at the current net asset value.<sup>358</sup> We asked for comments on the board's role, and specifically whether the rule should require that the fund simply *have* the ability to process transactions at the fund's current net asset value without a specific board determination.<sup>359</sup> Some commenters preferred that the board not be required to make such a determination, arguing that the determination is operational in nature and more appropriate for the fund's investment adviser or chief compliance officer to make.<sup>360</sup>

<sup>350</sup> Amended rule 2a-7(c)(13).

<sup>351</sup> Once a fund has broken a dollar, the fund could no longer use penny-rounding method of pricing or the amortized cost method of valuing portfolio securities, and therefore would have to compute share price by reference to the market values of the portfolio with the accuracy of at least a tenth of a cent. See 1983 Adopting Release, *supra* note 6, at n.6 and accompanying text. Thus, a fund whose market-based net asset value was determined to be \$0.994 would, upon ceasing to use the amortized cost method of valuation, begin to redeem shares at \$0.994 (rather than at \$0.990). See *generally id.*

<sup>352</sup> See, e.g., Dreyfus Comment Letter; Fund Democracy/CFA Comment Letter; MFDF Comment Letter.

<sup>353</sup> See, e.g., Federated Comment Letter; RidgeWorth Comment Letter.

<sup>354</sup> See Proposing Release, *supra* note 2, at Section V.A.6 (cost benefit analysis).

<sup>355</sup> See section 22(e) of the Act.

<sup>356</sup> As we noted in the Proposing Release, the inability of one money market fund in 2008 to be able to process securities at prices other than \$1.00 per share impeded its ability to distribute assets during its liquidation. See Proposing Release, *supra* note 2, at n.262 and accompanying text. Even if a fund were to break a dollar, decide to liquidate, and suspend redemptions in reliance on new rule 22e-3 that we are adopting today, See *infra* Section II.H, the fund's ability to process redemptions at prices other than the stable net asset value is necessary to facilitate the orderly liquidation of the fund.

<sup>357</sup> See *infra* Section V.

<sup>358</sup> Proposed rule 2a-7(c)(1) (last two sentences).

<sup>359</sup> See Proposing Release, *supra* note 2, at text following n.263.

<sup>360</sup> See, e.g., Federated Comment Letter; MFDF Comment Letter; NYC Bar Assoc. Comment Letter.

We agree that the focus of the rule should be on the fund's ability to process transactions, rather than on the board's determination regarding that ability, because the issue is operational in nature and need not directly involve the board. We have therefore revised the rule accordingly.<sup>361</sup>

Some commenters raised the issue of whether the rule applies to third-party intermediaries, i.e., whether it requires third parties to have the capacity to process transactions in a money market fund at prices other than the fund's stable net asset value.<sup>362</sup> The rule by its terms applies only to money market funds and their transfer agents. We note, however, that intermediaries themselves typically have separate obligations to investors with regard to the distribution of proceeds received in connection with investments made or assets held on behalf of those investors.<sup>363</sup>

Several commenters requested that, if the Commission adopted the rule amendment, it provide ample time for money market funds to change their systems to accommodate purchases and redemptions at the current net asset value.<sup>364</sup> We have established a compliance date of October 31, 2011, which is approximately 18 months after the *effective* date of the rule amendments, and more than 20 months after adoption of the amendments. This compliance period is designed to enable funds and those who act on their behalf sufficient time to come into full compliance with the amended rule.

### G. Exemption for Affiliate Purchases

The Commission is adopting an amendment to rule 17a-9 under the Investment Company Act to expand the circumstances under which certain affiliated persons can purchase portfolio securities from a money market fund.<sup>365</sup> The amendment permits money market funds to dispose of distressed securities (e.g., securities depressed in value as a result of market conditions) quickly during times of market stress. The Commission is also adopting a related amendment to rule 2a-7, which requires funds to report all such transactions to the Commission.

#### 1. Expanded Exemptive Relief

We are adopting the amendment to rule 17a-9, as proposed. The amendment expands the exemption provided by the rule from the Act's prohibition on affiliated transactions to permit affiliated persons to purchase from a money market fund a portfolio security that has defaulted,<sup>366</sup> but that continues to be an eligible security, as long as the conditions of the rule

<sup>361</sup> As adopted, the new requirement is paragraph (c)(13) of amended rule 2a-7, titled "Processing of Transactions."

<sup>362</sup> See, e.g., Tamarack Funds Comment Letter (requesting that the Commission clarify that funds "are not responsible for ensuring that intermediaries have the capacity to effect share transactions at other than \$1.00"); Russell Inv. Comment Letter (stating that the proposed rule amendment would not apply to intermediaries); see also ICI Comment Letter ("proposed amendments are silent with respect to...similar systems changes for broker-dealers, banks, insurance companies, trusts, 401(k) recordkeepers, and others that process such amendments"). Some commenters raised concerns about the costs that third parties might bear to revise their computer systems to have the capacity to accommodate purchases and redemptions of money market fund shares at prices other than the fund's stable net asset value. See, e.g., ICI Comment Letter.

<sup>363</sup> Cf. rule 15c3-3(e)(3) under the Securities Exchange Act [17 CFR 240.15c3-3(e)(3)] (requiring broker-dealers to periodically recompute the value of bank accounts held on behalf of broker-dealer customers); rule 15c3-2 under the Securities Exchange Act [17 CFR 240.15c3-2] (prohibiting a broker-dealer from using proceeds from free credit balances unless the proceeds are payable on demand of the customer). See also *Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 404 N.Y.S.2d 258, 262 (N.Y. Sup. Ct. 1978) (holding that after an investment is sold and proceeds belonging to the customer come into the broker's possession, the broker becomes a fiduciary with respect to those proceeds and may not consciously use them to the detriment of his customer and for his own benefit).

<sup>364</sup> See, e.g., Federated Comment Letter (requesting at least one year); ICI Comment Letter (requesting at least two and a half years); SIFMA Comment Letter (requesting an "adequate period of time").

<sup>365</sup> Rule 17a-9 provides an exemption from section 17(a) of the Act to permit affiliated persons of a money market fund to purchase distressed portfolio securities from the fund. Absent a Commission exemption, section 17(a)(2) prohibits any affiliated person or promoter of or principal underwriter for a fund (or any affiliated person of such a person), acting as principal, from knowingly purchasing securities from the fund. Rule 17a-9 exempts certain purchases of securities from a money market fund from section 17(a), if the purchase price is equal to the greater of the security's amortized cost or market value (in each case, including accrued interest). For convenience, in this Release we refer to all of the persons who would otherwise be prohibited by section 17(a)(2) from purchasing securities of a money market fund as "affiliated persons." "Affiliated person" is defined in section 2(a)(3) of the Act.

<sup>366</sup> The rule excludes an immaterial default unrelated to the financial condition of the issuer, which would make the rule unavailable in the case of defaults that are technical in nature, such as where the obligor has failed to provide a required notice or information on a timely basis. See Proposing Release, *supra* note 2, at n.272. Other provisions of rule 2a-7 currently except immaterial defaults unrelated to the financial condition of the issuer. See amended rule 2a-7(c)(7)(ii)(A).

governing the purchase price are satisfied.<sup>367</sup> These conditions require that the purchase price is paid in cash and is equal to the greater of the security's amortized cost or its market value, including accrued interest.<sup>368</sup>

We are adding a new provision to the rule that will more broadly permit affiliated persons, under the same conditions as discussed above, to purchase other portfolio securities from an affiliated money market fund, for any reason, provided that such person promptly remits to the fund any profit it realizes from the later sale of the security.<sup>369</sup> In these circumstances there may not be an objective indication that the security is distressed and thus that the transaction is clearly in the interest of the fund. Therefore, as proposed, we have added the “claw back” requirement to eliminate incentives for fund advisers and other affiliated persons to buy securities for reasons other than protecting fund shareholders from potential future losses.

Commenters supported the proposed amendment, agreeing that it would provide money market fund advisers with important flexibility to manage fund assets for the benefit of all shareholders during volatile periods.<sup>370</sup> One commenter opposed the proposed amendment out of concern that the expansion of the rule may exacerbate the unwarranted expectation of some shareholders that advisers will take whatever steps are necessary to financially support the \$1.00 share price of their money market funds.<sup>371</sup> While we appreciate the commenter's concern, we do not believe that today's action will materially change shareholders' perceptions about money market funds or the likelihood of sponsor support during times of market turmoil. The amendment simply extends the existing rule to types of transactions that historically have been permitted through no-action assurances obtained from the Commission's staff because the staff believed they were in the best interest of the fund's shareholders.<sup>372</sup>

The amendment to rule 17a-9 that we are adopting today is intended to enable advisers to address acute credit or liquidity problems in a money market fund portfolio by purchasing securities from the fund that would be difficult or impossible to sell on the open market at or near their amortized cost. We have crafted the conditions of the rule, including the pricing conditions and the new claw back provision, to protect shareholders' interests and prevent overreaching by advisers. Our staff's experience is that, under such circumstances, these transactions appear to be fair and reasonable and in the best interests of fund shareholders.<sup>373</sup> Moreover, we believe that the alternative of funds obtaining no-action assurances from the Commission staff for these transactions, particularly during times of market stress, is time consuming and inefficient.

## 2. New Reporting Requirement

We also are adopting an amendment to rule 2a-7 to require a money market fund whose securities have been purchased by an affiliated person in reliance on rule 17a-9 to provide us with prompt notice by electronic mail of the transaction and the reasons for the purchase.<sup>374</sup> Such reasons might include, for example, that the fund's adviser expected that the security would be downgraded, that due to the decreased market value of the security the fund was at risk of breaking the buck, or that the fund was experiencing significant redemption requests and wished to avoid a “fire sale” of assets to satisfy such requests. The amendment is intended to provide us with more complete information about these transactions and to alert us to potential problems the fund may be experiencing.

<sup>367</sup> See amended rule 17a-9(a). Previously, the exemption was available only for the purchase of a portfolio security that was no longer an “eligible security.” This could occur, for example, when a security's ratings are downgraded. As we explained in the Proposing Release, this limitation served as a proxy indicating that the market value of the security was likely less than its amortized cost value, and thus the resulting transaction was fair to the fund and did not involve overreaching. See Proposing Release, *supra* note 2, at n.269 and accompanying text.

<sup>368</sup> See amended rule 17a-9(a)(1)-(2).

<sup>369</sup> See amended rule 17a-9(b)(1)-(2).

<sup>370</sup> See, e.g., Dreyfus Comment Letter; Vanguard Comment Letter.

<sup>371</sup> See Federated Comment Letter.

<sup>372</sup> See Proposing Release, *supra* note 2, at nn.270–71 and preceding, accompanying, and following text.

<sup>373</sup> See Proposing Release, *supra* note 2, at text following n.271.

<sup>374</sup> Amended rule 2a-7(c)(7)(iii)(B). We have clarified that not only purchases by affiliated persons, but also purchases by promoters and principal underwriters of a fund, and any affiliated person of such persons, which are exempt under rule 17a-9, must be reported to the Commission under the provision. Compare amended rule 2a-7(c)(7)(iii)(B) with proposed rule 2a-7(c)(7)(iii)(B).

All commenters who addressed the proposed reporting requirement agreed with the need to provide the Commission with this information.<sup>375</sup> At the suggestion of one,<sup>376</sup> we have modified the requirement to provide that the notification must include the price at which the transaction was conducted and the amortized cost value of the security (which will be different if the market value is higher than the amortized cost), which will help us monitor whether the pricing conditions of rule 17a-9 have been satisfied.<sup>377</sup>

## H. Fund Liquidation

The Commission is adopting new rule 22e-3, which exempts money market funds from section 22(e) of the Act to permit them to suspend redemptions and postpone payment of redemption proceeds in order to facilitate an orderly liquidation of the fund. The rule permits a fund to suspend redemptions and payment of redemption proceeds if (i) the fund's board, including a majority of disinterested directors, determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results, (ii) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (iii) the fund, prior to suspending redemptions, notifies the Commission of its decision to liquidate and suspend redemptions.<sup>378</sup> The new rule replaces rule 22e-3T, a temporary rule that provided a similar exemption for money market funds that participated in the Treasury Department's Guarantee Program.<sup>379</sup>

Rule 22e-3 is intended to reduce the vulnerability of investors to the harmful effects of a run on the fund, and minimize the potential for disruption to the securities markets. Because the suspension of redemptions may impose hardships on investors who rely on their ability to redeem shares, the conditions of the rule limit the fund's ability to suspend redemptions to circumstances that present a significant risk of a run on the fund and potential harm to shareholders. The rule is designed only to facilitate the permanent termination of a fund in an orderly manner. We are revising one of the conditions of the rule, which requires that the board approve the liquidation of the fund, to provide that the fund board must have *irrevocably* approved the liquidation of the fund.<sup>380</sup>

Commenters generally supported the rule, which we are adopting largely as proposed.<sup>381</sup> We have revised one of the rule's conditions in response to commenters' concerns. The proposed rule conditioned its relief on a fund breaking a dollar and re-pricing its shares.<sup>382</sup> Some commenters argued that the rule should allow a fund to suspend redemptions before it breaks a dollar.<sup>383</sup> We are concerned that, without appropriate limits, fund sponsors might use the rule in the course of routine liquidations. We also recognize, however, that requiring a money market fund to actually re-price its securities may not be necessary in order to warrant the suspension of redemptions. Therefore, we have revised the rule's condition to require that the fund's board of directors, including a majority of disinterested directors, determine pursuant to rule

<sup>375</sup> See, e.g., BlackRock Comment Letter, Dreyfus Comment Letter. One suggested that sales prices of any securities purchased by the adviser pursuant to rule 17a-9 be promptly reported to the fund's board of directors as well as to the Commission. Comment Letter of the Independent Trustees of Fidelity Fixed Income Funds (Sept. 8, 2009) ("Fidelity Fixed Income Indep. Trustees Comment Letter"). We are not extending the reporting provision to include notification to fund boards because the provision is intended to enable the Commission to monitor how rule 17a-9 is being used. Nevertheless, we expect that fund boards will want to know this information and will request it.

<sup>376</sup> See Fidelity Fixed Income Indep. Trustees Comment Letter.

<sup>377</sup> See amended rule 2a-7(c)(iii)(B).

<sup>378</sup> Rule 22e-3(a). A fund that intends to be able to rely on rule 22e-3 may also need to update its prospectus to disclose the circumstances under which it may suspend redemptions. See, e.g., Item 6 of Form N-1A ("Purchase and Sale of Fund Shares").

<sup>379</sup> See Temporary Exemption for Liquidation of Certain Money Market Funds, Investment Company Act Release No. 28487 (Nov. 20, 2008) [73 FR 71919 (Nov. 26, 2008)]. The Treasury Department's Guarantee Program guaranteed that shareholders of a participating money market fund would receive the fund's stable share price for each share owned as of September 19, 2008, if the fund were to liquidate under the terms of the Program. See *supra* note 16 and accompanying text. The Program expired on September 19, 2009, and rule 22e-3T expired on October 18, 2009.

<sup>380</sup> Rule 22e-3(a)(2). This revision is designed to limit the availability of the rule to extraordinary circumstances, by preventing a fund from invoking the rule if the board determines to liquidate the fund but subsequently revokes its determination, which might, in effect, enable the fund to temporarily suspend redemptions.

<sup>381</sup> Commenters generally agreed that the rule would facilitate fair and orderly liquidations to the benefit of all fund shareholders. See, e.g., IDC Comment Letter; MFDF Comment Letter.

<sup>382</sup> Proposed rule 22e-3(a)(1).

<sup>383</sup> See, e.g., ABA Comment Letter; ICI Comment Letter; IMMFA Comment Letter.

2a-7(c)(8)(ii)(C)<sup>384</sup> that the extent of the deviation between the fund's amortized cost price per share and its shadow price may result in material dilution or other unfair results to investors or existing shareholders.<sup>385</sup> In order to invoke the exemption, therefore, the fund's board must make the same determination that it would make if it were deciding to break a dollar. We believe the revised condition provides fund directors with the appropriate amount of discretion to act in the interest of shareholders.<sup>386</sup>

Paragraph (b) of rule 22e-3 allows a conduit fund (i.e., a fund that invests in a money market fund) to rely on the rule if the money market fund in which it invests has suspended redemptions under the rule.<sup>387</sup> We anticipated when we proposed this provision that it would be used principally by insurance company separate accounts issuing variable insurance contracts and by funds participating in master-feeder arrangements.<sup>388</sup> At the suggestion of one commenter who pointed out that most insurance company separate accounts are organized as unit investment trusts rather than management companies,<sup>389</sup> we have expanded the rule to include unit investment trusts.<sup>390</sup>

Paragraph (c) of the rule provides that the Commission may take certain steps to protect shareholders. It permits the Commission to rescind or modify the relief provided by the rule (and thus require the fund to resume honoring redemptions) if, for example, a liquidating fund has not devised, or is not properly executing, a plan of liquidation that protects fund shareholders. Under this provision, the Commission may modify the relief after appropriate notice and opportunity for hearing in accordance with section 40 of the Act.<sup>391</sup> Commenters did not address this provision, and we are adopting it as proposed.

One commenter recommended that the rule not require prior notice to the Commission.<sup>392</sup> In light of the seriousness of the consequences to shareholders, we believe it is important that the Commission receive prior notice of a suspension of redemptions, particularly when the burden of providing such notice is minimal.<sup>393</sup> Another commenter suggested that the Commission require funds to disclose their plan of liquidation as a condition for suspending redemptions.<sup>394</sup> We are reluctant to impose such a requirement because the time needed to formulate such a plan may prevent fund boards from acting in a timely fashion in the case of an emergency, but we expect that funds would promptly communicate their plan of liquidation to shareholders. Another commenter recommended that the suspension period be limited to 60 days.<sup>395</sup> We have not modified the final rule in response to these comments because liquidations will proceed differently depending on a fund's particular circumstances, and we believe that fund management, under the supervision of the board, is best able to devise and execute a plan of liquidation that is in the best interest of fund shareholders. Furthermore, as discussed above, the Commission will retain authority under the rule to rescind or modify the relief (after appropriate notice and

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<sup>384</sup> Amended rule 2a-7(c)(8)(ii)(C) provides that, if a money market fund's board of directors believes that the deviation between the fund's amortized cost price per share and its shadow price may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent practicable such dilution or unfair results.

<sup>385</sup> Rule 22e-3(a)(1).

<sup>386</sup> Under the final rule, the exemption applies to securities tendered for redemption but not yet priced at the time the fund begins to rely on the rule. Therefore, for example, if a shareholder submits a redemption order at noon and the fund decides to liquidate and suspend redemptions pursuant to rule 22e-3 at 2:00 pm, the shareholder would be entitled to receive only his or her *pro rata* share of the fund's liquidation proceeds. This is also the case for shareholders who submitted redemption orders after the last time as of which the fund computed its net asset value and shareholders who submitted redemption orders after 2:00 pm.

<sup>387</sup> Rule 22e-3(b) also requires that the conduit fund promptly notify the Commission that it has suspended redemptions in reliance on the rule.

<sup>388</sup> See Proposing Release, *supra* note 2, at text accompanying n.289.

<sup>389</sup> See Committee Ann. Insur. Comment Letter.

<sup>390</sup> Rule 22e-3(b) (providing relief to a "registered investment company" rather than to a "fund," or "registered open-end management investment company," as proposed).

<sup>391</sup> Rule 22e-3(c).

<sup>392</sup> See ABA Comment Letter.

<sup>393</sup> In addition, these prior notices will, among other things, help us to ascertain whether a fund has erroneously invoked the rule in circumstances for which it was not intended to be used (*e.g.*, a routine liquidation).

<sup>394</sup> See Federated Comment Letter.

<sup>395</sup> See Bankers Trust Comment Letter.

opportunity for hearing) if we conclude, for example, that a liquidating fund has not devised, or is not properly carrying out, a plan of liquidation that protects fund shareholders.<sup>396</sup>

### III. COMPLIANCE DATES

The amendments to rules 2a-7, 17a-9 and 30b1-6T, and new rules 22e-3 and 30b1-7, and new Form N-MFP become effective May 5, 2010. Unless otherwise discussed below or in this Release, the compliance date is the date of effectiveness.

Some money market funds may have policies that can be changed only if authorized by a shareholder vote. For example, a money market fund may have a disclosed policy of maintaining a WAM (i.e., weighted average maturity) no greater than 90 days, which is less restrictive than the amendment the Commission is adopting today requiring a money market fund to maintain a WAM no greater than 60 days.<sup>397</sup> The Commission believes that, in those circumstances where the existing policy is less restrictive than the amendments we are today adopting and does not conflict with those amendments, a money market fund would not need to hold a shareholder vote under sections 8(b) or 13(a) of the Act merely to comply with the amendments.<sup>398</sup> Moreover, we would not object if a fund were to amend its registration statement to reflect the fund's compliance with the amended rule pursuant to rule 485(b) under the Securities Act of 1933, if other changes in the fund's post-effective amendment meet the conditions for immediate effectiveness under that rule.<sup>399</sup>

#### A. Portfolio Requirements

Except as indicated below, the compliance date for amendments to rule 2a-7 related to portfolio quality, maturity, liquidity, and repurchase agreements, is May 28, 2010. Funds are not required to dispose of portfolio securities owned, or terminate repurchase agreements entered into, as of the time of adoption of the amendments to comply with the requirements of the rule as amended. Fund portfolios must meet the new maximum WAM and WAL limits by June 30, 2010.

#### B. Designation of NRSROs

Each fund must disclose the designated NRSROs in its Statement of Additional Information pursuant to amended rule 2a-7(a)(11)(iii) no later than December 31, 2010. This additional time should permit fund boards of directors to evaluate and designate NRSROs without the need to call a special board meeting. Fund boards are free to take advantage of the rule amendments any time after the effective date.

#### C. Disclosure and Reporting of Portfolio Information

*Website disclosure.* The compliance date for public website disclosure is October 7, 2010. This should provide each fund sufficient time to revise its information and other systems to ensure that required information is accurately posted and maintained on its website.

*Reporting to the Commission.* All money market funds must begin filing information on Form N-MFP pursuant to rule 30b1-7 no later than December 7, 2010. This compliance date is designed to permit money market funds to develop systems necessary to collect and submit the portfolio information on Form N-MFP. Funds filing information with the Commission pursuant to rule 30b1-6T will no longer be required to file this information after December 1, 2010.

Beginning October 7, 2010, our staff will be able to receive trial data from funds, on a voluntary basis, pursuant to the requirements of rule 30b1-7. We will use these voluntary submissions and the experiences of funds during this period to make adjustments to our filing system and provide guidance to funds. We do not intend to make these submissions public.<sup>400</sup>

<sup>396</sup> See *supra* note 391 and accompanying paragraph.

<sup>397</sup> See *supra* Section II.B.1.

<sup>398</sup> 15 U.S.C. 80a-8(b), 80a-13(a).

<sup>399</sup> 17 CFR 230.485(b).

<sup>400</sup> We do not intend to make public the information submitted to us on Form N-MFP as trial data before the mandatory compliance date because of the possibility of errors in the information submitted. See *supra* text following note 339.

## D. Processing of Transactions

Funds must comply with the new requirement to be able to process transactions at prices other than stable net asset value no later than October 31, 2011, which is more than 20 months after adoption of the amendments.<sup>401</sup> This compliance period is designed to enable funds and those who act on their behalf sufficient time to come into full compliance with the amended rule.

## IV. PAPERWORK REDUCTION ACT ANALYSIS

Certain provisions of the amendments to rules 2a-7 and 30b1-6T, new rules 22e-3 and 30b1-7, and Form N-MFP under the Investment Company Act contain “collections of information” within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>402</sup> The titles for the existing collections of information that are affected by the rule amendments are: “Rule 2a-7 under the Investment Company Act of 1940, Money market funds” (OMB Control No. 3235-0268), “Rule 30b1-6T under the Investment Company Act of 1940, Weekly portfolio report for certain money market funds” (OMB Control No. 3235-0652), and “Rule 38a-1 under the Investment Company Act of 1940, Compliance procedures and practices of registered investment companies” (OMB Control No. 3235-0586). The titles for the new collections of information are: “Rule 22e-3 under the Investment Company Act of 1940, Exemption for liquidation of money market funds,” “Rule 30b1-7 under the Investment Company Act of 1940, Monthly report for money market funds,” and “Form N-MFP under the Investment Company Act of 1940, Portfolio Holdings of Money Market Funds.” We published notice soliciting comments on the collection of information requirements in the Proposing Release and submitted the proposed collections of information to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under the control numbers 3235-0268 (rule 2a-7), 3235-0654 (rule 22e-3), and 3235-0653 (rule 30b1-6 and Form N-MFP). OMB has approved the collection of information pursuant to rule 30b1-6T under the control number 3235-0652.

Our amendments and new rules are designed to make money market funds more resilient to risks in the short-term debt markets, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

### A. Rule 2a-7

Rule 2a-7 under the Investment Company Act exempts money market funds from the Act’s valuation requirements, permitting money market funds to maintain stable share pricing, subject to certain risk-limiting conditions. As discussed above, we are amending rule 2a-7 in several respects. Our amendments revise portfolio quality and maturity requirements; introduce liquidity requirements; require money market fund boards to adopt procedures providing for periodic stress testing of the fund’s portfolio; require funds to disclose monthly on their websites information on portfolio securities; and finally, require money market funds to have the capability to redeem and issue their securities at prices other than the fund’s stable net asset value per share.<sup>403</sup> Several of the amendments create new collection of information requirements. The respondents to these collections of information will be money market funds or their advisers, as noted below.

#### 1. Designation of NRSROs

Under the amendments to rule 2a-7, money market funds will be required to disclose designated NRSROs (including any limitation in the use of the designated NRSRO) in their SAI,<sup>404</sup> which constitutes a collection of information. Compliance with this disclosure requirement will be mandatory for any fund that holds itself out as a money market fund in reliance on rule 2a-7. This information will not be kept confidential. The disclosures are intended to provide investors and third-party analysts with information on NRSROs that money market funds will look to when they have to consider credit ratings under rule 2a-7, which may be relevant to investors in choosing among funds. Many money

<sup>401</sup> See *supra* text accompanying and following note 364.

<sup>402</sup> 44 U.S.C. 3501-3521.

<sup>403</sup> See *supra* Section II.A-F.

<sup>404</sup> Amended rule 2a-7(a)(11)(iii).



market funds currently discuss credit rating agencies in their registration statements describing threshold credit ratings for portfolio investments, and often specify NRSROs that rate instruments of the type the fund purchases. We anticipate that adding one or two sentences to the discussion identifying designated NRSROs (and any limitations on the use of a designated NRSRO) will not result in additional hourly burdens or printing costs beyond those currently approved in the existing collection of information titled “Form N-1A under the Securities Act of 1933 and under the Investment Company Act of 1940, registration statement of open-end management investment companies” (OMB Control No. 3235-0307).

## 2. *Portfolio Liquidity*

As discussed above, the amended rule includes a general liquidity requirement, under which each money market fund must hold securities that are sufficiently liquid to meet foreseeable shareholder redemptions in light of its obligations under section 22(e) of the Act and any commitments the fund has made to shareholders. We also noted that in order to comply with this provision in amended rule 2a-7 under the compliance rule, we expect that money market funds will adopt policies and procedures designed to assure that appropriate efforts are undertaken to identify risk characteristics of the fund’s shareholders.<sup>405</sup> We anticipate that these policies and procedures may add additional burdens to those currently approved in the existing collection of information under rule 38a-1 under the Investment Company Act. Based on commenters’ views, we assume that money market funds currently monitor and manage daily net flows in and out of the funds,<sup>406</sup> and in doing so, monitor the risk characteristics and likely redemptions of certain shareholders, which is a factor we would expect funds to consider under the general liquidity requirement in the amended rule. We believe, however, that many, if not most, funds may have to document the procedures they adopt for the compliance rule. For purposes of this PRA analysis, we estimate that funds would incur a one-time average burden of 8 hours to document policies and procedures to identify risk characteristics of the fund’s investors. In addition, staff estimates that the board of directors (as a whole) would take 1 hour to review and adopt these policies and procedures. Amortized over a 3 year period, this would be an annual burden per fund complex of 3 hours. We believe that these characteristics would be applicable to and documented on behalf of all money market funds in a fund complex, and we estimate that 163 fund complexes with money market funds are subject to rule 2a-7. Accordingly, we estimate that the total additional burden to document these policies would be 1467 hours.<sup>407</sup> Amortized over a 3 year period, the estimated annual hourly burden would be 489 hours for all money market fund complexes.<sup>408</sup> We believe that any ongoing burdens to reevaluate the need for changes in the policies and procedures would be incorporated in the current estimated burdens for rule 38a-1.

## 3. *Stress Testing*

We are requiring, substantially as proposed, that a money market fund’s board of directors adopt written procedures that provide for the periodic testing of the fund’s ability to maintain a stable net asset value per share based on certain hypothetical events.<sup>409</sup> The rule requires the board to determine the frequency of testing. The procedures must provide for a report of the testing results to be submitted to the board of directors at its next regularly scheduled meeting, or sooner if appropriate based on the results. The report must include an assessment by the fund’s adviser of the fund’s ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.<sup>410</sup> Compliance with the new reporting requirement is mandatory for any fund that holds itself out as a money market fund and uses either the amortized cost method of valuing portfolio securities or the penny-rounding method

<sup>405</sup> See *supra* note 198 and accompanying text.

<sup>406</sup> See Dreyfus Comment Letter; RidgeWorth Comment Letter.

<sup>407</sup> This estimate is based on the following calculation: (8 + 1) hours x 163 fund complexes = 1467 hours.

<sup>408</sup> PRA submissions for approval are made every three years. To estimate an annual burden for a collection of information that occurs one time, the total burden is amortized over the three-year period.

<sup>409</sup> See *supra* Section II.C.4. These events include, without limitation, a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund. See amended rule 2a-7(c)(10)(v)(A).

<sup>410</sup> Amended rule 2a-7(c)(10)(v)(B). The report to the board must include the dates on which the testing was performed and the magnitude of each hypothetical event that would cause the deviation of the money market fund’s net asset value calculated using available market quotations (or appropriate substitutes that reflect current market conditions) from its net asset value per share calculated using amortized cost to exceed ½ of 1%.

of pricing fund shares. When provided to the Commission in connection with staff examinations or investigations, the information will be kept confidential to the extent permitted by law.

We anticipate that stress testing will give fund advisers a better understanding of the effect of potential market events and shareholder redemptions on their funds' ability to maintain a stable net asset value, the fund's exposure to the risk of not maintaining a stable net asset value, and actions the adviser may need to take to mitigate the possibility of the fund breaking the buck.<sup>411</sup>

Commission staff believes that in light of the events of the fall of 2008, most, if not all, money market funds currently conduct some stress testing of their portfolios as a matter of routine fund management and business practice.<sup>412</sup> These procedures likely vary depending on the fund's investments. For example, a prime money market fund that is offered to institutional investors may test for hypothetical events such as potential downgrades or defaults in portfolio securities while a U.S. Treasury money market fund might not.<sup>413</sup> Some funds that currently conduct testing may be required to include additional hypothetical events under the amended rule. These funds likely provide regular reports of the test results to senior management. We assumed, however, that currently most funds do not have written procedures documenting the stress testing, do not report the results of testing to their boards of directors, and do not provide an assessment from the fund's adviser regarding the fund's ability to withstand the hypothetical events reasonably likely to occur in the next year.

Commission staff believes that stress testing procedures will be developed for all the money market funds in a fund complex by the fund adviser, and will address appropriate variations for individual money market funds within the complex.<sup>414</sup> Staff estimates that it will take a portfolio risk analyst an average of 22 hours initially to draft procedures documenting the complex's stress testing, and 3 hours for the board of directors (as a whole) to consider and adopt the written procedures.<sup>415</sup> We therefore estimate that the total burden to draft these procedures initially will be 4075 hours.<sup>416</sup> Amortized over a three-year period, this will result in an average annual burden of 8.33 hours for an individual fund complex and a total of 1358 hours for all fund complexes.<sup>417</sup> Staff estimates that a risk analyst will also spend an average of 6 hours per year revising the written procedures to reflect changes in the type or nature of hypothetical events appropriate to stress tests and the board will spend 1 hour to consider and adopt the revisions, for a total annual burden of 1141 hours.<sup>418</sup>

As noted above, each report to the board of directors will include an assessment by the fund's adviser of the funds' ability to withstand reasonably likely hypothetical events in the coming year. Staff estimates that it will take on average: (i) 10 hours of portfolio management time to draft each report to the board and 2 hours of an administrative assistant's time to compile and copy the report (for a total of 12 hours), and (ii) 15 hours for the fund adviser to provide its assessment. Under normal circumstances, the report must be provided at the next scheduled board meeting, and we estimate that the report and the adviser's assessment will cover all money market funds in a complex. We assume that funds will conduct stress tests no less than monthly. With an average of 6 board meetings each year, we estimate that the annual burden for

<sup>411</sup> See Proposing Release, *supra* note 2, at text following n.212.

<sup>412</sup> Commenters corroborated our staff's belief. See, e.g., State Street Comment Letter; T. Rowe Price Comment Letter. The estimates of hour burdens and costs provided in the PRA and cost benefit analyses in the Proposing Release were based on staff discussions with representatives of money market funds and on the experience of Commission staff. We did not receive any comment on the estimates and assumptions with respect to stress testing included in the analysis in our proposal. Accordingly, we have not modified any of those assumptions and estimates other than as necessary in light of the new requirement included in the amended rule.

<sup>413</sup> See TDAM Comment Letter (noting that testing Treasury funds for downgrades or defaults would be unnecessary).

<sup>414</sup> We expect that the board of directors would be the same for all the money market funds in a complex, and thus could adopt the stress test procedures for all money market funds in the complex at the same meeting.

<sup>415</sup> We have added 1 hour to the estimate of 21 hours in the Proposing Release to account for drafting procedures on when additional reports must be provided to the board based on the results of stress testing.

<sup>416</sup> This estimate is based on the following calculation: (22 hours + 3 hours) x 163 fund complexes = 4075 hours.

<sup>417</sup> These estimates are based on the following calculations: (22 + 3) ÷ 3 = 8.33 hours; 8.33 x 163 fund complexes = 1357.79 hours. PRA submissions for approval are made every three years. To estimate an annual burden for a collection of information that occurs one time, the total burden is amortized over the three-year period.

<sup>418</sup> This estimate is based on the following calculation: (6 hours (analyst) + 1 hour (board)) x 163 fund complexes = 1141 hours.

regularly scheduled reports would be 162 hours for an individual fund complex.<sup>419</sup> Under the final rule, a report must be provided earlier if appropriate in light of the results of the test. Staff estimates that as a result of unanticipated changes in market conditions or other events, stress testing results are likely to prompt additional reports on average four times each year.<sup>420</sup> Thus, we estimate these reports would result in an additional 108 hours for an individual fund complex each year.<sup>421</sup> We estimate the total annual burden for all fund complexes would be 44,010 hours.<sup>422</sup>

The amended rule requires a money market fund to retain records of the reports on stress tests for at least 6 years (the first two in an easily accessible place).<sup>423</sup> The retention of these records is necessary to allow the staff during examinations of funds to determine whether a fund is in compliance with the stress test requirements. We estimate that the burden will be 10 minutes per fund complex per report to retain these records for a total annual burden of 272 hours for all fund complexes.<sup>424</sup>

Thus, we estimate that for the three years following adoption, the average annual burden resulting from the stress testing requirements will be 287 hours for each fund complex with a total of 46,781 hours for all fund complexes.<sup>425</sup>

#### 4. Repurchase Agreements

We are adopting, as proposed, amendments affecting a money market fund's ability to "look through" a repurchase agreement for purposes of rule 2a-7's diversification provisions.<sup>426</sup> One of these amendments is that a money market fund will be able to look through a repurchase agreement only if the fund's board of directors or its delegate evaluates the counterparty's creditworthiness.<sup>427</sup>

Several commenters stated that money market fund boards already evaluate the credit quality of counterparties in the course of making an overall credit risk determination under rule 2a-7(c)(3)(i).<sup>428</sup> Because we are adding a separate creditworthiness evaluation in rule 2a-7(c)(4)(ii)(A), funds will need to keep records of such evaluations pursuant to rule 2a-7(c)(11)(ii), which requires a money market fund to retain a record of considerations and actions under the rule for at least 6 years (the first two in an easily accessible place).<sup>429</sup> Compliance with this recordkeeping requirement is mandatory for all funds that take advantage of the special look-through treatment for diversification purposes. We estimate that the burden to keep those records will be 2 hours per fund complex, for a total annual burden of 326 hours for all fund complexes.<sup>430</sup>

#### 5. Public Website Posting

The amendments require money market funds to post monthly portfolio information on their websites.<sup>431</sup> We believe that greater transparency of fund portfolios will provide investors with a better understanding of the fund's investment risks, and may allow investors to exert influence on risk-taking by fund advisers and thus reduce the likelihood that a fund will

<sup>419</sup> This estimate is based on the following calculation: (10 hours + 2 hours + 15 hours) x 6 meetings = 162 hours.

<sup>420</sup> We anticipate that in many years there will be no need for special reports, but that in a year in which there is severe market stress, a fund may report to the board weekly for a period of 3 to 6 months. Such reporting would generate 9 to 18 reports in addition to the regular monthly reports. Assuming that this type of event may occur once every five years, and additional reports would be generated for 6 months, a fund would produce an average of four additional reports per year (18 additional reports ÷ 5 = 3.6 reports).

<sup>421</sup> This estimate is based on the following calculation: (10 hours + 2 hours + 15 hours) x 4 = 108 hours.

<sup>422</sup> This estimate is based on the following calculation: (162 hours + 108 hours) x 163 fund complexes = 44,010 hours.

<sup>423</sup> Amended rule 2a-7(c)(11)(vii).

<sup>424</sup> This estimate is based on the following calculation: 0.1667 hours x 10 reports x 163 fund complexes = 271.7 hours.

<sup>425</sup> These estimates are based on the following calculations: 8.33 hours (draft procedures) + 7 hours (revise procedures) + 120 hours (10 reports) + 150 hours (10 assessments) + 1.67 hours (record retention) = 287 hours; 287 hours x 163 complexes = 46,781 hours.

<sup>426</sup> See *supra* Section II.D; Proposing Release, *supra* note 2, at Section II.E.

<sup>427</sup> Amended rule 2a-7(c)(4)(ii)(A).

<sup>428</sup> See *supra* note 277.

<sup>429</sup> Amended rule 2a-7(c)(11)(ii).

<sup>430</sup> This estimate is based on the following calculation: 2 hours x 163 fund complexes = 326 hours.

<sup>431</sup> Amended rule 2a-7(c)(12).

break the buck. Information will be posted on a public website, and compliance with this requirement is mandatory for any fund that holds itself out as a money market fund in reliance on rule 2a-7. In the Proposing Release, Commission staff estimated that there are approximately 750 money market funds that would be affected by the amendments. In addition, our staff noted that based on interviews with industry representatives, most money market funds already post portfolio information on their webpages at least quarterly.<sup>432</sup> Commission staff also estimated that 20 percent of money market funds, or 150 funds, do not currently post this information at least quarterly, and therefore would need to develop a webpage to comply with the amendments. Staff estimated that a money market fund would spend approximately 24 hours of internal money market fund staff time initially to develop the webpage. Staff further estimated that a money market fund would spend approximately 4 hours of professional time to maintain and update the relevant webpage with the required information on a monthly basis.

No commenters addressed the number of money market funds that would be affected by the proposal or the estimated burden hours for developing, maintaining and updating the webpage. Although, as described above, we have revised the proposed disclosure which should result in less information being required on a fund's website, Commission staff believes that the number of money market funds is currently 719 and that the hour burden per fund remains the same as previously estimated. Although it is possible that the reduced information required might result in a minimal decrease in the amount of time required to develop, maintain and update the webpage, Commission staff believes that the decrease would be negligible.

One commenter stated that the funds that currently post portfolio holdings information at least quarterly on their websites would need, under the rule amendments, to develop the capability to retain previous months' portfolio holdings information on their websites, resulting in an additional one-time burden that Commission staff did not include in its estimate in the Proposing Release.<sup>433</sup> Based on a review of some of the current portfolio website disclosure by some commenters and follow-up discussions with some commenters, Commission staff estimates that 500 of the 575 funds that currently post portfolio information on their webpages at least quarterly will need to develop this capability. Commission staff further estimates that each of these 500 funds will spend 12 hours to develop this capability, resulting in an additional one-time burden for all such funds of 6000 hours.<sup>434</sup>

Based on an estimate of 719 money market funds posting their portfolio holdings on their webpages, including 144 funds incurring start-up costs to develop a webpage and 500 funds incurring a one-time cost to develop the capability to retain previous months' portfolio holdings information on their websites, we estimate that, in the aggregate, the amendment will result in a total of 37,664 average burden hours for all money market funds for each of the first three years.<sup>435</sup>

## 6. Reporting of Rule 17a-9 Transactions

We are amending rule 2a-7 to require a money market fund to promptly notify the Commission by electronic mail of the purchase of a money market fund's portfolio security by certain affiliated persons in reliance on rule 17a-9 and to explain the reasons for, and the transaction price of, such purchase.<sup>436</sup> The reporting requirement is designed to assist Commission staff in monitoring money market funds' affiliated transactions that otherwise would be prohibited. The new collection of information will be mandatory for money market funds that rely on rule 2a-7 and that rely on rule

<sup>432</sup> Certain of the required information is currently maintained by money market funds for regulatory reasons, such as in connection with accounting, tax, and disclosure requirements. We understand that the remaining information is retained by funds in the ordinary course of business. Accordingly, for the purposes of our analysis, we do not ascribe any time to producing the required information.

<sup>433</sup> See Data Communiqué Comment Letter. Under our proposal, funds would have been required to maintain the portfolio holdings information on their websites for at least 12 months. We are adopting a 6-month maintenance period for portfolio holding information.

<sup>434</sup> The estimated 12 hours is one-half the time that we estimated that a fund would need to set up a new webpage (24 hours).

<sup>435</sup> The estimate is based on the following calculations. The staff estimates that 144 funds will require a total of 3456 hours initially to develop a webpage (144 funds x 24 hours per fund = 3456 hours) and 500 funds will require a total of 6000 hours initially to develop the capability to maintain historical portfolio holding information (500 funds x 12 hours per fund = 6000 hours). In addition, each of the 719 funds would require 48 hours per year to update and maintain the webpage, for a total of 34,512 hours per year (4 hours per month x 12 months = 48 hours per year; 48 hours per year x 719 funds = 34,512). The average annual hour burden for each of the first three years would thus equal 37,664 hours (3456 + 6000 + (34,512 x 3) ÷ 3).

<sup>436</sup> See amended rule 2a-7(c)(7)(iii)(B).

17a-9 for an affiliated person to purchase a money market fund's portfolio security. Information submitted to the Commission related to a rule 17a-9 transaction will not be kept confidential.

We estimate that fund complexes will provide one notice for all money market funds in a particular fund complex holding a distressed security purchased in a transaction under rule 17a-9. As noted above, Commission staff estimates that there are 163 fund complexes with money market funds subject to rule 2a-7. Of these fund complexes, Commission staff estimates that an average of 25 per year will be required to provide notice to the Commission of a rule 17a-9 transaction, with the total annual response per fund complex, on average, requiring 1 hour of an in-house attorney's time. We received no comments on this estimate and have not modified it. Given these estimates, the total annual burden of this amendment to rule 2a-7 for all money market funds would be approximately 25 hours.<sup>437</sup>

### 7. Total burden

The currently approved burden for rule 2a-7 is 310,983 hours. The additional burden hours associated with the proposed amendments to rule 2a-7 will increase the renewal estimate to 395,779 hours annually.<sup>438</sup>

### B. Rule 22e-3

Rule 22e-3 permits a money market fund that has broken the buck, or is at imminent risk of breaking the buck, to suspend redemptions and postpone the payment of proceeds pending board-approved liquidation proceedings. The rule also requires a money market fund to provide prior notification to the Commission of its decision to suspend redemption and liquidate. Rule 22e-3 is intended to facilitate an orderly liquidation, reduce the vulnerability of shareholders to the harmful effects of a run on a fund, and minimize the potential for market disruption. The notification requirement is a collection of information under the PRA, and is designed to assist Commission staff in monitoring a money market fund's suspension of redemption. The respondents to this information collection would be money market funds that break the buck, or are at imminent risk of breaking the buck, and elect to rely on the exemption afforded by the rule. Respondents also will include certain conduit funds that have invested in money market funds that suspended redemptions in reliance on the rule. Compliance with the notification requirement is mandatory for funds and conduit funds that rely on rule 22e-3, and the information will not be kept confidential.

In the Proposing Release, Commission staff estimated for purposes of the Paperwork Reduction Act that, on average, one money market fund would break the buck and liquidate every six years.<sup>439</sup> The staff further estimated that a fund would spend approximately one hour of an in-house attorney's time to prepare and submit the notice. No commenter addressed the estimated number of money market funds that would rely on the rule or the estimated burden hours associated with complying with the rule's notification requirement. The rule permits funds that invest in a money market fund pursuant to section 12(d)(1)(E) of the Act ("conduit funds") to rely on the rule, and requires the conduit fund to notify the Commission of its reliance on the rule.<sup>440</sup> The proposed rule would have applied only to conduit funds that are registered open-end management investment companies, and in response to one comment we have expanded the provision to also permit conduit funds that are organized as unit investment trusts to rely on the rule.<sup>441</sup> The staff estimates that there are a total of 780 conduit funds that may invest in money market funds that suspend redemptions in reliance on the rule, and that an average of 10 conduit funds may invest in any money market fund.<sup>442</sup> Given these estimates, the total annual burden of proposed rule 22e-3 for all money market funds and conduit funds would be approximately 110 minutes.<sup>443</sup>

<sup>437</sup> The estimate is based on the following calculation: (25 fund complexes x 1 hour) = 25 hours.

<sup>438</sup> This estimate is based on the following calculation: 310,983 hours (current burden) + 46,781 hours (stress testing) + 326 hours (repurchase agreements) + 37,664 hours (website posting) + 25 hours (reporting 17a-9 transactions) = 395,779 hours.

<sup>439</sup> As noted above, only two money market funds have broken the buck since the adoption of rule 2a-7 in 1983.

<sup>440</sup> See rule 22e-3(b).

<sup>441</sup> See *supra* note 390 and accompanying text.

<sup>442</sup> These estimates are based on a review of filings with the Commission.

<sup>443</sup> This estimate is based on the following calculations: (1 hour ÷ 6 years) = 10 minutes per year for each fund and conduit fund that is required to provide notice under the rule. 10 minutes per year x 11 (combined number of affected funds and conduit funds) = 110 minutes.

### C. Monthly Reporting of Portfolio Holdings

Rule 30b1-7 requires money market funds to file electronically a monthly report on Form N-MFP within five business days after the end of each month. The rule is intended to improve transparency of information about money market funds' portfolio holdings and facilitate oversight of money market funds. The information required by the form will be data-tagged in XML format and filed through EDGAR. The respondents to rule 30b1-7 will be investment companies that are regulated as money market funds under rule 2a-7. Compliance with rule 30b1-7 is mandatory for any fund that holds itself out as a money market fund in reliance on rule 2a-7. Responses to the disclosure requirements will not be kept confidential.

In the Proposing Release, Commission staff estimated that 750 money market funds would be required by proposed rule 30b1-6 to file, on a monthly basis, a complete Form N-MFP disclosing certain information regarding the fund and its portfolio holdings.<sup>444</sup> No commenters addressed this estimate. For purposes of this PRA analysis, the burden associated with the requirements of rule 30b1-7 has been included in the collection of information requirements of Form N-MFP.

Based on our experience with other interactive data filings, we estimated in the Proposing Release that money market funds would require an average of approximately 40 burden hours to compile, tag, and electronically file the required portfolio holdings information for the first time and an average of approximately 8 burden hours in subsequent filings.<sup>445</sup> Two commenters asserted that the Commission's estimates did not include time to review the information required in Form N-MFP.<sup>446</sup> While the estimate did include time for the review of the information, we nevertheless have increased our estimate to include an additional 2 hours per filing for review of the information to account for a full and careful review of the information to be filed. We now estimate that there are 719 money market funds and that they will require an average of approximately 42 burden hours to compile (including review of the information), tag and electronically file the required portfolio holdings information for the first time and an average of approximately 10 burden hours in subsequent filings. Based on these estimates, we estimate the average annual burden over a three-year period would be 131 hours per money market fund.<sup>447</sup> Based on an estimate of 719 money market funds submitting Form N-MFP in interactive data format, each incurring 131 hours per year on average, we estimate that, in the aggregate, Form N-MFP would result in 94,189 burden hours, on average, for all money market funds for each of the first three years.<sup>448</sup>

### D. Weekly Reporting of Portfolio Holdings

Rule 30b1-6T requires a money market fund whose market-based net asset value is less than \$0.9975 to electronically (i) notify the Commission promptly and submit a portfolio schedule within one business day, and (ii) submit a portfolio schedule within two business days after the end of each week until such time as the fund's market-based net asset value equals or exceeds \$0.9975. The rule is intended to facilitate our oversight of money market funds. We are adopting as final rule 30b1-6T. As adopted, the only change to the rule is the expiration date. Rule 30b1-6T will expire on December 1, 2010. The respondents to rule 30b1-6T are investment companies that are regulated as money market funds under rule

<sup>444</sup> As noted above, in September 2009 we adopted interim final temporary rule 30b1-6T. In order to minimize confusion over rule numbering, we are adopting proposed rule 30b1-6 as rule 30b1-7.

<sup>445</sup> See Proposing Release, *supra* note 2, at n.334 and accompanying text. We understand that the required information is currently maintained by money market funds pursuant to other regulatory requirements or in the ordinary course of business. Accordingly, for the purposes of our analysis, we do not ascribe any time to producing the required information.

<sup>446</sup> See Data Communiqué Comment Letter; Comment Letter of Bowne & Co. Inc. (Oct. 29, 2009) ("Bowne Comment Letter"). In addition, one commenter asserted that the Commission's estimate of 128 burden hours per money market fund for the first year (1 filing x 40 hours + 11 filings x 8 hours) is far too low for subadvised funds. See Committee Ann. Insur. Comment Letter. The commenter, however, did not provide an estimate of the first year burden hour for subadvised funds. As explained below in our discussion of the effect the rule and form will have on competition, we do not believe that the one-time burden for subadvised funds will be much different than the burden on non-subadvised money market funds because the information already should be readily available to the subadviser and the lengthened time for filing Form N-MFP (from the proposed two business days to five business days after the end of each month) should provide subadvisers with sufficient time to send the information to the principal adviser without having to invest in new infrastructure to provide the information on a real-time basis. See also *infra* Section VI.D.

<sup>447</sup> The staff estimates that a fund will make 36 filings in three years. The first filing will require 42 hours and subsequent filings would require 10 hours each, for an average annual burden of 131 hours (1 filing x 42 hours = 42 hours; 35 filings x 10 hours = 350 hours; 42 hours + 350 hours = 392 hours; 392 hours ÷ 3 years = 130.66 hours). Thereafter, filers generally would not incur the start-up burdens applicable to the first filing.

<sup>448</sup> This estimate is based on the following calculation: 719 portfolios x 131 hours = 94,189 hours.

2a-7. Compliance with the rule is mandatory for any money market fund whose market-based NAV is less than \$0.9975. Responses to the disclosure requirements will be kept confidential.

We previously estimated, based on past experience under the Guarantee Program, that at any given time 10 money market funds will be required by rule 30b1-6T to provide weekly reports disclosing certain information regarding the fund's portfolio holdings.<sup>449</sup> We received no comments on our estimates. We estimate that money market funds will require an average of approximately 6 burden hours to compile and electronically submit the initial required portfolio holdings information, and an average of approximately 4 burden hours in subsequent reports.<sup>450</sup> Based on these estimates, we estimate the annual burden will be 210 hours per money market fund that is required to provide the information.<sup>451</sup> Based on an estimate of 10 money market funds submitting information under the rule, we estimate that, in the aggregate, rule 30b1-6T will result in 2100 burden hours for all money market funds required to submit portfolio schedules.

## V. COST BENEFIT ANALYSIS

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the amendments and new rules. We received comments on the Commission's cost benefit analysis of our proposed amendments to rule 2a-7 and on new rule 30b1-7 and Form N-MFP, which are discussed below. The Commission notes that no comments addressed the Commission's analysis of the costs and benefits associated with the proposed amendments to rule 17a-9 and new rule 22e-3 contained in the Proposing Release. We also received no comments on the cost benefit analysis of rule 30b1-6T. As discussed throughout the release, although there are costs associated with the rules, we think the rules we are adopting will provide significant benefits to the investing public and money market funds. We believe these benefits justify the costs.

### A. Rule 2a-7

#### 1. *Second Tier Securities, Portfolio Maturity, and Liquidity Requirements*

We are adopting several changes to the risk-limiting conditions of rule 2a-7. While we believe that these changes will impart substantial benefits to money market funds, we recognize that they also may also impose certain costs.

First, we are amending rule 2a-7 to further restrict money market funds' exposure to the risks presented by second tier securities. Under the amendments, money market funds will not be permitted to acquire second tier securities unless immediately after their acquisition the money market fund would not have invested (i) more than three percent of its total assets in second tier securities and (ii) more than 0.5 percent of its total assets in second tier securities of any particular issuer.<sup>452</sup> In addition, money market funds will not be permitted to acquire any second tier security with a remaining maturity in excess of 45 days.<sup>453</sup>

Second, we are changing rule 2a-7's portfolio maturity limits. We are reducing the maximum weighted average maturity of a money market fund permitted by rule 2a-7 from 90 days to 60 days.<sup>454</sup> We also are adopting a new 120-day maturity

<sup>449</sup> See Rule 30b1-6T Release, *supra* note 303, at Section V.

<sup>450</sup> We understand that the required information is currently maintained by money market funds pursuant to other regulatory requirements or in the ordinary course of business. Accordingly, for the purposes of our analysis, we do not ascribe any time to producing the required information.

<sup>451</sup> Because one report is required each week, a fund would submit 52 reports in one year. The first report would require 6 hours and subsequent reports would require 4 hours each. The difference between the hours is due to the fact that funds generally would not incur the additional start-up time applicable to the first report. The burden of the reporting requirement would be 210 hours (1 report x 6 hours = 6 hours, 51 reports x 4 hours = 204 hours, and 6 hours + 204 hours = 210 hours).

<sup>452</sup> See amended rule 2a-7(c)(3)(ii) (portfolio quality—second tier securities); amended rule 2a 7(a)(27) (defining “total assets”); amended rule 2a-7(c)(4)(i)(C) (portfolio diversification—issuer diversification—second tier securities). We also are proportionately reducing by half the ability of a money market fund to acquire “demand features” or “guarantees” of a single issuer that are second tier securities from 5% to 2.5% of the money market fund's total assets. See amended rule 2a-7(c)(4)(iii)(B) and discussion of our rationale for making this change in note 59 *supra*.

<sup>453</sup> See amended rule 2a-7(c)(3)(ii).

<sup>454</sup> See amended rule 2a-7(c)(2)(ii).

limitation on the “weighted average life” of fund portfolio securities that will limit the portion of a fund’s portfolio that can be held in longer term floating- or variable-rate securities.<sup>455</sup> This restriction will require a fund to calculate the weighted average maturity of its portfolio without regard to interest rate reset dates. Finally, we are deleting a provision in rule 2a-7 that permitted money market funds not relying on the amortized cost method of valuation to acquire Government securities with a remaining maturity of up to 762 calendar days.<sup>456</sup> Under the amended rule, money market funds cannot acquire any security with a remaining maturity of more than 397 days, subject to the maturity shortening provisions for floating- and variable-rate securities and securities with a demand feature.<sup>457</sup>

Third, we are adopting new liquidity requirements for money market funds. In particular, we are amending rule 2a-7 to (i) require that each money market fund hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of its obligations under section 22(e) of the Act and any commitments the fund has made to shareholders;<sup>458</sup> (ii) further limit a money market fund’s investments in illiquid securities (i.e. securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to them by the money market fund);<sup>459</sup> and (iii) require a taxable money market fund to hold at least 10 percent of its total assets in “daily liquid assets” and any money market fund to hold at least 30 percent of its total assets in “weekly liquid assets.”<sup>460</sup>

#### *a. Benefits*

We believe that the amendments to rule 2a-7’s risk-limiting conditions are likely to produce broad benefits for money market fund investors. As discussed in Sections II.A-C above, commenters agreed that the proposed rule 2a-7 amendments concerning second tier securities, maturity, and liquidity would benefit money market funds and their investors.<sup>461</sup> The amendments should reduce money market funds’ exposure to certain credit, interest rate, spread, and liquidity risks. For example, limiting money market funds’ ability to acquire second tier securities will decrease money market funds’ exposure to credit, spread, and liquidity risks. Reducing the maximum weighted average maturity of money market funds’ portfolios will further decrease their interest rate sensitivity. It also will increase their ability to maintain a stable net asset value in the face of multiple shocks to a money market fund, such as a simultaneous widening of spreads and increase in redemptions, such as occurred during the fall of 2008.<sup>462</sup> Introducing the weighted average life limitation on money market funds’ portfolios will limit credit spread risk and interest rate spread risk to funds from longer term floating- or variable-rate securities. In addition, fund portfolios with a lower WAM and a 120-day maximum WAL will turn over more quickly, and the fund will be better able to increase its holdings of highly liquid securities in the face of illiquid markets than funds operating under a maximum 90 day WAM limitation.

We believe that the new liquidity requirements will decrease liquidity risk. As discussed above, they are designed to increase a money market fund’s ability to withstand illiquid markets by ensuring that the fund further limits its acquisitions of illiquid securities and that a certain percentage of its assets are held in daily and weekly liquid assets.<sup>463</sup> Under the general liquidity requirement, moreover, each money market fund must assess its liquidity needs on an ongoing basis and take additional actions as appropriate in order to manage its liquidity. Together, these requirements

<sup>455</sup> See amended rule 2a-7(c)(2)(iii).

<sup>456</sup> Compare amended rule 2a-7(c)(2)(i) with current rule 2a-7(c)(2)(ii). In a conforming change, we also are amending the maturity-shortening provision of the rule for variable-rate Government securities to require that the variable rate of interest is readjusted no less frequently than every 397 days, instead of 762 days as previously permitted. See amended rule 2a-7(d)(1).

<sup>457</sup> See amended rule 2a-7(c)(2)(i); amended rule 2a-7(d)(1)-(5).

<sup>458</sup> See amended rule 2a-7(c)(5).

<sup>459</sup> See amended rule 2a-7(c)(5)(i). Under the amended rule, a money market fund cannot acquire illiquid securities if immediately after the acquisition, the fund would have invested more than five percent of its total assets in illiquid securities.

<sup>460</sup> See amended rule 2a-7(c)(5)(ii)-(iii). See also amended rule 2a-7(a)(8) (defining “daily liquid assets”) and 2a-7(a)(32) (defining “weekly liquid assets”).

<sup>461</sup> See *supra* notes 36–40 and accompanying text; notes 137–139 and accompanying text; notes 159–161 and accompanying text; and notes 184–185 and accompanying text.

<sup>462</sup> See discussion in Section II.B.1 of this Release for an example of the size of simultaneous shocks that a money market fund could withstand with a WAM of 90 days as opposed to a WAM of 60 days.

<sup>463</sup> See *supra* Section II.C.



should decrease the likelihood that a fund would have to realize losses from selling portfolio securities into an illiquid market to satisfy redemption requests, which could put pressure on the fund's ability to maintain a stable net asset value.<sup>464</sup> The minimum daily and weekly liquidity standards require a money market fund to hold cash or securities that can be readily converted to cash. In certain circumstances, funds would be required to increase the level of these assets under the general liquidity standard.<sup>465</sup> We believe that these requirements, rather than our traditional notion of liquidity, which was based on a fund's ability to find a buyer of a security, are more likely to enable money market fund advisers to meet their funds' liquidity needs and adjust the funds' portfolios to increase liquidity when needed.<sup>466</sup>

We believe that a reduction of these credit, interest rate, spread, and liquidity risks will better enable money market funds to weather market turbulence and maintain a stable net asset value per share. The amendments are designed to reduce the risk that a money market fund will break the buck, and thereby prevent losses to fund investors. To the extent that money market funds are more stable, they also will reduce systemic risk to the capital markets and provide a more stable source of financing for issuers of short-term credit instruments, thus promoting capital formation. If money market funds become more stable investments as a result of the rule amendments, they may attract further investment, increasing their role as a source of capital.

*b. Costs*

We recognize that our amendments regarding second tier securities, portfolio maturity, and liquidity will impose costs on some money market funds. For example, yields might decrease in funds depending on their current positions in second tier securities, less liquid securities, and longer term instruments because those instruments typically offer above average yields. We note that the yield offered by a security is tied to its risk. It is important to consider our rule amendments' impact on money market fund yields in this context.

*Second Tier Securities.* We received several comments on the estimated costs of eliminating money market funds' ability to acquire second tier securities. One commenter stated that such an elimination would cost a money market fund 2 basis points in yield, assuming that this money market fund held 5 percent of its assets in second tier securities.<sup>467</sup> This commenter stated that it believed that this cost would be appropriate to strengthen the stability of money market funds to weather potential future liquidity and credit crises and to promote investor confidence. Several commenters agreed, stating that they did not expect elimination to lead to market disruption.<sup>468</sup> One commenter added that given the small size of the second tier securities market, the benefits of elimination would far outweigh any disadvantages.<sup>469</sup>

Another commenter stated that the benefits of money market funds being able to invest in second tier securities, in terms of reducing portfolio concentration in financial institution securities and providing affordable financing for second tier security issuers, outweigh any potential increased credit risk.<sup>470</sup> This commenter estimated that elimination of a money market fund's ability to acquire second tier securities would cost it 3 basis points in yield, again assuming that the money market fund held a full 5 percent of its assets in second tier securities. Finally, a third commenter estimated that elimination of money market funds' ability to acquire second tier securities would cost a retail money market fund 4-8 basis points in yield, a non-rated institutional money market fund 2-4 basis points in yield, and a rated institutional

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<sup>464</sup> *See id.*

<sup>465</sup> *See supra* Section II.C.1.

<sup>466</sup> *See supra* Section II.C.

<sup>467</sup> This number was obtained in discussions with a commenter clarifying certain aspects of its comment letter. *See* J.P. Morgan Asset Mgt. Comment Letter.

<sup>468</sup> ICI Comment Letter; TDAM Comment Letter; Thrivent Comment Letter.

<sup>469</sup> TDAM Comment Letter.

<sup>470</sup> *See* Federated Comment Letter. As discussed in Section II.A.1 of this Release, other commenters also asserted that a complete ban on acquisition of second tier securities would not be justified on a cost-benefit basis, would have a material adverse impact on second tier security issuers, would have unintended effects on the capital markets, and would increase borrowing costs for second tier security issuers. We discuss these comments, and provide our response, *supra* notes 41-53 and accompanying and following text.

fund 1-3 basis points in yield.<sup>471</sup> This commenter assumed that these money market funds held 5 percent of their assets in second tier securities and 5 percent of their assets in lower quality first tier assets, and that all of these assets would not be held if funds' ability to acquire second tier securities was eliminated.

As discussed above, we have determined not to eliminate money market funds' ability to acquire second tier securities, but instead are further restricting this ability. This change from our proposal should result in costs that are less than estimated in the proposal and less than commenters estimated for full-scale elimination. We believe that the 3 percent limitation on money market funds' ability to acquire second tier securities will have a small impact on money market funds.<sup>472</sup> Based on commenters' estimates described above, a reduction in a money market fund's investment in second tier securities from 5 percent to 3 percent of its total assets would reduce its yield on average by approximately 1.2 basis points.<sup>473</sup> However, very few money market funds hold more than 3 percent of their total assets in second tier securities, and even fewer hold a full 5 percent. Our staff's review of money market fund portfolios in September 2008 found that only 4 percent of money market funds held more than 3 percent of their assets in second tier securities. Accordingly, we estimate that each of only 29 money market funds<sup>474</sup> would face a reduction of yield of 1.2 basis points as a result of our amendments.

We also are further reducing the ability of money market funds to acquire second tier securities of any particular issuer from the greater of 1 percent of assets or \$1 million to 0.5 percent of assets. Based on our staff's review of money market fund portfolios in September 2008, 8 percent of money market funds held second tier securities of any particular issuer in excess of 0.5 percent of the money market fund's assets. We expect that these money market funds, however, will simply reinvest this excess in the securities of other second tier issuers and, therefore, that there will be no loss in fund yield as a result of this restriction.<sup>475</sup> Several commenters argued that there are many second tier security issuers worthy of investment.<sup>476</sup> If any of these money market funds did not perform credit analysis of a large enough group of second tier security issuers, these funds may incur some administrative costs in tracking additional issuers.<sup>477</sup>

Finally, we are limiting money market funds to only acquiring second tier securities with a remaining maturity of less than 45 days. According to Federal Reserve data, in 2009, only 4 percent of A2/P2 non-financial commercial paper had a maturity of greater than 40 days on issuance, and thus we do not expect that the 45-day maturity limit will have more than a negligible cost impact on taxable money market funds.<sup>478</sup> In addition, based on our staff's review of tax-free money market fund portfolios in September 2008, we estimate that very few money market funds held second tier municipal

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<sup>471</sup> Fidelity Comment Letter. According to the iMoneyNet Money Market Fund Analyzer Database, as of November 17, 2009, 61% of money market fund assets were held in funds that were top rated by at least one NRSRO and 34% of money market funds had a top rating from at least one NRSRO. In order to retain a top rating, money market funds must only hold first tier securities. According to analysis of the iMoneyNet analyzer database, as of December 1, 2009, approximately 48% of money market funds were retail funds and 52% were institutional funds. Accordingly, Fidelity's estimates result in a blended impact on money market funds of (6 basis points x 48% retail funds) + (3 basis points x 34% non-rated institutional funds) + (2 basis points x 18% rated institutional funds) = 4.3 basis points per fund.

<sup>472</sup> As discussed above, we do not believe that further limitations on money market funds' ability to acquire second tier securities will prevent their ability to achieve diversification benefits. *See supra* note 47 and accompanying text.

<sup>473</sup> This estimate is based on averaging the 2 basis point, 3 basis point, and 4.3 basis point estimates from commenters for a reduction in second tier securities investment from 5% to 0%, proportionately adjusted to reflect a reduction in investment from 5% to 3%.

<sup>474</sup> This estimate is based on the following calculation: 719 money market funds x 4% = 29 money market funds.

<sup>475</sup> Commenters (for example, the Federated Comment Letter and the Fidelity Comment Letter) asserted that there are numerous quality second tier security issuers. Because this limitation, when combined with the 3% aggregate limitation on acquisition of second tier securities, only limits money market funds to holding a minimum of 6 second tier issuers if it were to maximize the limitations (rather than 5 second tier issuers under the current rule), we do not expect that money market funds would have difficulty finding six appropriate second tier security issuers in which to invest.

<sup>476</sup> *See, e.g.*, Chamber/Tier 2 Issuers Comment Letter; Federated Comment Letter; Fidelity Comment Letter; USAA Comment Letter.

<sup>477</sup> Based on discussions we had with certain commenters clarifying certain aspects of their comment letters, we understand that all of these larger managers track sufficient second tier security issuers that the 0.5% limitation per second tier security issuer should not create additional costs related to tracking additional issuers.

<sup>478</sup> *See* Federal Reserve, *Volume Statistics for Commercial Paper, A2/P2 Nonfinancial*, available at <http://www.federalreserve.gov/releases/cp/volumestats.htm>.

securities with a maturity of greater than 45 days that were second tier securities at the time of acquisition. As a result, we do not expect that the 45-day maturity limit will have more than a negligible cost impact on money market funds.

*WAM and WAL.* Three commenters provided cost estimates for a reduction in the maximum weighted average maturity for money market funds. One commenter estimated that if all money market funds had a WAM of 75 days and reduced their WAM to 60 days, it would cost each money market fund 2.5 to 3 basis points in yield.<sup>479</sup> Similarly, another commenter estimated that this same reduction would cost each money market fund 3 basis points in yield, and a reduction in WAM from 90 days to 75 days would also cost a money market fund 3 basis points in yield.<sup>480</sup> Finally, a third commenter estimated that if all money market funds had a WAM of 90 days and reduced their WAM to 60 days, it would cost each money market fund 5 to 10 basis points in yield.<sup>481</sup> According to these estimates, it would cost a money market fund 5 to 10 basis points in yield to reduce its WAM from 90 days to 60 days.

However, historically most money market funds have not maintained a WAM of more than 60 days. According to data provided by the ICI, from January 1998 through April 2009, even the 75th percentile of prime money market funds has maintained an average WAM of 53 days and the 90th percentile of prime money market funds has maintained an average WAM of 65 days.<sup>482</sup> As of November 17, 2009, despite the historically low interest rate environment in which money market funds have tended to extend WAM closer to the maximum limits to gain additional yield, only 1.5 percent of taxable money market funds reported a WAM of more than 75 days (with most of those having a WAM of only slightly over 75 days) and only 15.5 percent reported a WAM of 61-75 days (with these funds having an average WAM of 68 days).<sup>483</sup> We understand that most money market funds like to have some cushion by maintaining a WAM below the permitted maximum, but we do not believe that money market funds believe that such a large cushion must always be maintained. Rather, we believe that many money market funds have maintained lower WAMs than required because they believed that it is prudent management of their portfolio to do so.<sup>484</sup> Based on this data, on the WAMs of taxable and prime money market funds and on commenters' estimates of the impact of a reduction in WAM, we estimate that 10 money market funds will have to reduce their WAM from 78 days to 55 days at a cost of 6 basis points per fund. We further estimate that 70 money market funds will have to reduce their WAM from 68 days to 55 days at a cost of 2 basis points per fund.

Three commenters provided cost estimates for a reduction in the maximum weighted average life for money market funds. One commenter estimated that if all money market funds had a WAL of 180 days and reduced their WAL to 120 days, it would cost each money market fund 2 to 4 basis points in yield.<sup>485</sup> Another commenter estimated that a WAL reduction of 150 to 120 days would cost each money market fund 1 to 3 basis points in yield.<sup>486</sup> Finally, a third commenter estimated that if all money market funds reduced their WAL to 120 days, it would cost each money market fund 3 basis points in yield.<sup>487</sup> According to these estimates, it would cost a money market fund 1 to 3 basis points in

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<sup>479</sup> J.P. Morgan Asset Mgt. Comment Letter.

<sup>480</sup> Federated Comment Letter.

<sup>481</sup> Fidelity Comment Letter.

<sup>482</sup> Investment Company Institute, *Average Maturity of Taxable Prime Money Market Funds, 1998–2009*, available at <http://www.sec.gov/comments/s7-11-09/s71109-14.htm>.

<sup>483</sup> Based on data from the iMoneyNet Money Market Fund Analyzer Database as of November 17, 2009. The WAMs of the funds with WAMs over 75 days were: 2 at 76 days, 1 at 77 days, and 3 at 78 days. Tax-free money market funds have WAMs considerably lower (30% of money market funds were tax-free as of December 8, 2009, according to data from the iMoneyNet Money Market Fund Analyzer Database).

<sup>484</sup> See, e.g., *supra* notes 137–139 and accompanying text.

<sup>485</sup> J.P. Morgan Asset Mgt. Comment Letter and subsequent Commission staff conversation with J.P. Morgan staff breaking down the cost estimate in the J.P. Morgan Asset Mgt. Comment Letter by each proposed amendment to rule 2a-7.

<sup>486</sup> Fidelity Comment Letter (focusing on government money market funds).

<sup>487</sup> Federated Comment Letter. The Federated Comment Letter did not specify a WAL starting point for its assumed reduction to a 120-day WAL. Rather, it evaluated instruments that it believed would likely be subject to greater demand or a shorter maturity with a 120-day maximum WAL requirement and estimated the increased cost to money market funds from those securities becoming more expensive as a result.

yield to reduce its WAL from 150 days to 120 days.<sup>488</sup> We estimate that two-thirds of taxable money market funds and all tax-free money market funds already maintain a WAL of 120 days or less and thus will incur no cost in transitioning to this amendment to rule 2a-7.<sup>489</sup> We estimate that the other third of taxable money market funds, or 163 funds, maintain a maximum WAL of no greater than 150 days and will incur on average a cost of 2 basis points per fund to reduce their WAL to 120 days.

Several commenters stated that the new WAM limitation would reduce the range of securities available for money market fund investment and increase demand for shorter term securities.<sup>490</sup> No commenters provided any cost estimate for this potential impact. If this did occur, and if the increased demand was not met with increased supply of such securities, the new maturity limitations could result in additional incremental costs to money market funds.

A few commenters also believed that the amended maturity limitations would increase security issuer costs because they would have to issue shorter maturity securities and assume greater risk from having to roll over their securities more frequently.<sup>491</sup> No commenters provided any cost estimate for this potential impact. If security issuer costs do increase as a result of the amended maturity limitations and these issuers as a consequence are unable to obtain the same amount of financing, it may have a negative impact on capital formation.

*General Liquidity Requirement.* As discussed above, the amended rule includes a general liquidity requirement, under which a fund's management and its board must evaluate the funds' liquidity needs and protect shareholders from the harm that can occur from the failure to properly anticipate and provide for those needs. We also noted that in order to comply with this provision in amended rule 2a-7 under the compliance rule, we expect that money market funds would adopt policies and procedures designed to assure that appropriate efforts are undertaken to identify risk characteristics of the fund's shareholders.<sup>492</sup> For purposes of the PRA analysis, we estimated that each fund complex would incur, on average, 9 hours to document, review, and adopt policies and procedures for monitoring the risk characteristics of money market fund investors.<sup>493</sup> Based on this estimate, we estimate that it would cost a fund complex \$6976 to document, review, and adopt these policies and procedures, for a total cost of \$1,137,000.<sup>494</sup>

*Illiquid Securities.* Two commenters provided estimates with respect to the proposed ban on purchases of illiquid securities. One commenter estimated that the proposed ban would decrease money market funds' yields from 2 to 6 basis points, assuming that the fund holds 10 percent of its total assets in illiquid securities.<sup>495</sup> Another commenter submitted

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<sup>488</sup> Based on discussions we had with certain commenters clarifying certain aspects of their comment letters, we do not believe that more than a negligible number of money market funds are maintaining a WAL of 180 days.

<sup>489</sup> We are not aware of any data provider that tracks the WAL of all money market funds (likely because money market funds are not limited currently in the weighted average life that they must maintain). An analysis of the 16 largest, top-rated, prime institutional money market funds (representing 53% of all prime institutional money market fund assets as of June 30, 2009) found that of the 14 funds providing information on the final maturities of their portfolio securities, all had a WAL of under 120 days. See Capital Advisor's Group, *How Safe Are Money Market Funds?* (Nov. 1, 2009), available at <http://web.capitaladvisors.com/whitepapers/How%20Safe%20Are%20MMFs.pdf> ("CAG Report"). This information, combined with discussions we had with certain commenters clarifying certain aspects of their comment letters, leads us to estimate that two thirds of money market funds currently are maintaining a WAL of no greater than 120 days and that the other third currently are maintaining a WAL of no greater than 150 days. We also understand that the majority of money market funds currently are in compliance with the maximum 120-day WAL because of their voluntary compliance with the recommendations contained in the ICI Report. Because most securities held by tax-free money market funds have a demand feature reducing the security's maturity under the WAL calculation to a very short duration, we understand that tax-free money market funds do not have a WAL greater than 120 days.

<sup>490</sup> See, e.g., Charles Schwab Comment Letter; J.P. Morgan Asset Mgt. Comment Letter; State Street Comment Letter.

<sup>491</sup> See, e.g., Fannie Mae Comment Letter; State Street Comment Letter; Wells Fargo Comment Letter.

<sup>492</sup> See *supra* note 198 and accompanying text.

<sup>493</sup> See *supra* note 407 and accompanying and preceding text.

<sup>494</sup> These estimates are based on the following calculations: 8 hours x \$372/hour (for a senior portfolio manager) = \$2976; 1 hour x \$4000 (for a board of directors) = \$4000; (\$2976 + \$4000) x 163 complexes = \$1,137,088. The hourly wage used for senior portfolio managers is from the SIFMA *Report on Management & Professional Salaries Data* (Sept. 2008), modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

<sup>495</sup> See Fidelity Comment Letter.

that the ban on illiquid securities would decrease yields by 3 basis points.<sup>496</sup> Based on commenters' estimates, a money market fund that reduces its investments in illiquid securities from 10 percent to 5 percent would reduce its yield on average by 2 basis points.<sup>497</sup>

Our staff's review of money market funds' portfolios in September 2008 found that 24 percent of funds reported held any illiquid securities.<sup>498</sup> Based on the staff's review as applied to the current number of money market funds (719),<sup>499</sup> we estimate current money market fund holdings of illiquid securities as follows:

Percentage of total assets represented by illiquid securities	Percentage of funds	Number of funds
10 percent	0.6	4
9 percent	0.4	3
8 percent	0.4	3
7 percent	0.4	3
6 percent	1.0	7
5 percent or less	97.2	698

Based on these estimated holdings, staff makes the following estimates: 4 funds with 10 percent of assets invested in illiquid securities will experience a reduction in holdings of 5 percent and a yield impact of 2 basis points;<sup>500</sup> 3 funds with 9 percent of assets invested in illiquid securities holdings will experience a reduction in holdings of 4 percent and a yield impact of 1.6 basis points;<sup>501</sup> 3 funds with 8 percent of assets invested in illiquid securities holdings will experience a reduction in holdings of 3 percent and a yield impact of 1.2 basis points;<sup>502</sup> 3 funds with 7 percent of assets invested in illiquid securities holdings will experience a reduction in holdings of 2 percent and a yield impact of 0.8 basis points;<sup>503</sup> 7 funds with 6 percent of assets invested in illiquid securities holdings will experience a reduction in holdings of 1 percent and a yield impact of 0.4 basis points.<sup>504</sup>

*Daily Liquidity Requirements.* Two commenters specifically addressed the proposed daily liquidity requirements. Both commenters estimated that there would be no yield impact as a result of the proposed 10 percent threshold.<sup>505</sup> Based on these comments, we assume that the 10 percent daily minimum liquidity standard we are adopting will have no impact on money market funds' yield.<sup>506</sup>

<sup>496</sup> See Federated Comment Letter (without specifying the assumed holdings of illiquid securities).

<sup>497</sup> The individual reduction in basis points is calculated by taking the average of the estimated range of 2 to 6 basis points  $((2+6) \div 2 = 4$  basis points;  $4 \text{ basis points} \div 10\% = 0.4 \text{ basis points per } 1\% \text{ reduction})$ , proportionally adjusted to reflect an adjustment in investment in illiquid securities from 10% to 5%  $(5 \times 0.4 = 2)$ .

<sup>498</sup> We note that these holdings are likely to include some securities that were not illiquid at acquisition. Thus, our estimates on the impact of reducing holdings of illiquid securities may be higher than the impact that would be experienced by some money market funds.

<sup>499</sup> The number of money market funds is based on Investment Company Institute, *Trends in Mutual Fund Investing*, Oct. 2009, available at [http://www.ici.org/research/stats/trends/trends\\_10\\_09](http://www.ici.org/research/stats/trends/trends_10_09).

<sup>500</sup>  $(10\% - 5\% \text{ (allowable amount remaining)} = 5\%) \times 0.4 \text{ basis points (basis point impact per } 1\%) = 2 \text{ basis points}$ .

<sup>501</sup>  $(9\% - 5\% \text{ (allowable amount remaining)} = 4\%) \times 0.4 \text{ basis points} = 1.6 \text{ basis points}$ .

<sup>502</sup>  $(8\% - 5\% \text{ (allowable amount remaining)} = 3\%) \times 0.4 \text{ basis points} = 1.2 \text{ basis points}$ .

<sup>503</sup>  $(7\% - 5\% \text{ (allowable amount remaining)} = 2\%) \times 0.4 \text{ basis points} = 0.8 \text{ basis points}$ .

<sup>504</sup>  $(6\% - 5\% \text{ (allowable amount remaining)} = 1\%) \times 0.4 \text{ basis points} = 0.4 \text{ basis points}$ .

<sup>505</sup> See Federated Comment Letter; Fidelity Comment Letter.

<sup>506</sup> Our understanding is that money market funds' current practice is to maintain approximately 10% of their portfolio in daily liquid assets. See CAG Report, *supra* note 489; Fitch Report, *supra* note 274, at 6 (Fitch-rated prime money market funds' aggregate exposure to sources of overnight liquidity, including repurchase agreements, time deposits and shares of other money market funds, was approximately 15% of total assets for the six-month period ended on May 15, 2009).

*Weekly Liquidity Requirements.* A few commenters provided estimates on the costs of the proposed weekly liquidity requirements. One commenter estimated that the yield impact of the proposed 30 percent weekly liquidity standard for institutional funds would range from 15 to 20 basis points,<sup>507</sup> while another commenter estimated that the yield impact would be 10 basis points.<sup>508</sup> A third commenter submitted that the proposed 30 percent weekly liquidity requirement would have a yield impact of 9 basis points, but would have no impact if the threshold was 20 percent and included agency discount notes with remaining maturities of 95 days or less.<sup>509</sup> None of these commenters explained the baseline (i.e., the percentage of weekly liquid assets institutional funds currently hold) on which their estimated impacts on yield are based. A fourth commenter estimated that if money market funds had to increase their weekly liquid assets by 10 percent, the yield impact would be between 3 and 6 basis points.<sup>510</sup> Thus, commenters' estimates of the yield impact to institutional funds of maintaining 30 percent of their portfolio in weekly liquid assets ranged from 3 to 20 basis points.<sup>511</sup> We have averaged these estimates to determine our estimated yield impact on institutional funds of 1.025 basis points per percentage increase in existing assets that would have to be converted to weekly liquid assets.<sup>512</sup>

We estimate that half of institutional money market funds currently maintain 30 percent or more of their total assets in weekly liquid assets and thus would experience no reduction in yield as a result of the weekly liquidity requirement. We further estimate that 38 percent of institutional funds maintain 25 percent of their assets in weekly liquid assets; 6 percent of institutional funds maintain 20 percent of their assets in weekly liquid assets and 6 percent of institutional funds maintain 15 percent of their assets in weekly liquid assets.<sup>513</sup> Based on these estimates, we estimate that 187 funds may experience no impact, 142 funds may experience a 5.125 basis point impact on yield, 22 funds may experience a 10.25 basis points, and 22 funds may experience a 15.375 basis point impact on yield.<sup>514</sup>

One commenter provided specific estimates for the impact of the proposed 15 percent weekly liquid asset requirement on retail money market funds of between two and four basis points.<sup>515</sup> Assuming that the starting point for these estimates was 10 percent of investments in weekly liquid assets, we estimate that the yield impact per percentage increase to satisfy the weekly liquid asset requirement would be 0.6 basis points.<sup>516</sup>

<sup>507</sup> See Fidelity Comment Letter (noting that including agency discount notes with remaining maturities of 397 days or less in weekly liquid assets would have reduced this estimate by about 3 basis points for institutional money market funds).

<sup>508</sup> GE Asset Mgt. Comment Letter (arguing that the requirement could cause a more pronounced yield widening effect as a result of supply/demand dynamics, i.e., there would be an increase in demand for securities with 7-day maturities or less, which would result in a corresponding decrease in yield for such instruments; consequently, there could also be a reduced demand for longer-dated instruments, which would adversely impact the short-term financing for issuers of such instruments).

<sup>509</sup> Federated Comment Letter.

<sup>510</sup> J.P. Morgan Asset Mgt. Comment Letter and subsequent Commission staff conversation with J.P. Morgan staff breaking down the cost estimate in the J.P. Morgan Asset Mgt. Comment Letter by each proposed amendment to rule 2a-7.

<sup>511</sup> We note that the range of these estimates is likely to be lower if agency discount notes with remaining maturities of less than 60 days are included. We have not adjusted for that, however, to maintain a conservative estimate.

<sup>512</sup> Our estimate is based on an average of the commenters' estimated (or the midpoint of commenters' estimated) impacts of 17.5, 10, 9, and 4.5 basis points per 10% increase in weekly liquid assets as proportionally adjusted:  $1.75 + 1.0 + 0.9 + 0.45 = 4.1$ ;  $4.1 \text{ basis points} \div 4 = 1.025 \text{ basis point increase}$ . See notes 507–510 and accompanying text.

<sup>513</sup> While we are not aware of any data provider that tracks the actual maturities of securities (as opposed to WAM, which estimates the maturity of floating rate notes based on the interest reset date rather than actual maturity), we are able to provide estimates based on the analysis of the Capital Advisors Group that found that on or near September 30, 2009, the 16 funds providing information on their portfolio securities averaged 30% of assets in securities convertible to cash in 1 to 7 days. In addition, 8 (50%) had 7-day liquidity of 30% or greater; 6 (38%) had 7-day liquidity of 25%–30%; 1 (6%) had liquidity of 20%–25%, and 1 (6%) had 7-day liquidity of 15%–20%. See CAG Report, *supra* note 489. For purposes of our estimates, we are assuming the funds in each category held the lowest level of weekly liquid assets in the category.

<sup>514</sup> As noted above, there are currently 719 money market funds, of which we estimate that 52% (374) are institutional funds. See *supra* notes 471 and 499.

<sup>515</sup> See Fidelity Comment Letter.

<sup>516</sup> This assumes an average of 3 basis points proportionally adjusted for an increase of 5%. We assume that the commenter based its estimate on an increase from 10% holdings because as noted above, we assume that all money market funds have on average daily liquidity of at least 10% and the commenter based its estimates on the proposed weekly liquid asset requirement of 15% for retail funds. See *supra* note 506 and accompanying text.

We estimate that all retail money market funds maintain 15 percent of their total assets in weekly liquid assets.<sup>517</sup> Based on this estimate, we estimate that the average yield impact for each retail money market fund would be 9 basis points.<sup>518</sup>

*Investors.* The decreased yield that some money market funds may offer as a result of the amendments we are adopting today may limit the range of choices that individual money market fund investors have to select their desired level of investment risk. This might cause some investors to shift their assets to, among other places, bank deposits or offshore or other enhanced cash funds unregulated by rule 2a-7 that are able to offer a higher yield.<sup>519</sup> Investors that choose to move to unregulated products may have fewer protections than they had in money market funds regulated under rule 2a-7. When markets come under stress, investors may be more likely to withdraw their money from these offshore or private funds due to their perceived higher risk<sup>520</sup> and substantial redemptions from those funds and accompanying sales of their portfolio securities could increase systemic risk to short-term credit markets, which would impact money market funds. In addition, the stricter portfolio quality, maturity, and liquidity requirements may result in some money market funds having fewer issuers from which to select securities if some issuers only offer second tier securities, less liquid securities, or a larger percentage of longer term securities.

*Issuers.* Our new portfolio quality, maturity, and liquidity restrictions also may impact issuers. Issuers may experience increased financing costs to the extent that they are unable to find alternative purchasers at previous market rates of second tier securities, less liquid securities, longer term securities, or adjustable-rate securities that money market funds determine to no longer acquire because of the new restrictions. Several commenters stated that elimination of money market funds' ability to acquire second tier securities would increase issuers' borrowing costs and thus could increase the cost of capital formation.<sup>521</sup> No commenters provided estimates of such costs.

As noted earlier in this section, we do not believe that money market funds currently hold a significant amount of second tier securities or securities that are illiquid at acquisition in excess of the newly adopted limitations for these securities. Thus, we expect that the amendments' impact on issuers of these securities will be minimal. We also know that few money market funds maintain a WAM in excess of 60 days, and we therefore believe that our new WAM restriction will not have a significant impact on issuers of longer term securities.<sup>522</sup> To the extent that the new WAM limitation results in companies or governments issuing shorter maturity securities, those issuers may be exposed to an increased risk of insufficient demand for their securities and adverse credit market conditions because they must roll over their short-term financing more frequently. We note that this impact could be mitigated if money market funds sufficiently staggered or "laddered" the maturity of the securities in their portfolios.

Finally, we estimate that one third of taxable money market funds will have to reduce the WAL of their portfolio,<sup>523</sup> and thus it is possible that some adjustable-rate security issuers will need to shorten the maturities of some of the securities they offer, which may result in increased borrowing costs.<sup>524</sup> In addition, the markets for longer term securities may become less liquid if the rule amendments cause issuance of these instruments to decline.<sup>525</sup>

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<sup>517</sup> We believe that most retail money market funds currently are in voluntary compliance with the 20% weekly liquidity standard recommended by the ICI Report, which would include agency discount notes with original issue maturity of 95 days or less. The final rule permits agency discount notes with remaining maturities of 60 days or less, and we are conservatively estimating that retail funds maintain an average of 15% of assets in weekly liquid assets.

<sup>518</sup> 0.6 basis points x 15% = 9 basis points. This estimate may be overstated because, as noted above, we believe that most retail funds hold 20% of their assets in weekly liquid assets, and thus would have to convert a smaller percentage of assets to weekly liquid assets.

<sup>519</sup> Some commenters suggested this possibility. *See, e.g.*, Goldman Sachs Comment Letter; State Street Comment Letter (making this comment with respect to reducing the maximum permissible WAM).

<sup>520</sup> During the market events of 2007-2008, investors redeemed substantial amounts of assets from certain bond funds and offshore money market funds. *See* ICI Report, *supra* note 14, at 106-07.

<sup>521</sup> *See, e.g.*, Am. Elec. P. Comment Letter; Chamber/Tier 2 Issuers Comment Letter. *But see* ICI Comment Letter (stating their belief that elimination would have a manageable impact on second tier security issuers).

<sup>522</sup> *See supra* notes 482-483 and accompanying text.

<sup>523</sup> *See supra* note 489 and accompanying and following text.

<sup>524</sup> *See supra* note 491 and accompanying text for comments asserting this possible negative impact.

<sup>525</sup> No commenters addressed this possibility.

*Government Securities.* We do not believe that eliminating the provision in rule 2a-7 that allowed money market funds relying solely on the penny-rounding method of pricing to hold Government securities with remaining maturities of up to 762 days will have a material impact on money market funds, investors, or issuers of longer term Government securities because we believe that substantially all money market funds rely on the amortized cost method of valuation, and not exclusively on the penny-rounding method of pricing, and thus are not eligible to rely on this exception. We received one comment on this proposal, which stated that they were not aware of any money market funds that relied on the penny rounding method of pricing.<sup>526</sup>

## 2. Designation of NRSROs

The amendments to rule 2a-7 require a money market fund's board of directors to designate at least four NRSROs whose credit ratings the fund will use in determining the eligibility of portfolio securities under the rule and that the board determines annually issue credit ratings that are sufficiently reliable for this use.<sup>527</sup> In addition, money market funds are required to disclose designated NRSROs in their registration statements.<sup>528</sup>

We anticipate that the requirement to designate at least four NRSROs could foster competition among NRSROs to produce the most accurate ratings in order to obtain designation by money market fund boards. Several commenters agreed that designating at least three NRSROs could encourage competition among NRSROs to achieve designation by money market fund boards.<sup>529</sup> To the extent that competition increases the reliability of the credit ratings of designated NRSROs, this could increase the efficiency of fund managers in determining eligibility of portfolio securities. Some commenters expressed concern, however, that a requirement to designate at least three NRSROs could result in fund boards designating only the three largest NRSROs that issue most of the ratings,<sup>530</sup> which could result in decreased competition among NRSROs. To address this concern, in light of the Commission's goal of increasing competition among NRSROs, we are requiring each fund to designate at least four NRSROs. In addition, requiring designation of four NRSROs may encourage new NRSROs that issue ratings specifically for money market fund instruments to enter the market.

We recognize that the requirement to designate and annually evaluate at least four NRSROs will result in costs to the fund.<sup>531</sup> For the purposes of the PRA, we estimate that the requirement that money market funds disclose this designation, including any limitations on the use of the designations, in their SAIs will not result in additional costs for funds.<sup>532</sup> We expect that boards will designate NRSROs based on recommendations from the fund's adviser and its credit analysts. Similarly, we believe the board's annual determination regarding designated NRSROs will be based on recommendations from the adviser and its credit analysts. Staff estimates that it will take each fund's board of directors approximately 6 hours each year to designate NRSROs and determine whether the NRSROs ratings are sufficiently reliable for such use. Based on an hourly rate for the board of \$4000, we estimate that each money market fund will incur \$24,000 and all fund complexes will incur \$3.9 million annually for the boards of directors to initially designate and determine the reliability and sufficiency of the designated NRSROs' credit ratings for use in determining eligibility of portfolio securities.<sup>533</sup>

<sup>526</sup> BlackRock Comment Letter.

<sup>527</sup> Amended rule 2a-7(a)(11) (defining the term "designated NRSRO").

<sup>528</sup> Amended rule 2a-7(a)(11)(iii). The fund would be required to make the disclosure in its SAI, under Part B of Form N-1A [17 CFR 239.15A].

<sup>529</sup> See, e.g., HighMark Capital Comment Letter; Invesco Aim Comment Letter.

<sup>530</sup> See DBRS Comment Letter; C. Wesselkamper Comment Letter. We note that of the 10 registered NRSROs, three issued over 97% of the ratings across categories that NRSROs reported to the Commission. See SEC, Annual Report on Nationally Recognized Statistical Ratings Organizations at 9 (Sept. 2009).

<sup>531</sup> While we received comments regarding the designation of NRSROs, none of the comments discussed the costs of designation to funds or their advisers.

<sup>532</sup> See *supra* Section IV.A.1.

<sup>533</sup> This estimate is based on the following calculation: \$24,000 x 163 (fund complexes) = \$3,912,000. We have estimated total costs for fund complexes because we assume that boards of directors will undertake to designate and determine for all funds in the complex at the same time (although boards may designate and make annual determinations with respect to different NRSROs for different money market funds).



We expect that fund advisers currently evaluate the reliability of NRSRO ratings and ratings criteria as part of the credit analysis they perform (under delegated authority from the board) in determining the eligibility of portfolio securities. We also assume that this evaluation includes consideration and internal documentation of whether an NRSRO's rating is sufficient for that use. Accordingly, while we do not anticipate that fund advisers will incur additional time to prepare their recommendations, we expect that fund advisers will incur costs to draft those recommendations in a presentation or report for board review regarding designation of NRSROs and the sufficiency of designated NRSROs' ratings. Staff estimates that the investment adviser for each complex will spend 6 hours annually to prepare a report based on the adviser's internal review and documentation that summarizes its recommendation with respect to each NRSRO that may be considered for designation and any limits on the use of that NRSRO under the rule at a cost per fund complex of \$1770 and a total cost of \$288,510.<sup>534</sup>

As noted above, we understand that money market fund advisers currently evaluate NRSROs that rate securities in which the fund invests. We also understand that fund advisers monitor NRSROs for potential downgrades of portfolio securities. Prior to today's amendments, if the fund invested in unrated or second tier securities, the adviser had to monitor all NRSROs in case there was a downgrade of a second tier security or an unrated security received a rating below one of the top two categories.<sup>535</sup> Thus, we do not expect that limiting the number of NRSROs that a fund must monitor to four (or more, if the fund chooses) will result in increased costs to fund advisers to monitor NRSROs.

### 3. Stress Testing

As proposed, we are amending rule 2a-7 to require that a money market fund's board of directors adopt written procedures that provide for the periodic stress testing of each money market fund's portfolio.<sup>536</sup> A fund's board of directors determines the frequency of stress testing. The procedures must require testing of the fund's ability to maintain a stable net asset value per share based upon certain hypothetical events.<sup>537</sup> The procedures also must provide for a report to be delivered to the fund's board of directors at its next regularly scheduled meeting on the results of the testing, or more often as appropriate in light of the results.<sup>538</sup> The report must include an Amended rule 2a-7(c)(10)(v)(B). The report must include dates on which the testing was performed and the magnitude of each hypothetical event that would cause the deviation of the money market fund's net asset value, calculated using available market quotations (or appropriate assessment by the fund's adviser of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.<sup>539</sup>

We anticipate that stress testing will give fund advisers a better understanding of the effect of potential market events and shareholder redemptions on their funds' ability to maintain a stable net asset value, the funds' exposure to the risk that they would break the buck, and actions the advisers may need to take to mitigate the possibility of the funds breaking the buck.<sup>540</sup> We believe that many funds currently conduct stress testing as a matter of routine fund management and business practice.<sup>541</sup> We anticipate, however, that funds that do not currently perform stress testing and funds that may

<sup>534</sup> These estimates are based on the following calculations: (\$202/hour (intermediate portfolio manager) x 3 hours) + (\$388/hour (senior portfolio manager) x 3 hours) = \$1770; \$1770 x 163 fund complexes = \$288,510. Hourly wages used for purposes of the estimate of portfolio manager salaries are from the SIFMA *Report on Management & Professional Salaries Data* (Sept. 2008), modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

<sup>535</sup> See current rule 2a-7(c)(6)(i)(A)(2).

<sup>536</sup> See *supra* Section II.C.4. We did not receive any comment on the estimates and assumptions included in our proposal. Accordingly, we have not modified any of those estimates except to reflect the new requirement included in the amended rule.

<sup>537</sup> As proposed, the hypothetical events described in the final rule include a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on a portfolio security, and widening or narrowing of spreads between yields on a benchmark selected by the fund and securities held by the fund. See amended rule 2a-7(c)(10)(v)(A).

<sup>538</sup> Amended rule 2a-7(c)(10)(v)(B). The report must include dates on which the testing was performed and the magnitude of each hypothetical event that would cause the deviation of the money market fund's net asset value, calculated using available market quotations (or appropriate substitutes that reflect current market conditions), from its net asset value per share, calculated using amortized cost, to exceed ½ of 1%. Amended rule 2a-7(c)(10)(v)(B)(1).

<sup>539</sup> Amended rule 2a-7(c)(10)(v)(B)(2).

<sup>540</sup> See *supra* note 411 and accompanying and preceding text.

<sup>541</sup> See Proposing Release, *supra* note 2, at paragraph following n.358.

revise their procedures in light of the amended rule will give their managers a tool to better manage those risks. For fund boards of directors that do not currently receive stress test results, we believe that the regular reports of the testing and assessments will provide money market fund boards a better understanding of the risks to which the fund is exposed.

We understand that today rigorous stress testing is a best practice followed by many money market funds.<sup>542</sup> We understand that the fund complexes that conduct stress tests include smaller complexes that offer money market funds externally managed by advisers experienced in this area of management.<sup>543</sup> Accordingly, staff estimates that as a result of the new requirement to adopt stress testing procedures: (i) funds that currently conduct rigorous stress testing, including tests for hypothetical events listed in the amended rule (and concurrent occurrences of those events), will incur some costs to evaluate whether their current test procedures comply with the new requirement, but will be likely to incur relatively few costs to revise those procedures or continue the stress testing they currently perform; (ii) funds that conduct less rigorous stress testing, or that do not test for all the hypothetical events listed in the amended rule, will incur somewhat greater expenses to revise those procedures in light of the new requirement and maintain the revised testing; and (iii) funds that do not conduct stress testing will incur costs to develop and adopt stress test procedures and conduct stress tests.

As noted above, we believe that there is a range in the extent and rigor of stress testing currently performed by money market funds. We also expect that stress test procedures are being or will be developed by the adviser to a fund complex for all money market funds in the complex, while specific stress tests are performed for each individual money market fund. We estimate that a fund complex that currently does not conduct stress testing will require approximately 1 month for 2 risk management specialists and 2 systems analysts to develop stress test procedures at a cost of approximately \$155,000, 22 hours for a risk management specialist to draft the procedures, and 3 hours of board of directors' time to adopt the procedures for a total of approximately \$173,000.<sup>544</sup> Costs for fund complexes that will have to revise or fine-tune their stress test procedures would be less. For purposes of this cost benefit analysis, we estimate that these funds will incur half the costs of development, for a total of approximately \$96,000.<sup>545</sup> Funds that will not have to change their test procedures will incur approximately \$20,000 to determine compliance with the new requirement and to draft and adopt the procedures.<sup>546</sup> We also anticipate that in light of the new demand to develop stress testing procedures, third parties will develop programs that funds will be able to purchase for less than our estimated cost to develop the programs themselves.

As with the development of stress test procedures, the costs funds will incur each year as a result of the proposed amendments to update test procedures, conduct stress tests, and provide reports on the tests and assessments to the board of directors will vary. Funds that currently conduct stress tests already incur costs to perform the tests. In addition, some of those funds may currently provide reports to senior management (if not the board) of their test results. We assume, however, that few, if any, fund advisers provide a regular assessment to the board of the fund's ability to withstand the events reasonably likely to occur in the following year. For that reason, we estimate that for routine reports, each fund complex will incur costs of \$3000 to provide a written report on the test results to the board, \$4000 to provide the assessment in the report, and \$10 to retain records of the reports for a total annual cost to a fund complex of \$42,000.<sup>547</sup>

<sup>542</sup> See *id.* at n.359 and accompanying text.

<sup>543</sup> These complexes do not, however, meet the definition of "small entities" under the Investment Company Act for purposes of the Regulatory Flexibility Act of 1980. 17 CFR 270.0-10. See *infra* note 636.

<sup>544</sup> This estimate is based on the following calculations: \$275/hour x 280 hours (collectively, 2 senior risk management specialists) + \$244/hour x 320 hours (collectively, 2 senior systems analysts) = \$155,080; \$275/hour (senior risk management specialist) x 22 hours = \$6050; \$4000/hour x 3 hours = \$12,000; \$155,080 + \$6050 + \$12,000 = \$173,130.

<sup>545</sup> This estimate is based on the following calculation: (\$155,080 x 0.5) (revise procedures) + \$6050 (draft procedures) + \$12,000 (board approval) = \$95,590.

<sup>546</sup> This estimate is based on the following calculation: \$275/hour (senior risk management specialist) x 8 hours = \$2200; \$2200 + \$6050 + \$12,000 = \$20,250.

<sup>547</sup> See *supra* note 419 and preceding, accompanying, and following text. This estimate is based on the following calculation: *Report*: \$275/hour x 10 hours (senior risk management specialist) + \$62 x 2 hours (administrative assistant) = \$2874; *Assessment*: \$275/hour x 15 hours (senior risk management specialist) = \$4125; *Record retention*: \$62/hour x 0.1667 hours (administrative assistant) = \$10.33; (\$2874 + \$4125 + \$10) x 6 (board meetings per year) = \$42,054. Hourly wages used for purposes of the estimate of administrative assistant salaries are from the SIFMA *Report on Management & Professional Salaries Data* (Sept. 2008), modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

As noted above, however, the procedures must provide for additional reports to the board as appropriate based on testing results, and we estimate that each fund complex will incur costs of \$28,000 for an average of four of these reports each year.<sup>548</sup> We estimate that a portion of funds will incur additional costs to perform stress tests and update their procedures each year, up to a maximum of approximately \$149,000.<sup>549</sup>

For purposes of this cost benefit analysis, Commission staff has estimated that 25 percent of fund complexes (or 41 complexes) will have to develop stress test procedures, 50 percent (or 81) would have stress test procedures, but have to revise those procedures, and 25 percent of complexes (or 41 complexes) will review the procedures without having to change them. Based on these estimates, staff further estimates that the total one-time costs for fund complexes to develop or refine existing stress test procedures will be approximately \$16 million.<sup>550</sup> In addition, staff estimates that the annual costs to all funds to conduct stress tests, update test procedures, provide reports to fund boards, and retain records of the reports will be approximately \$24 million.<sup>551</sup>

#### 4. Repurchase Agreements

We are adopting, as proposed, changes affecting a money market fund's ability to "look through" a repurchase agreement for purposes of rule 2a-7's diversification provisions.<sup>552</sup> Under the amended rule, a money market fund will be able to look through a repurchase agreement only if it is collateralized by cash items or Government securities, and if the fund's board of directors or its delegate evaluates the counterparty's creditworthiness.

The changes are designed to reduce money market funds' risks related to repurchase agreement investments so that funds will be better positioned to weather market turbulence and maintain a stable net asset value per share. A money market fund that invests in a repurchase agreement collateralized by cash items or Government securities is less likely to experience losses upon the sale of collateral in the event of a counterparty's default.<sup>553</sup> The creditworthiness evaluation, moreover, will diminish the risk that a money market fund in the first place enters into a repurchase agreement with a counterparty that subsequently defaults.

We believe that the costs associated with these changes will be minimal. As confirmed by commenters, most money market funds typically do not look through repurchase agreements collateralized with securities other than Government securities.<sup>554</sup> Under the amended rule, money market funds will be able, as they have in the past, to invest in such repurchase agreements, although the funds will not be able to look through the repurchase agreements for purposes of rule 2a-7's diversification provisions.<sup>555</sup>

With regard to the new creditworthiness evaluation, several commenters stated that money market funds already evaluate the credit quality of counterparties under rule 2a-7(c)(3).<sup>556</sup> We estimate, therefore, that investment advisers to only approximately 20 percent of all 163 fund complexes are not currently making such determinations. To the extent that boards or their delegates, in response to the amended rule, will make determinations that they would not otherwise make, those parties will expend time and/or resources in making those determinations. We estimate that, if an

<sup>548</sup> See *supra* note 420 and accompanying text. This estimate is based on the following calculation: (\$2874 (reports) + (\$4125 (assessment) + \$10 (recordkeeping)) x 4 = \$28,036.

<sup>549</sup> This estimate is based on the following calculations: Tests: \$275/hour x 15 hours (senior risk management specialist) + \$244/hour x 20 hours (senior systems analyst) = \$9005; \$9005 x 12 (monthly testing) + (\$9005 x 4 additional "appropriate" testing) = \$144,080; Update procedures: \$275/hour x 5 hours (senior risk management specialist) + \$4000/hour x 1 hour = \$5375; \$144,080 + \$5375 = \$149,455.

<sup>550</sup> This estimate is based on the following calculation: (41 x \$173,000) + (81 x \$95,000) + (41 x \$20,000) = \$15,608,000.

<sup>551</sup> This estimate is based on the following calculation: (41 x \$149,455) + (81 x \$149,455 x 0.5) + (163 x \$70,090 (reports, including assessments)) = \$23,605,252.5.

<sup>552</sup> See *supra* Section II.D; Proposing Release, *supra* note 2, at Section II.E.

<sup>553</sup> See *supra* note 272 and accompanying text.

<sup>554</sup> See *supra* note 274 and accompanying text.

<sup>555</sup> No commenter has expressed the view that the new diversification requirement will increase money market funds' cost of investing in repurchase agreements.

<sup>556</sup> As discussed above, three commenters argued that the proposed creditworthiness evaluation is unnecessary because it is already an element of the minimal credit risk determination that a fund makes pursuant to rule 2a-7(c)(3). See *supra* note 277.

investment adviser were to spend 10 hours a year making creditworthiness determinations that it would not otherwise make concerning repurchase agreement counterparties, it would spend approximately \$2750 per year.<sup>557</sup> Therefore the total cost to all money market funds would be approximately \$90,750 per year.<sup>558</sup> In addition to these costs, we also estimated above, for purposes of the Paperwork Reduction Act, that funds might spend 2 hours per year maintaining records concerning the determinations made under the amended rule.<sup>559</sup> We estimate the aggregate total costs associated with this recordkeeping to be \$20,212 per year.<sup>560</sup>

### 5. Public Website Posting

The amendments to rule 2a-7 require money market funds to post monthly portfolio information on their websites.<sup>561</sup> The rule amendments are intended to provide shareholders with timely information about the securities held by the money market fund.

We anticipate that requiring funds to post monthly portfolio information on their websites will benefit investors by providing them a better understanding of their own risk exposure enabling them to make better informed investment decisions. The rule amendments may thus instill more discipline into portfolio management and reduce the likelihood of a money market fund breaking the buck.

The website posting requirement will impose certain costs on funds. We estimated in the Proposing Release that money market funds would be required to spend 24 hours of internal money market fund staff time initially to develop a webpage, at a cost of \$4944 per fund.<sup>562</sup> We also estimated that all money market funds would be required to spend 4 hours of professional time to maintain and update the webpage each month, at a total annual cost of \$9888 per fund.<sup>563</sup> We also stated that we believe, however, that our estimates may overstate the actual costs that would be incurred to comply with the website posting requirement because many funds currently post their portfolio holdings on a monthly, or more frequent, basis.<sup>564</sup> For purposes of the cost benefit analysis in the Proposing Release, Commission staff estimated that 20 percent of money market portfolios (150 portfolios) did not post portfolio holdings information on their websites.<sup>565</sup> We requested comment on these estimated costs in the Proposing Release.<sup>566</sup> One commenter suggested that we may have underestimated the costs associated with the initial development of the webpage, but also may have overestimated the costs associated with the ongoing maintenance of website reporting.<sup>567</sup> The commenter did not provide any cost estimates. Commission staff continues to believe that these cost estimates are appropriate. In addition, as discussed above, we have decided not to require some of the information required by Regulation S-X, which we proposed that funds post on their websites.<sup>568</sup> We expect that eliminating the mandatory posting of this information, which we believe is not critical to be made available to investors, will reduce costs for funds and their advisers.<sup>569</sup>

One commenter, however, stated that the cost estimates did not include the cost for the 80 percent of money market portfolios that currently post portfolio holdings information at least quarterly on their websites to develop the capability

<sup>557</sup> This estimate is based on the following calculation: \$275/hour (senior risk management specialist) x 10 hours= \$2750.

<sup>558</sup> This estimate is based on the following calculation: \$275/hour (senior risk management specialist) x 10 hours x 33 fund complexes = \$90,750.

<sup>559</sup> See *supra* Section IV.A.4

<sup>560</sup> This estimate is based on the following calculation: \$62/hour (administrative assistant) x 2 hours 163 fund complexes = \$20,212

<sup>561</sup> Amended rule 2a-7(c)(12).

<sup>562</sup> See Proposing Release, *supra* note 2, at n.374 and accompanying text. The staff estimated that a webmaster at a money market fund would require 24 hours (at \$206 per hour) to develop and review the webpage (24 hours x \$206 = \$4944).

<sup>563</sup> See Proposing Release, *supra* note 2, at n.375 and accompanying text. The staff estimated that a webmaster would require 4 hours (at \$206 per hour) to maintain and update the relevant webpages on a monthly basis (4 hours x \$206 x 12 months = \$9888).

<sup>564</sup> See Proposing Release, *supra* note 2, at n.376 and accompanying text.

<sup>565</sup> See Proposing Release, *supra* note 2, at text preceding n.377.

<sup>566</sup> See Proposing Release, *supra* note 2, at Section V.A.5.

<sup>567</sup> See Clearwater Comment Letter.

<sup>568</sup> See *supra* note 285 and accompanying text.

<sup>569</sup> *Id.*

to retain previous months' portfolio holdings information on their websites.<sup>570</sup> Based on a review of some of the commenters' current portfolio website disclosure and follow-up discussions with some commenters, Commission staff estimates that 500 funds will need to develop this capability. Commission staff estimates that each of these 500 funds will spend approximately 12 hours, at a one-time cost of \$2472 per fund, to develop this capability.<sup>571</sup>

Based on these estimates, we estimate that the total initial costs for the website disclosure will be \$1,947,936.<sup>572</sup> In addition, we estimate that the annual costs for all money market funds to maintain and update their webpages will be \$7.1 million.<sup>573</sup>

In addition, monthly website disclosure may impose other costs on funds and their shareholders. For example, more frequent disclosure of portfolio holdings may arguably expand the opportunities for professional traders to exploit this information by engaging in predatory trading practices, such as front-running. However, given the short-term nature of money market fund investments and the restricted universe of eligible portfolio securities, we believe that the risk of trading ahead is severely curtailed in the context of money market funds.<sup>574</sup> For similar reasons, we believe that the potential for "free riding" on a money market fund's investment strategies, i.e., obtaining for free the benefits of fund research and investment strategies, is minimal. Given that shares of money market funds are ordinarily purchased and redeemed at the stable price per share, we believe that there would be relatively few opportunities for profitable arbitrage. Thus, we estimate that the costs of predatory trading practices under the amended rule will be minimal. Furthermore, as previously noted, most money market fund portfolios (80 percent) already are posted on fund websites at least quarterly.

## 6. Processing of Transactions

The amendments to rule 2a-7 require a money market fund to have the capacity to redeem and sell its securities at a price based on the fund's current net asset value per share, including the capacity to sell and redeem shares at prices that do not correspond to the stable net asset value or price per share.<sup>575</sup> As discussed above, the events of fall 2008 revealed that some funds had not implemented automated systems to process redemptions at prices other than the funds' stable net asset value per share. As a result, transactions were processed manually, which extended the time that investors had to wait for the proceeds from their redeemed shares. This experience showed that funds that cannot electronically process redemptions at prices other than the funds' stable net asset value per share risk being unable to meet their obligations to redeem shares and pay redemption proceeds within seven days, as required under the Act.

The amendments to rule 2a-7 mitigate the risk that money market funds would not be able to meet these obligations in the event the fund breaks a buck. These amendments benefit shareholders because they increase the likelihood that shareholders will timely receive the proceeds of their investments when a fund breaks the buck.

Because funds have an existing obligation to redeem at other than their stable net asset value per share, we do not believe that this amendment to rule 2a-7 imposes any additional costs on funds or their transfer agents.<sup>576</sup> Nonetheless, to the extent that funds and transfer agents have to change their systems, we estimated in the Proposing Release that the total cost for a fund complex would be \$39,040.<sup>577</sup> We further estimated that one-third of the fund complexes are not

<sup>570</sup> See Data Communiqué Comment Letter. Under our proposal, funds would have been required to maintain the portfolio holdings information on their websites for at least twelve months. We are adopting a six-month maintenance period for portfolio holding information.

<sup>571</sup> The staff estimates that a webmaster at a money market fund would require 12 hours (at \$206 per hour) to develop the capability to retain previous months' portfolio holdings information on their websites as required by the rule (12 hours x \$206 = \$2472).

<sup>572</sup> This calculation was based on the following estimate: (\$4944 x 144 portfolios) (cost to develop webpage) + (\$2472 x 500 portfolios) (cost to develop capability to retain previous months' portfolio holdings information on existing websites) = \$1,947,936.

<sup>573</sup> This calculation was based on the following estimate: (\$9888 x 719 portfolios) = \$7,109,472.

<sup>574</sup> See ICI Report, *supra* note 14, at 93.

<sup>575</sup> Amended rule 2a-7(c)(13).

<sup>576</sup> See *supra* Section II.F.

<sup>577</sup> This estimate is based on the following calculation: \$244/hour x 160 hours (senior systems analyst) = \$39,040.

currently able to redeem at prices other than stable net asset value, and thus the total cost to all money market funds would be \$2,225,280.<sup>578</sup>

Several commenters claimed that the costs of changing the systems would exceed our estimates.<sup>579</sup> One commenter estimated that the costs of making the required changes to the core transfer agent and ancillary systems would total approximately \$24 million for ten fund complexes, representing 63 percent of money market fund assets, and two of the three largest transfer agent service providers.<sup>580</sup> Based on those figures, we have revised our estimate to reflect that the total cost of making the required systems changes for all money market funds would be approximately \$38.1 million.<sup>581</sup>

## B. Rule 17a-9

The Commission is amending rule 17a-9 to expand the circumstances under which affiliated persons can purchase money market fund portfolio securities. Under the amendment, a money market fund generally will be able to sell a portfolio security that has defaulted to an affiliated person for cash equal to the greater of the security's amortized cost value or market value (including accrued interest), even though the security continues to be an eligible security.<sup>582</sup>

The amendment essentially codifies past Commission staff no-action letters<sup>583</sup> and should benefit investors by enabling money market funds to dispose of distressed securities (e.g., securities depressed in value as a result of market conditions) from their portfolios quickly without any loss to fund shareholders. It also benefits money market funds by eliminating the cost and delay of requesting no-action assurances in these scenarios and the uncertainty whether such assurances will be granted.<sup>584</sup> We do not believe that there are any costs associated with this amendment, and we received no comments on this analysis.

In addition, the amendment permits affiliated persons to purchase other portfolio securities from an affiliated money market fund, for any reason, as long as the security's purchase price meets the rules' other conditions and such person promptly remits to the fund any profit it realizes from the later sale of the security.<sup>585</sup> Our staff provided temporary no-action assurances during the fall of 2008 to certain funds facing extraordinary levels of redemption requests for affiliated persons of such funds to purchase eligible securities from the funds at the greater of amortized cost or market value (plus accrued and unpaid interest).<sup>586</sup> In these circumstances, money market funds may need to obtain cash quickly to avoid selling securities into the market at fire sale prices to meet shareholder redemption requests, to the detriment of remaining shareholders. The staff also provided no-action assurances to money market funds for affiliated persons of the fund to purchase at the greater of amortized cost or market value (plus accrued and unpaid interest) certain distressed securities that were depressed in value due to market conditions potentially threatening the stable share price of the fund, but that remained eligible securities and had not defaulted.<sup>587</sup> Money market funds and their shareholders benefit if affiliated persons are able to purchase securities from the fund at the greater of amortized cost or market value (plus accrued and unpaid interest) in such circumstances without the time, expense, and uncertainty of applying to Commission staff for no-action assurances.

<sup>578</sup> This estimate was based on the following calculation:  $(171 \text{ fund complexes} \div 3) \times \$39,040 = \$2,225,280$ .

<sup>579</sup> See, e.g., HighMark Capital Comment Letter; ICI Comment Letter.

<sup>580</sup> See ICI Comment Letter. The ICI conducted a survey of its members and gathered data from 10 fund complexes and 2 transfer agent service providers. Six of the 12 respondents indicated that their transfer agent system already had the capability to process money market fund trades at other than a \$1.00 stable net asset value.

<sup>581</sup> We believe that the systems changes costs are correlated to the size of the fund complex. Accordingly, this estimate is based on the following calculations:  $\$24 \text{ million} \div 63\% = \$38.1 \text{ million}$ . The ICI Comment Letter also provided additional cost estimates for changes to the systems of intermediaries who perform sub-transfer agency or similar recordkeeping functions. We do not discuss those additional costs here because, as discussed above, the rule does not impose any requirements on those intermediaries. See *supra* text preceding note 363.

<sup>582</sup> See amended rule 17a-9(a).

<sup>583</sup> See *supra* Section II.G.1.

<sup>584</sup> Commission staff estimates that the costs to obtain staff no-action assurances range from \$50,000 to \$100,000.

<sup>585</sup> See amended rule 17a-9(b).

<sup>586</sup> Many of the no-action letters can be found on our website. See <http://www.sec.gov/divisions/investment/im-noaction.shtml#money>.

<sup>587</sup> *Id.*

Affiliated persons purchasing such securities will have costs in creating and implementing a system for tracking the purchased securities and remitting to the money market fund any profit ultimately received as a result. We estimate that creating such a system on average would require 5 hours of a senior programmer's time, at a cost of \$1460 for each of the 163 fund complexes with money market funds, and a total cost of \$237,980.<sup>588</sup> After the initial creation of this system, we expect that the time spent noting in this system that a security was purchased under rule 17a-9 would require a negligible amount of compliance personnel's time. Based on our experience, we do not anticipate that there would be many instances, if any, in which an affiliated person will be required to repay profits in excess of the purchase price paid to the fund. However, if there is a payment, it would be made to the fund. If the payment is sufficiently large, we believe that funds are likely to include it with the next distribution to shareholders, which would not result in any additional costs to the fund. We received no comments on this analysis.

The Commission also is adopting a related amendment to rule 2a-7, which requires that funds report all transactions under rule 17a-9 to the Commission. We believe that this reporting requirement benefits fund investors by allowing the Commission to monitor the purchases for possible abuses and conflicts of interest on the part of the affiliates. It also allows the Commission to observe what types of securities are distressed and which money market funds are holding distressed securities or are subject to significant redemption pressures. This information will assist us in monitoring emerging risks at money market funds. For purposes of the Paperwork Reduction Act analysis, we estimate this amendment will impose relatively small reporting costs on money market funds of \$7625 per year.<sup>589</sup> We received no comments on this analysis.

### C. Rule 22e-3

Rule 22e-3 permits a money market fund that has broken the buck, or is at imminent risk of breaking the buck, to suspend redemptions and postpone the payment of proceeds pending board-approved liquidation proceedings. By facilitating orderly liquidations in distressed circumstances, we anticipate that rule 22e-3 will reduce the vulnerability of shareholders to the harmful effects of a run on a fund and minimize the potential for market disruption. The rule also enables funds to avoid the expense and delay of obtaining an exemptive order from the Commission, which we estimate would otherwise cost approximately \$75,000, and will provide legal certainty to funds that wish to suspend redemptions during a liquidation in the interest of fairness to all shareholders.

Rule 22e-3 will impose certain minimal costs on funds relying on the rule by requiring them to provide prior notice to the Commission of their decision to suspend redemptions in connection with a liquidation. Furthermore, the rule will impose minimal costs on certain conduit funds that have invested in money market funds that suspended redemptions in reliance on the rule by also requiring those conduit funds to provide notice to the Commission. We estimate that the total annual burden of the notification requirement for all money market funds and conduit funds will be 110 minutes, at a cost of \$559.<sup>590</sup> In addition, rule 22e-3 imposes costs on shareholders who seek to redeem their shares, but are unable to do so. In those instances, shareholders may have to borrow funds from another source, and thereby incur interest charges and other transaction fees. We believe, however, that the costs associated with rule 22e-3 are minimal because the rule provides a very limited exemption that is triggered only when a fund breaks the buck, or is in imminent risk of breaking the buck, and liquidates.

### D. Rule 30b1-7 and Form N-MFP: Monthly Reporting of Portfolio Holdings

Rule 30b1-7 and Form N-MFP require money market funds to file with the Commission interactive data-formatted portfolio holdings information on a monthly basis. We expect that the rule and form will improve the efficiency and effectiveness of the Commission's oversight of money market funds by enabling Commission staff to manage and analyze comprehensive money market fund portfolio information more quickly and at a lower cost than is currently possible. The interactive data will also facilitate the flow of information between money market funds and other users of this information, such as information services, academics, and investors. As a result, users of this information, including investors, may benefit by gaining a better understanding of money market funds' risk exposure and becoming better

<sup>588</sup> This estimate is based on the following calculation: \$292/hour x 5 hours x 163 fund complexes = \$237,980.

<sup>589</sup> This estimate is based on the following calculation: 25 (notices) x \$305/hour (attorney) x 1 hour = \$7625. See *supra* note 437 and accompanying text.

<sup>590</sup> See *supra* note 443 and accompanying text. This estimate is based on the following calculation: \$305/hour x 110 minutes = \$559.

informed in their investment decisions. As the development of software products to analyze the data continues to grow, we expect these benefits will increase. Finally, the portfolio reporting may instill more discipline into portfolio management and reduce the likelihood of a money market fund breaking the buck.

Money market funds may also realize cost savings from the rule. Currently, money market funds provide portfolio holdings information in a variety of formats to different third-parties, such as information services and NRSROs. The rule may encourage the industry to adopt a standardized format, thereby reducing the burdens on money market funds of having to produce this information in multiple formats.

The reporting requirement will also impose certain costs. We estimated in the Proposing Release, that, for the purposes of the PRA, these filing requirements (including collecting, tagging, and electronically filing the report) would impose 128 burden hours at a cost of \$35,968<sup>591</sup> per money market fund for the first year, and 96 burden hours at a cost of \$26,976<sup>592</sup> per money market fund in subsequent years.<sup>593</sup> We requested comment on these estimated costs in the Proposing Release.<sup>594</sup>

As discussed above, two commenters asserted that the Commission's cost estimates did not include time to review the information required in Form N-MFP.<sup>595</sup> In response to these commenters, we revised our PRA estimates to include an additional 2 hours per filing for review of the information.<sup>596</sup> As a result of this increase, we have revised our cost estimates. We estimate that, for the purposes of the PRA, these filing requirements (including collecting (and review), tagging, and electronically filing the report) would impose 152 burden hours at a cost of \$42,712<sup>597</sup> per money market fund for the first year, and 120 burden hours at a cost of \$33,720<sup>598</sup> per money market fund in subsequent years.<sup>599</sup> We estimate that the total cost for all money market funds for the first year would be \$30,709,928.<sup>600</sup> The total annual estimated cost for all money market funds in subsequent years would be \$24,244,680.<sup>601</sup>

In addition, funds may incur additional costs as a result of the public availability of a fund's market-based net asset value, which is required to be included in Form N-MFP filings. In particular, some commenters noted that if investors systematically redeem shares for one dollar when the market-based net asset value is less than one dollar, the fund might have difficulty maintaining its stable price. However, in response to concerns about the disclosure of market-based values, we are delaying the public availability of the information filed on Form N-MFP for 60 days after the end of the reporting

<sup>591</sup> See Proposing Release, *supra* note 2, at n.396 and accompanying text. This estimate was based on the following calculation: \$281/hour x 128 hours (senior database administrator) = \$35,968.

<sup>592</sup> See Proposing Release, *supra* note 2, at n.397 and accompanying text. This estimate was based on the following calculation: \$281/hour x 96 hours (senior database administrator) = \$26,976.

<sup>593</sup> We understand that some money market funds may outsource all or a portion of these responsibilities to a filing agent, software consultant, or other third-party service provider. We believe, however, that a fund would engage third-party service providers only if the external costs were comparable, or less than, the estimated internal costs of compiling, tagging, and filing the Form N-MFP.

<sup>594</sup> See Proposing Release, *supra* note 2, at paragraph following n.398.

<sup>595</sup> See Bowne Comment Letter; Data Communiqué Comment Letter. Another commenter suggested that we may have underestimated the costs associated with the initial filing of Form N-MFP, but also may have overestimated the ongoing costs associated with subsequent filings. See Clearwater Comment Letter. The commenter, however, did not provide any cost estimates.

<sup>596</sup> See *supra* Section IV.C.

<sup>597</sup> This estimate is based on the following calculation: \$281/hour x 152 hours (senior database administrator) = \$42,712.

<sup>598</sup> This estimate is based on the following calculation: \$281/hour x 120 hours (senior database administrator) = \$33,720.

<sup>599</sup> We understand that some money market funds may outsource all or a portion of these responsibilities to a filing agent, software consultant, or other third-party service provider. We believe, however, that a fund would engage third-party service providers only if the external costs were comparable, or less than, the estimated internal costs of compiling, tagging, and filing the Form N-MFP.

<sup>600</sup> This estimate is based on the following calculation: \$42,712 (total estimated cost per fund for first year) x 719 funds = \$30,709,928.

<sup>601</sup> This estimate is based on the following calculation: \$33,720 (total estimated cost per fund after the first year) x 719 funds = \$24,244,680.



period.<sup>602</sup> We acknowledge that investors might choose to sell their money market fund shares that have a low market-based net asset value, and it is possible that a run could develop. Nevertheless, at least two other factors will reduce the risk of a run. First, portfolio managers may choose to follow less risky investment strategies in an effort to maintain a high market-based net asset value. Second, funds may be quicker to ask for help from their affiliates through, for example, rule 17a-9 transactions.

The money market fund industry is characterized by a mix of competitors with and without affiliates that can provide financial support. The disclosure of a fund's market-based net asset value might encourage funds that have affiliates with the ability to provide financial support to request such support as soon as any problems develop. This support could provide stability to funds that receive the support. This support might also give a competitive advantage to funds that receive it because they may be more willing to invest in securities with higher risk and higher yields. However, the extent of this competitive advantage may be mitigated because the amendments will require the disclosure of the fund's market-based NAV with and without capital support agreements. In addition, much of the extent to which fund managers might take advantage of capital support arrangements to boost fund yields is independent of the amendments we are adopting today and affiliated persons of money market funds are not obligated to support these funds. For the reasons outlined in the discussion on the monthly website posting requirement, we estimate that there will be minimal additional costs incurred from predatory trading practices (e.g., front-running or "free riding") as a result of the reporting requirement.<sup>603</sup>

### E. Rule 30b1-6T

We adopted rule 30b1-6T to enable the Commission staff to continue to have effective oversight of money market funds. The rule was designed to improve the efficiency and effectiveness of the Commission's oversight by providing useful information about money market funds that report under the rule, and by enabling the staff to manage and analyze money market fund portfolio information more quickly and at a lower cost than possible without electronic submissions of portfolio schedules. When we adopted rule 30b1-6T in September 2009, we requested comments on the costs and benefits of the rule but received no comments.<sup>604</sup>

Rule 30b1-6T will impose some costs on funds. For the purposes of the PRA, we estimated that the rule will result in an increase of 2100 burden hours per year. We estimate that these burden hours will cost a total of \$590,100.<sup>605</sup> We do not believe that rule 30b1-6T will impose other significant costs, especially given the nonpublic nature of the reports required under the rule.

## VI. COMPETITION, EFFICIENCY, AND CAPITAL FORMATION

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>606</sup>

### A. Rule 2a-7

#### 1. *Second Tier Securities, Portfolio Maturity, and Liquidity Limits*

We are adopting several amendments to rule 2a-7 to tighten the risk-limiting conditions of the rule. As discussed above, we are further restricting money market funds' ability to acquire second tier securities. The amendments reduce the maximum weighted average maturity of a money market fund permitted by rule 2a-7 from 90 days to 60 days.<sup>607</sup> They

<sup>602</sup> See rule 30b1-7(b). See also *supra* text accompanying note 320. As noted above, money market funds currently must disclose their mark-to-market net asset value per share semiannually in their Form N-SAR filings [17 CFR 274.101], which are publicly available. Form N-SAR must be filed with the Commission no later than the 60th day after the end of the fiscal period for which the report is being prepared. See *supra* note 337 and accompanying text. Thus, investors already have access to market-based portfolio value information on the basis of which they could make redemptions.

<sup>603</sup> See *supra* note 574 and accompanying and following text.

<sup>604</sup> See Rule 30b1-6T Release, *supra* note 303, at Section VI.

<sup>605</sup> This estimate is based on the following calculation: 2100 hours x \$281/hour (senior database administrator) = \$590,100.

<sup>606</sup> 15 U.S.C. 80a-2(c).

<sup>607</sup> See amended rule 2a-7(c)(2)(ii).

also impose a new maturity limitation based on the weighted average “life” of fund securities that limits the portion of a fund’s portfolio that can be held in longer term floating- or variable-rate securities.<sup>608</sup> We are deleting a provision in rule 2a-7 that permitted money market funds not relying on the amortized cost method of valuation to acquire Government securities with a remaining maturity of up to 762 calendar days.

Finally, we are adopting new liquidity requirements for money market funds. In particular, we are amending rule 2a-7 to (i) require that each money market fund hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of its obligations under section 22(e) of the Act and any commitments the fund has made to shareholders;<sup>609</sup> (ii) further limit a money market fund’s investments in illiquid securities (*i.e.* securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to them by the money market fund);<sup>610</sup> and (iii) require a taxable money market fund to hold at least 10 percent of its total assets in “daily liquid assets” and any money market fund to hold at least 30 percent of its total assets in “weekly liquid assets.”<sup>611</sup>

We believe that these changes will reduce money market funds’ sensitivity to interest rate, credit, and liquidity risks. These changes will also limit the spread risk produced by longer term securities and second tier securities. A reduction of these risks will help individual money market funds to weather market turbulence and maintain a stable net asset value per share, which will increase the stability of the entire money market fund industry. To the extent that money market funds are more stable, the changes also will reduce systemic risk to the capital markets and ensure a stable source of financing for issuers of short-term credit instruments. We believe that these effects will encourage capital formation by encouraging investment in money market funds as well as the issuance of securities that money market funds can purchase.

These changes also may reduce maturities of short-term credit securities that issuers offer, which may increase financing costs for these issuers who might have to go back more frequently to the market for financing. As discussed above, several commenters stated that the elimination of money market funds’ ability to acquire second tier securities could increase second tier security issuers’ borrowing costs and thus increase capital formation costs.<sup>612</sup> Some of these commenters also asserted that such a prohibition could require second tier security issuers to rely more on bank financing, which could negatively impact banks’ ability to lend to other parts of the economy.<sup>613</sup> We note that these impacts should be mitigated given that we are limiting and not eliminating money market funds’ ability to acquire second tier securities. However, to the extent that some issuers are unwilling or unable to issue securities that match money market fund demand given these new restrictions or that banks become less willing to lend to finance new businesses, the amendments could have a negative impact on capital formation.

As discussed in the cost benefit analysis above, we expect that the amendments will reduce yields that some money market funds are able to offer. The lower yields may affect the ability of money market funds to compete with other investment vehicles. While money market funds compete with each other, they also compete for investors on the basis of risk-return tradeoff with other lower-risk investment vehicles, such as offshore or unregulated money market funds, bank money market deposit accounts, and deposit accounts in general. The reduction in yield may cause some investors to move their money to, among other places, offshore or unregulated money market funds that do not follow rule 2a-7’s strictures and thus are able to offer a higher yield. Beyond the competitive impact, such a change could increase systemic risks to short-term credit markets and capital formation by increasing investment in less stable short-term instruments.

Further limitations on money market funds’ ability to acquire second tier securities also may have anticompetitive effects on some relatively small money market funds that may compete with larger funds on the basis of yield. One commenter

<sup>608</sup> See amended rule 2a-7(c)(2)(iii).

<sup>609</sup> Amended rule 2a-7(c)(5).

<sup>610</sup> Amended rule 2a-7(c)(5)(i). Under the amended rule, a money market fund cannot acquire illiquid securities if immediately after the acquisition, the fund would have invested more than five percent of its total assets in illiquid securities.

<sup>611</sup> See amended rule 2a-7(c)(5)(ii)-(iii). See also amended rule 2a-7(a)(8) (defining “daily liquid assets”); 2a-7(a)(32) (defining “weekly liquid assets”).

<sup>612</sup> See *supra* notes 48–49 and accompanying paragraph.

<sup>613</sup> See, *e.g.*, Chamber/Tier 2 Issuers Comment Letter.

stated that elimination of money market funds' ability to acquire second tier securities could have a disproportionate impact on smaller money market funds.<sup>614</sup> Our review of money market fund holdings of second tier securities during September 2008 did not reveal smaller money market funds holding second tier securities to a greater extent than larger funds, although smaller funds may try to increase their holdings of second tier securities in different market environments. Even if there were any anticompetitive effects on smaller money market funds, these effects should be reduced by the fact that we are only further limiting, and not eliminating, money market funds' ability to acquire second tier securities.

The further limitations on the ability of money market funds to invest in second tier securities may affect the capital raising ability and strategies of second tier security issuers or otherwise affect their financing arrangements, and may affect the flexibility of investing options for funds. As a preliminary matter, taking into account commenters' concerns, we have determined not to eliminate money market funds' ability to acquire second tier securities. Further, as noted above, second tier securities represent only a very small percentage of money market fund portfolios today and money market funds are not the primary purchasers of second tier securities, which suggests that our amendments would not in themselves have a material effect on capital formation.<sup>615</sup> Nonetheless, we recognize that some non-rule 2a-7 regulated cash management funds and investment pools voluntarily use rule 2a-7 as an investment guideline.<sup>616</sup> However, since we are only further limiting, and not eliminating, money market funds' ability to acquire second tier securities, we do not believe that the behavior of these non-rule 2a-7 funds will have a material adverse effect on capital formation.

## 2. Designation of NRSROs

We are adopting amendments requiring money market fund boards to designate at least four NRSROs that the fund will use in determining the eligibility of portfolio securities and that the board determines annually issue credit ratings that are sufficiently reliable for this use.<sup>617</sup> As noted above, several commenters suggested that designating at least three NRSROs could encourage competition among NRSROs to achieve designation by money market fund boards.<sup>618</sup> We assume that three NRSROs issue more than 90 percent of ratings of short-term debt.<sup>619</sup> Requiring the designation of at least four NRSROs will ensure that money market funds will consider NRSROs beyond the dominant three. In addition, the amendment may encourage new NRSROs that issue ratings specifically for money market fund instruments to enter the market. To the extent that requiring designation of at least four NRSROs will further increase competition, it also should increase the reliability of the credit ratings of designated NRSROs. Having better information about risk could increase the efficiency of fund managers in determining eligibility of portfolio securities. We do not anticipate that the proposed designation of NRSROs will have an adverse impact on capital formation.

## 3. Stress Testing

We are amending rule 2a-7 to require the board of directors of each money market fund to adopt procedures providing for periodic stress testing of the money market fund's portfolio, reporting the results of the testing to fund boards, and providing an assessment to the board.<sup>620</sup> We believe that stress testing will increase the efficiency of money market funds by enhancing their risk management and thus making it more likely that the fund will be better prepared for potential stress on the fund due to market events or shareholder behavior. Money market funds will likely become more stable as a result of the risk management benefits provided by stress testing, allowing them to expand and attract further investment.

<sup>614</sup> See Thrivent Comment Letter.

<sup>615</sup> Based on discussions with one commenter to clarify certain aspects of its comment letter, however, we understand that money market funds purchase approximately 80% of the commercial paper of at least one second tier issuer. See Chamber/Tier 2 Issuers Comment Letter. We understand that such a significant reliance on money market funds to purchase a second tier issuer's securities is quite unusual.

<sup>616</sup> See, e.g., Chamber/Tier 2 Issuers Comment Letter.

<sup>617</sup> Amended rule 2a-7(a)(11)(i).

<sup>618</sup> See, e.g., HighMark Capital Comment Letter; Invesco Aim Comment Letter.

<sup>619</sup> See Proposing Release, *supra* note 2, at text accompanying and following n.116. See also *supra* note 104 and accompanying text.

<sup>620</sup> Amended rule 2a-7(c)(10)(v).

If so, this result will promote capital formation. We do not believe that stress testing will have an adverse impact on competition or capital formation.<sup>621</sup>

#### 4. Repurchase Agreements

We are adopting, as proposed, changes to the conditions under which a money market fund may take advantage of the special look-through treatment of repurchase agreements under rule 2a-7's diversification provisions.<sup>622</sup> In order to obtain such special treatment, a money market fund will be limited to investing in repurchase agreements collateralized by cash items or Government securities and the fund's board of directors or its delegate will have to evaluate the creditworthiness of the repurchase agreement's counterparty.

We believe that these changes will limit the risk that a money market fund incurs losses upon the sale of collateral in the event of a counterparty's default.<sup>623</sup> The lower risk will in turn increase money market funds' ability to maintain a stable net asset value per share, thereby preventing losses to fund investors. More stable money market funds may attract greater investments, thus promoting capital formation and providing a greater source of financing in the capital markets. The changes will not negatively impact competition, efficiency, or capital formation. In particular, commenters noted that most money market funds typically do not look through to collateral consisting of non-Government securities.<sup>624</sup>

#### 5. Public Website Disclosure

One of the amendments to rule 2a-7 requires money market funds to disclose certain portfolio holdings information on their websites on a monthly basis.<sup>625</sup> In the Proposing Release, we requested comment on what effect this rule amendment would have on competition, efficiency, and capital formation.<sup>626</sup> No commenters addressed the effect of this amendment on competition, efficiency, and capital formation.

The rule amendment will provide greater transparency of the fund's investments for current and prospective shareholders, and may thus promote more efficient allocation of investments by investors.<sup>627</sup> We believe the rule amendment may also improve competition, as better-informed investors may prompt funds managers to provide better services and products. We do not anticipate that funds would be disadvantaged, with respect to competition, because so many already have chosen to provide the information more frequently than monthly. In addition, the investments selected by money market funds are less likely than, for example, equity funds, to be investments from which competing funds would obtain benefit by scrutinizing on a monthly basis.

The rule amendment may also promote capital formation by making portfolio holdings information readily accessible to investors, who may thus be more inclined to allocate their investments in a particular fund or in money market funds instead of an alternative product. Alternatively, the rule amendment might have the reverse effect if the portfolio holdings information makes investors less confident regarding the risks associated with money market funds, including the risk that market participants might use the information obtained through the disclosures to the detriment of the fund and its investors, such as by trading along with the fund or ahead of the fund by anticipating future transactions based on past transactions. We also recognize the potential for runs on money market funds that might result from any investors who compute market-based net asset values from the public disclosure of portfolio holdings. As discussed above, however,

<sup>621</sup> No commenters addressed the analysis in the Proposing Release regarding whether the proposed stress testing requirements would promote competition, efficiency, and capital formation.

<sup>622</sup> See *supra* Section II.D; Proposing Release, *supra* note 2, at Section II.E.

<sup>623</sup> See *supra* note 272 and accompanying text.

<sup>624</sup> See *supra* note 274. Wells Fargo stated that the amendment would negatively affect capital formation because money market funds will no longer invest in repurchase agreements collateralized with securities with the highest rating or unrated securities of comparable quality, which would negatively affect counterparties and issuers of collateral. See Wells Fargo Comment Letter. We discuss those comments above. See *supra* note 273.

<sup>625</sup> See *supra* Section II.E.1.

<sup>626</sup> See Proposing Release, *supra* note 2, at Section VI.A.4.

<sup>627</sup> Due to the availability of the portfolio holding information on fund websites, investors may allocate their investments away from funds with riskier portfolios. Among other things, this may reduce systemic risks as money market funds may respond by investing in securities with less risk.

most money market funds currently disclose their portfolio holdings on their websites, and therefore we do not believe that our requirement that funds post monthly portfolio holdings will have a material effect on the ability of investors to compute market-based values and incite a run on the fund.

#### *6. Processing of Transactions*

The amendments to rule 2a-7 require a money market fund to have the capacity to redeem and sell its securities at a price based on the fund's current net asset value per share, even if the fund's current net asset values does not correspond to the fund's stable net asset value or price per share. This amendment increases efficiency at money market funds that break the buck by increasing the speed and minimizing the operational difficulties in satisfying shareholder redemption requests in such circumstances. It may also reduce investors' concerns that redemptions would be unduly delayed if a money market fund were to break the buck. We do not believe that this amendment has a material impact on competition or capital formation.

#### **B. Rule 17a-9**

The Commission is amending rule 17a-9 to expand the circumstances under which affiliated persons can purchase money market fund securities. Under the amendments, a money market fund generally will be able to sell a portfolio security that has defaulted to an affiliated person for the greater of the security's amortized cost value or market value (including accrued interest), even though the security continued to be an eligible security.<sup>628</sup> In addition, the amendment permits affiliated persons, for any reason, to purchase other portfolio securities from an affiliated money market fund on the same terms as long as such person is required to promptly remit to the fund any profit it realizes from the later sale of the security.<sup>629</sup> These amendments increase the efficiency of both the Commission and money market funds by allowing affiliated persons to purchase portfolio securities from money market funds under distress without having to seek no-action assurances from Commission staff. The money market fund industry is competitive; some money market funds have well-funded affiliates to support the money market fund while others do not. This amendment may increase the competitive advantage of money market funds with well-funded affiliates relative to other money market funds, which we balanced against the need to promote stability in money market funds. We do not believe that the amendments will have any material impact on capital formation. We received no comments on this analysis.

#### **C. Rule 22e-3**

Rule 22e-3 permits a money market fund that has broken the buck, or is at imminent risk of breaking the buck, to suspend redemptions and postpone the payment of proceeds pending board-approved liquidation proceedings. We anticipate the rule will promote efficiency in the financial markets by facilitating the orderly disposal of assets during a liquidation. To the extent that investors choose money market funds over alternative investments because the rule provides reassurance as to the protection of fund assets in the event a money market fund breaks the buck, the rule also may promote capital formation. If, however, the possibility that redemptions may be suspended during a liquidation makes money market funds less appealing to investors, the rule may have a negative effect on capital formation. The rule also may help make investors more confident that they will receive the proceeds from their investment in the event of a liquidation. We do not believe that the rule will have any adverse effect on competition. We received no comments on this analysis.

#### **D. Rule 30b1-7 and Form N-MFP: Monthly Reporting of Portfolio Holdings**

New rule 30b1-7 and Form N-MFP mandate the monthly electronic filing of each money market fund's portfolio holdings information in XML-tagged format. As discussed above, we believe the new reporting requirement will improve the efficiency and effectiveness of the Commission's oversight of money market funds. The availability, and usability, of this data will also promote efficiency for other third parties that may be interested in collecting and analyzing money market funds' portfolio holdings information. Money market funds currently are often required to provide this information to various third parties in different formats. To the extent that the new reporting requirement may encourage a standardized format for disclosure or transmission of portfolio holdings information, it may promote efficiency for money market funds. We do not believe that the reporting requirement will have an adverse effect on

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<sup>628</sup> See amended rule 17a-9(a).

<sup>629</sup> See amended rule 17a-9(b).

capital formation.<sup>630</sup> In the Proposing Release, we requested comment on what effect the proposed rule would have on competition, efficiency, and capital formation.<sup>631</sup> One commenter stated that the Commission's view that the proposed rule would not have an adverse effect on competition may be incorrect for subadvised money market funds, because a number of the information items in Form N-MFP require information that typically is in the possession of the subadviser who manages the portfolio and not the principal adviser who, in most cases, would be responsible for preparing Form N-MFP. The commenter stated that obtaining the data from subadvisers would be costly because it would have to be done on a real-time basis, which would require a significant investment in new infrastructure.<sup>632</sup> The information required by the items cited by the commenter, however, already should be readily available to the subadviser.<sup>633</sup> The information also is not needed on a real-time basis by the principal adviser because the form requires information as of the last business day of the preceding month. Moreover, we have lengthened the time for filing Form N-MFP from the proposed two business days after the end of each month to five business days after the end of each month. This change should provide subadvisers with sufficient time to send the information to the principal adviser without having to invest in new infrastructure to provide the information on a real-time basis.<sup>634</sup> We therefore continue to believe that the reporting requirement will not have an adverse effect on competition.

The amendments also will require the public disclosure of a money market fund's market-based net asset value. We expect that the disclosure of month-end market-based NAV may discourage the fund's portfolio manager from taking certain risks that could reduce the fund's market-based NAV. The money market fund industry is characterized by a mix of competitors with and without affiliates that can provide financial support. The new disclosure might encourage funds that have affiliates with the ability to provide financial support to request such support as soon as any problems develop. This support could provide stability to funds that receive the support. This support might also give a competitive advantage to funds that receive it because they may be more willing to invest in securities with higher risk and higher yields. However, the extent of this competitive advantage may be mitigated because the amendments will require the disclosure of the fund's market-based NAV with and without capital support agreements. In addition, much of the extent to which fund managers might take advantage of capital support arrangements to boost fund yields is independent of the amendments we are adopting today and affiliated persons of money market funds are not obligated to support these funds.

The disclosure of a market-based net asset value below \$1.00 also might precipitate a run on the fund. If one fund were to fail for this reason, runs might develop in other money market funds, even those with relatively high market-based net asset values. However, we believe that shareholders will benefit from knowing the monthly market-based net asset values of money market funds. We anticipate that the public availability of these values will help investors make informed decisions about whether to invest, or maintain their investments, in money market funds. We also anticipate that retail investors over time will become acclimated to the market-based net asset value information that money market funds will be required to disclose, and that most of those investors will not likely make decisions based on immaterial changes to funds' portfolio values. In response to concerns expressed by some commenters about the potential for harm that

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<sup>630</sup> The rule was proposed as rule 30b1-6. As noted above, in September 2009 we adopted interim final temporary rule 30b1-6T. We therefore have adopted proposed rule 30b1-6 as rule 30b1-7.

<sup>631</sup> See Proposing Release, *supra* note 2, at Section VI.D.

<sup>632</sup> See Committee Ann. Insur. Comment Letter. In particular, the commenter stated that the information required by Items 17 (dollar weighted average life maturity), 20 (CIK of the issuer of security), 26(b) (credit rating given by the NRSROs for the security), and 30-35 (information on enhancements) of proposed Form N-MFP are not typically in the possession of the principal adviser and must be obtained from the subadviser managing the portfolio. The commenter asserted that the Commission's estimate of 128 burden hours per money market fund for the first year (1 filing x 40 hours + 11 filings x 8 hours) is far too low for subadvised funds. For the reasons discussed below, we do not believe that subadvised funds would be subject to significant investment in new *infrastructure* and thus we believe that the burden estimate is not too low for subadvised funds. The commenter does not state that there would be any ongoing additional costs for compliance with Form N-MFP by subadvised money market funds.

<sup>633</sup> Subadvisers must have all of the information required by the particular items the commenter specifies in order to manage the portfolio on a day-to-day basis in compliance with rule 2a-7, other than an issuer's CIK. Under Form N-MFP, as adopted, the CIK of the issuer of the security is only required if the security does not have a CUSIP and the issuer has a CIK. Under our proposal the CIK number of the issuer would have been required for all securities.

<sup>634</sup> By increasing the deadline to five business days, filers also will have at least two non-business days (in addition to the extra three business days) in which to complete and submit the form.

immediate public disclosure may pose for funds, we will delay for 60 days after the end of the reporting period, public disclosure of the information filed on Form N-MFP, including the market-based net asset values.<sup>635</sup>

### E. Rule 30b1-6T

Rule 30b1-6T is intended to facilitate oversight of money market funds that present a greater risk that they will be unable to maintain their primary investment objectives. As noted above, the nonpublic reports are designed to improve the efficiency and effectiveness of the Commission's oversight of such money market funds, which may also provide reassurance to investors, which may in turn promote capital formation. We do not believe that the rule will have any effect on competition.

## VII. Regulatory Flexibility Act Certification

The Commission certified, pursuant to section 605(b) of the Regulatory Flexibility Act of 1980 that the proposed amendments to rules 2a-7, 17a-9, and 30b1-5, and proposed rules 30b1-6 and 22e-3 under the Investment Company Act would not have a significant economic impact on a substantial number of small entities.<sup>636</sup> We included this certification in Section VII of the Proposing Release. Although we encouraged written comments regarding this certification, no commenters responded to this request.<sup>637</sup>

## VIII. Statutory Authority

The Commission is adopting amendments to rule 2a-7 under the exemptive and rulemaking authority set forth in sections 6(c), 8(b), 22(c), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-8(b), 80a-22(c), 80a-37(a)]. The Commission is adopting amendments to rule 17a-9 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-37(a)]. The Commission is adopting rule 22e-3 pursuant to the authority set forth in sections 6(c), 22(e) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-22(e), and 80a-37(a)]. The Commission is adopting an amendment to rule 30b1-6T pursuant to authority set forth in sections 8(b), 30(b), 31(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-29(b), 80a-30(a), and 80a-37(a)]. The Commission is adopting new rule 30b1-7 and Form N-MFP pursuant to authority set forth in sections 8(b), 30(b), 31(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-29(b), 80a-30(a), and 80a-37(a)].

### List of Subjects

17 CFR Parts 270 and 274 Investment companies, Reporting and recordkeeping requirements, Securities.

### Text of Rules, Rule Amendments, and Form

For reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

#### Part 270—Rules and Regulations, Investment Company Act of 1940

1. The authority citation for Part 270 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

2. Section 270.2a-7 is revised to read as follows:

<sup>635</sup> See *supra* Section II.E.2.

<sup>636</sup> 5 U.S.C. 605(b). Based on information in filings submitted to the Commission, we believe that there are no money market funds that are small entities. Under rule 0-10 under the Investment Company Act, an investment company is considered a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.

<sup>637</sup> We also certified that rule 30b1-6T would not have a significant economic impact on a substantial number of small entities. See Rule 30b1-6T Release, *supra* note 303, at Section VIII. We received no comment on that certification.

**§ 270.2a-7 Money market funds.**

(a) *Definitions.*

(1) *Acquisition* (or *Acquire*) means any purchase or subsequent rollover (but does not include the failure to exercise a Demand Feature).

(2) *Amortized Cost Method* of valuation means the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.

(3) *Asset Backed Security* means a fixed income security (other than a Government Security) issued by a Special Purpose Entity (as defined in this paragraph), substantially all of the assets of which consist of Qualifying Assets (as defined in this paragraph). *Special Purpose Entity* means a trust, corporation, partnership, or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from Qualifying Assets, but does not include a registered investment company. *Qualifying Assets* means financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(4) *Business Day* means any day, other than Saturday, Sunday, or any customary business holiday.

(5) *Collateralized Fully* means "Collateralized Fully" as defined in § 270.5b-3(c)(1) except that § 270.5b-3(c)(1)(iv)(C) and (D) shall not apply.

(6) *Conditional Demand Feature* means a Demand Feature that is not an Unconditional Demand Feature. A Conditional Demand Feature is not a Guarantee.

(7) *Conduit Security* means a security issued by a Municipal Issuer (as defined in this paragraph) involving an arrangement or agreement entered into, directly or indirectly, with a person other than a Municipal Issuer, which arrangement or agreement provides for or secures repayment of the security. *Municipal Issuer* means a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality of a state or territory of the United States. A Conduit Security does not include a security that is:

(i) Fully and unconditionally guaranteed by a Municipal Issuer;

(ii) Payable from the general revenues of the Municipal Issuer or other Municipal Issuers (other than those revenues derived from an agreement or arrangement with a person who is not a Municipal Issuer that provides for or secures repayment of the security issued by the Municipal Issuer);

(iii) Related to a project owned and operated by a Municipal Issuer; or

(iv) Related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a Municipal Issuer.

(8) *Daily Liquid Assets* means:

(i) Cash;

(ii) Direct obligations of the U.S. Government; or

(iii) Securities that will mature or are subject to a Demand Feature that is exercisable and payable within one Business Day.

(9) *Demand Feature* means:

(i) A feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise. A Demand Feature must be exercisable either:



(A) At any time on no more than 30 calendar days' notice; or

(B) At specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice; or

(ii) A feature permitting the holder of an Asset Backed Security unconditionally to receive principal and interest within 397 calendar days of making demand.

(10) *Demand Feature Issued By A Non-Controlled Person* means a Demand Feature issued by:

(i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature (*control* means "control" as defined in section 2(a)(9) of the Act) (15 U.S.C. 80a-2(a)(9)); or

(ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.

(11) *Designated NRSRO* means any one of at least four nationally recognized statistical rating organizations, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(62)), that:

(i) The money market fund's board of directors:

(A) Has designated as an NRSRO whose credit ratings with respect to any obligor or security or particular obligors or securities will be used by the fund to determine whether a security is an Eligible Security; and

(B) Determines at least once each calendar year issues credit ratings that are sufficiently reliable for such use;

(ii) Is not an "affiliated person," as defined in section 2(a)(3)(C) of the Act (15 U.S.C. 80a-2(a)(3)(C)), of the issuer of, or any insurer or provider of credit support for, the security; and

(iii) The fund discloses in its statement of additional information is a Designated NRSRO, including any limitations with respect to the fund's use of such designation.

(12) *Eligible Security* means:

(i) A Rated Security with a remaining maturity of 397 calendar days or less that has received a rating from the Requisite NRSROs in one of the two highest short-term rating categories (within which there may be sub-categories or gradations indicating relative standing); or

(ii) An Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(12)(i) of this section, as determined by the money market fund's board of directors; provided, however, that: a security that at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less and that is an Unrated Security is not an Eligible Security if the security has received a long-term rating from any Designated NRSRO that is not within the Designated NRSRO's three highest long-term ratings categories (within which there may be sub categories or gradations indicating relative standing), unless the security has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories.

(iii) In addition, in the case of a security that is subject to a Demand Feature or Guarantee:

(A) The Guarantee has received a rating from a Designated NRSRO or the Guarantee is issued by a guarantor that has received a rating from a Designated NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee, unless:

(1) The Guarantee is issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the Guarantee (other than a sponsor of a Special Purpose Entity with respect to an Asset Backed Security);

(2) The security subject to the Guarantee is a repurchase agreement that is Collateralized Fully; or

- (3) The Guarantee is itself a Government Security; and
- (B) The issuer of the Demand Feature or Guarantee, or another institution, has undertaken promptly to notify the holder of the security in the event the Demand Feature or Guarantee is substituted with another Demand Feature or Guarantee (if such substitution is permissible under the terms of the Demand Feature or Guarantee).
- (13) *Event of Insolvency* means “Event of Insolvency” as defined in § 270.5b-3(c)(2).
- (14) *First Tier Security* means any Eligible Security that:
- (i) Is a Rated Security that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing);
  - (ii) Is an Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(14)(i) of this section, as determined by the fund’s board of directors;
  - (iii) Is a security issued by a registered investment company that is a money market fund; or
  - (iv) Is a Government Security.
- (15) *Floating Rate Security* means a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and that, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.
- (16) *Government Security* means any “Government security” as defined in section 2(a)(16) of the Act (15 U.S.C. 80a-2(a)(16)).
- (17) *Guarantee* means an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the Guarantee (if required), the principal amount of the underlying security plus accrued interest when due or upon default, or, in the case of an Unconditional Demand Feature, an obligation that entitles the holder to receive upon exercise the approximate amortized cost of the underlying security or securities, plus accrued interest, if any. A Guarantee includes a letter of credit, financial guaranty (bond) insurance, and an Unconditional Demand Feature (other than an Unconditional Demand Feature provided by the issuer of the security).
- (18) *Guarantee Issued By A Non-Controlled Person* means a Guarantee issued by:
- (i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Guarantee (*control* means “control” as defined in section 2(a)(9) of the Act) (15 U.S.C. 80a-2(a)(9)); or
  - (ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.
- (19) *Illiquid Security* means a security that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.
- (20) *Penny-Rounding Method* of pricing means the method of computing an investment company’s price per share for purposes of distribution, redemption, and repurchase whereby the current net asset value per share is rounded to the nearest one percent.
- (21) *Rated Security* means a security that meets the requirements of paragraphs (a)(21)(i) or (ii) of this section, in each case subject to paragraph (a)(21)(iii) of this section:
- (i) The security has received a short-term rating from a Designated NRSRO, or has been issued by an issuer that has received a short-term rating from a Designated NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security; or

(ii) The security is subject to a Guarantee that has received a short-term rating from a Designated NRSRO, or a Guarantee issued by a guarantor that has received a short-term rating from a Designated NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the Guarantee; but

(iii) A security is not a Rated Security if it is subject to an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement as provided in paragraph (a)(21)(i) of this section, or the credit support agreement with respect to the security has received a short-term rating as provided in paragraph (a)(21)(ii) of this section.

(22) *Refunded Security* means “Refunded Security” as defined in § 270.5b-3(c)(4).

(23) *Requisite NRSROs* means:

(i) Any two Designated NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or

(ii) If only one Designated NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund acquires the security, that Designated NRSRO.

(24) *Second Tier Security* means any Eligible Security that is not a First Tier Security.

(25) *Single State Fund* means a Tax Exempt Fund that holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and, where applicable, subdivisions thereof.

(26) *Tax Exempt Fund* means any money market fund that holds itself out as distributing income exempt from regular federal income tax.

(27) *Total Assets* means, with respect to a money market fund using the Amortized Cost Method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets.

(28) *Unconditional Demand Feature* means a Demand Feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities.

(29) *United States Dollar-Denominated* means, with reference to a security, that all principal and interest payments on such security are payable to security holders in United States dollars under all circumstances and that the interest rate of, the principal amount to be repaid, and the timing of payments related to such security do not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars.

(30) *Unrated Security* means a security that is not a Rated Security.

(31) *Variable Rate Security* means a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(32) *Weekly Liquid Assets* means:

(i) Cash;

(ii) Direct obligations of the U.S. Government;

(iii) Government Securities that are issued by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States that:

(A) Are issued at a discount to the principal amount to be repaid at maturity; and

(B) Have a remaining maturity date of 60 days or less; or

(iv) Securities that will mature or are subject to a Demand Feature that is exercisable and payable within five Business Days.

(b) *Holding Out and Use of Names and Titles.*

(1) It shall be an untrue statement of material fact within the meaning of section 34(b) of the Act (15 U.S.C. 80a-33(b)) for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by section 24(b) of the Act (15 U.S.C. 80a-24(b)), to hold itself out to investors as a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), (c)(4), and (c)(5) of this section.

(2) It shall constitute the use of a materially deceptive or misleading name or title within the meaning of section 35(d) of the Act (15 U.S.C. 80a-34(d)) for a registered investment company to adopt the term “money market” as part of its name or title or the name or title of any redeemable securities of which it is the issuer, or to adopt a name that suggests that it is a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), (c)(4), and (c)(5) of this section.

(3) For purposes of this paragraph, a name that suggests that a registered investment company is a money market fund or the equivalent thereof shall include one that uses such terms as “cash,” “liquid,” “money,” “ready assets” or similar terms.

(c) *Share Price Calculations.* The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (“money market fund” or “fund”), notwithstanding the requirements of section 2(a)(41) of the Act (15 U.S.C. 80a-2(a)(41)) and of §§ 270.2a-4 and 270.22c-1 thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; provided, however, that:

(1) *Board Findings.* The board of directors of the money market fund shall determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the Amortized Cost Method or the Penny-Rounding Method, and that the money market fund will continue to use such method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.

(2) *Portfolio Maturity.* The money market fund shall maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share or price per share; provided, however, that the money market fund will not:

(i) Acquire any instrument with a remaining maturity of greater than 397 calendar days;

(ii) Maintain a dollar-weighted average portfolio maturity that exceeds 60 calendar days; or

(iii) Maintain a dollar-weighted average portfolio maturity that exceeds 120 calendar days, determined without reference to the exceptions in paragraph (d) of this section regarding interest rate readjustments.

(3) *Portfolio Quality—*

(i) *General.* The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund’s board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by a Designated NRSRO) and that are at the time of Acquisition Eligible Securities.

(ii) *Second Tier Securities*. No money market fund shall Acquire a Second Tier Security with a remaining maturity of greater than 45 calendar days. Immediately after the Acquisition of any Second Tier Security, a money market fund shall not have invested more than three percent of its Total Assets in Second Tier Securities.

(iii) *Securities Subject to Guarantees*. A security that is subject to a Guarantee may be determined to be an Eligible Security or a First Tier Security based solely on whether the Guarantee is an Eligible Security or First Tier Security, as the case may be.

(iv) *Securities Subject to Conditional Demand Features*. A security that is subject to a Conditional Demand Feature (“Underlying Security”) may be determined to be an Eligible Security or a First Tier Security only if:

(A) The Conditional Demand Feature is an Eligible Security or First Tier Security, as the case may be;

(B) At the time of the Acquisition of the Underlying Security, the money market fund’s board of directors has determined that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur; and

(1) The conditions limiting exercise either 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

(2) The terms of the Conditional Demand Feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand Feature in accordance with its terms; and

(C) The Underlying Security or any Guarantee of such security (or the debt securities of the issuer of the Underlying Security or Guarantee that are comparable in priority and security with the Underlying Security or Guarantee) has received either a short-term rating or a long-term rating, as the case may be, from the Requisite NRSROs within the NRSROs’ two highest short-term or long-term rating categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund’s board of directors to a security that has received a rating from the Requisite NRSROs within the NRSROs’ two highest short-term or long-term rating categories, as the case may be.

(4) *Portfolio Diversification*—

(i) *Issuer Diversification*. The money market fund shall be diversified with respect to issuers of securities Acquired by the fund as provided in paragraphs (c)(4)(i) and (c)(4)(ii) of this section, other than with respect to Government Securities and securities subject to a Guarantee Issued By A Non-Controlled Person.

(A) *Taxable and National Funds*. Immediately after the Acquisition of any security, a money market fund other than a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security; provided, however, that such a fund may invest up to twenty-five percent of its Total Assets in the First Tier Securities of a single issuer for a period of up to three Business Days after the Acquisition thereof; provided, further, that the fund may not invest in the securities of more than one issuer in accordance with the foregoing proviso in this paragraph at any time.

(B) *Single State Funds*. With respect to seventy-five percent of its Total Assets, immediately after the Acquisition of any security, a Single State Fund shall not have invested more than five percent of its Total Assets in securities issued by the issuer of the security.

(C) *Second Tier Securities*. Immediately after the Acquisition of any Second Tier Security, a money market fund shall not have invested more than one-half of one percent of its Total Assets in the Second Tier Securities of any single issuer.

(ii) *Issuer Diversification Calculations*. For purposes of making calculations under paragraph (c)(4)(i) of this section:

(A) *Repurchase Agreements*. The Acquisition of a repurchase agreement may be deemed to be an Acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully and the fund’s board of directors has evaluated the seller’s creditworthiness.

(B) *Refunded Securities*. The Acquisition of a Refunded Security shall be deemed to be an Acquisition of the escrowed Government Securities.

(C) *Conduit Securities*. A Conduit Security shall be deemed to be issued by the person (other than the Municipal Issuer) ultimately responsible for payments of interest and principal on the security.

(D) *Asset Backed Securities*—

(1) *General*. An Asset Backed Security Acquired by a fund (“Primary ABS”) shall be deemed to be issued by the Special Purpose Entity that issued the Asset Backed Security, provided, however:

(i) *Holdings of Primary ABS*. Any person whose obligations constitute ten percent or more of the principal amount of the Qualifying Assets of the Primary ABS (“Ten Percent Obligor”) shall be deemed to be an issuer of the portion of the Primary ABS such obligations represent; and

(ii) *Holdings of Secondary ABS*. If a Ten Percent Obligor of a Primary ABS is itself a Special Purpose Entity issuing Asset Backed Securities (“Secondary ABS”), any Ten Percent Obligor of such Secondary ABS also shall be deemed to be an issuer of the portion of the Primary ABS that such Ten Percent Obligor represents.

(2) *Restricted Special Purpose Entities*. A Ten Percent Obligor with respect to a Primary or Secondary ABS shall not be deemed to have issued any portion of the assets of a Primary ABS as provided in paragraph (c)(4)(ii)(D)(1) of this section if that Ten Percent Obligor is itself a Special Purpose Entity issuing Asset Backed Securities (“Restricted Special Purpose Entity”), and the securities that it issues (other than securities issued to a company that controls, or is controlled by or under common control with, the Restricted Special Purpose Entity and which is not itself a Special Purpose Entity issuing Asset Backed Securities) are held by only one other Special Purpose Entity.

(3) *Demand Features and Guarantees*. In the case of a Ten Percent Obligor deemed to be an issuer, the fund shall satisfy the diversification requirements of paragraph (c)(4)(iii) of this section with respect to any Demand Feature or Guarantee to which the Ten Percent Obligor’s obligations are subject.

(E) *Shares of Other Money Market Funds*. A money market fund that Acquires shares issued by another money market fund in an amount that would otherwise be prohibited by paragraph (c)(4)(i) of this section shall nonetheless be deemed in compliance with this section if the board of directors of the Acquiring money market fund reasonably believes that the fund in which it has invested is in compliance with this section.

(iii) *Diversification Rules for Demand Features and Guarantees*. The money market fund shall be diversified with respect to Demand Features and Guarantees Acquired by the fund as provided in paragraphs (c)(4)(iii) and (c)(4)(iv) of this section, other than with respect to a Demand Feature issued by the same institution that issued the underlying security, or with respect to a Guarantee or Demand Feature that is itself a Government Security.

(A) *General*. Immediately after the Acquisition of any Demand Feature or Guarantee or security subject to a Demand Feature or Guarantee, a money market fund, with respect to seventy-five percent of its Total Assets, shall not have invested more than ten percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, subject to paragraphs (c)(4)(iii)(B) and (C) of this section.

(B) *Second Tier Demand Features or Guarantees*. Immediately after the Acquisition of any Demand Feature or Guarantee (or a security after giving effect to the Demand Feature or Guarantee) that is a Second Tier Security, a money market fund shall not have invested more than 2.5 percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee.

(C) *Demand Features or Guarantees Issued by Non-Controlled Persons*. Immediately after the Acquisition of any security subject to a Demand Feature or Guarantee, a money market fund shall not have invested more than ten percent of its Total Assets in securities issued by, or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, unless, with respect to any security subject to Demand Features or Guarantees from that

institution (other than securities issued by such institution), the Demand Feature or Guarantee is a Demand Feature or Guarantee Issued By A Non-Controlled Person.

*(iv) Demand Feature and Guarantee Diversification Calculations—*

(A) *Fractional Demand Features or Guarantees.* In the case of a security subject to a Demand Feature or Guarantee from an institution by which the institution guarantees a specified portion of the value of the security, the institution shall be deemed to guarantee the specified portion thereof.

(B) *Layered Demand Features or Guarantees.* In the case of a security subject to Demand Features or Guarantees from multiple institutions that have not limited the extent of their obligations as described in paragraph (c)(4)(iv)(A) of this section, each institution shall be deemed to have provided the Demand Feature or Guarantee with respect to the entire principal amount of the security.

(v) *Diversification Safe Harbor.* A money market fund that satisfies the applicable diversification requirements of paragraphs (c)(4) and (c)(6) of this section shall be deemed to have satisfied the diversification requirements of section 5(b)(1) of the Act (15 U.S.C. 80a-5(b)(1)) and the rules adopted thereunder.

(5) *Portfolio Liquidity.* The money market fund shall hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under section 22(e) of the Act (15 U.S.C. 80a-22(e)) and any commitments the fund has made to shareholders; provided, however, that:

(i) *Illiquid Securities.* The money market fund shall not Acquire any Illiquid Security if, immediately after the Acquisition, the money market fund would have invested more than five percent of its Total Assets in Illiquid Securities.

(ii) *Minimum Daily Liquidity Requirement.* The money market fund shall not Acquire any security other than a Daily Liquid Asset if, immediately after the Acquisition, the fund would have invested less than ten percent of its Total Assets in Daily Liquid Assets. This provision shall not apply to Tax Exempt Funds.

(iii) *Minimum Weekly Liquidity Requirement.* The money market fund shall not Acquire any security other than a Weekly Liquid Asset if, immediately after the Acquisition, the fund would have invested less than thirty percent of its Total Assets in Weekly Liquid Assets.

(6) *Demand Features and Guarantees Not Relied Upon.* If the fund's board of directors has determined that the fund is not relying on a Demand Feature or Guarantee to determine the quality (pursuant to paragraph (c)(3) of this section), or maturity (pursuant to paragraph (d) of this section), or liquidity of a portfolio security, and maintains a record of this determination (pursuant to paragraphs (c)(10)(ii) and (c)(11)(vi) of this section), then the fund may disregard such Demand Feature or Guarantee for all purposes of this section.

*(7) Downgrades, Defaults and Other Events—*

*(i) Downgrades—*

(A) *General.* Upon the occurrence of either of the events specified in paragraphs (c)(7)(i)(A)(1) and (2) of this section with respect to a portfolio security, the board of directors of the money market fund shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders:

(1) A portfolio security of a money market fund ceases to be a First Tier Security (either because it no longer has the highest rating from the Requisite NRSROs or, in the case of an Unrated Security, the board of directors of the money market fund determines that it is no longer of comparable quality to a First Tier Security); and

(2) The money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware that any Unrated Security or Second Tier Security held by the money market fund has, since the security was Acquired by the fund, been given a rating by a Designated NRSRO below the Designated NRSRO's second highest short-term rating category.

(B) *Securities to Be Disposed Of.* The reassessments required by paragraph (c)(7)(i)(A) of this section shall not be required if the fund disposes of the security (or it matures) within five Business Days of the specified event and, in the case of events specified in paragraph (c)(7)(i)(A)(2) of this section, the board is subsequently notified of the adviser's actions.

(C) *Special Rule for Certain Securities Subject to Demand Features.* In the event that after giving effect to a rating downgrade, more than 2.5 percent of the fund's Total Assets are invested in securities issued by or subject to Demand Features from a single institution that are Second Tier Securities, the fund shall reduce its investment in securities issued by or subject to Demand Features from that institution to no more than 2.5 percent of its Total Assets by exercising the Demand Features at the next succeeding exercise date(s), absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund.

(ii) *Defaults and Other Events.* Upon the occurrence of any of the events specified in paragraphs (c)(7)(ii)(A) through (D) of this section with respect to a portfolio security, the money market fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security):

(A) The default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(B) A portfolio security ceases to be an Eligible Security;

(C) A portfolio security has been determined to no longer present minimal credit risks; or

(D) An Event of Insolvency occurs with respect to the issuer of a portfolio security or the provider of any Demand Feature or Guarantee.

(iii) *Notice to the Commission.* The money market fund shall promptly notify the Commission by electronic mail directed to the Director of Investment Management or the Director's designee, of any:

(A) Default or Event of Insolvency with respect to the issuer of one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or any issuer of a Demand Feature or Guarantee to which one or more portfolio securities is subject, and the actions the money market fund intends to take in response to such event, where immediately before default the securities (or the securities subject to the Demand Feature or Guarantee) accounted for  $\frac{1}{2}$  of 1 percent or more of the money market fund's Total Assets; or

(B) Purchase of a security from the fund by an affiliated person, promoter, or principal underwriter of the fund, or an affiliated person of such a person, in reliance on § 270.17a-9, including identification of the security, its amortized cost, the sale price, and the reasons for such purchase.

(iv) *Defaults for Purposes of Paragraphs (c)(7)(ii) and (iii).* For purposes of paragraphs (c)(7)(ii) and (iii) of this section, an instrument subject to a Demand Feature or Guarantee shall not be deemed to be in default (and an Event of Insolvency with respect to the security shall not be deemed to have occurred) if:

(A) In the case of an instrument subject to a Demand Feature, the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest; or

(B) The provider of the Guarantee is continuing, without protest, to make payments as due on the instrument.

(8) *Required Procedures: Amortized Cost Method.* In the case of a money market fund using the Amortized Cost Method:

(i) *General.* In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to



stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

(ii) *Specific Procedures*. Included within the procedures adopted by the board of directors shall be the following:

(A) *Shadow Pricing*. Written procedures shall provide:

(1) That the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions;

(2) For the periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation; and

(3) For the maintenance of records of the determination of deviation and the board's review thereof.

(B) *Prompt Consideration of Deviation*. In the event such deviation from the money market fund's amortized cost price per share exceeds ½ of 1 percent, the board of directors shall promptly consider what action, if any, should be initiated by the board of directors.

(C) *Material Dilution or Unfair Results*. Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results.

(9) *Required Procedures: Penny-Rounding Method*. In the case of a money market fund using the Penny-Rounding Method, in supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's investment adviser, the money market fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.

(10) *Specific Procedures: Amortized Cost and Penny-Rounding Methods*. Included within the procedures adopted by the board of directors for money market funds using either the Amortized Cost or Penny-Rounding Methods shall be the following:

(i) *Securities for Which Maturity is Determined by Reference to Demand Features*. In the case of a security for which maturity is determined by reference to a Demand Feature, written procedures shall require ongoing review of the security's continued minimal credit risks, and that review must be based on, among other things, financial data for the most recent fiscal year of the issuer of the Demand Feature and, in the case of a security subject to a Conditional Demand Feature, the issuer of the security whose financial condition must be monitored under paragraph (c)(3)(iv) of this section, whether such data is publicly available or provided under the terms of the security's governing documentation.

(ii) *Securities Subject to Demand Features or Guarantees*. In the case of a security subject to one or more Demand Features or Guarantees that the fund's board of directors has determined that the fund is not relying on to determine the quality (pursuant to paragraph (c)(3) of this section), maturity (pursuant to paragraph (d) of this section) or liquidity (pursuant to paragraph (c)(5) of this section) of the security subject to the Demand Feature or Guarantee, written procedures shall require periodic evaluation of such determination.

(iii) *Adjustable Rate Securities Without Demand Features*. In the case of a Variable Rate or Floating Rate Security that is not subject to a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section, written procedures shall require periodic review of whether the interest rate formula, upon readjustment of its interest rate, can reasonably be expected to cause the security to have a market value that approximates its amortized cost value.

(iv) *Asset Backed Securities*. In the case of an Asset Backed Security, written procedures shall require the fund to periodically determine the number of Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section; provided, however, written procedures need not require periodic determinations with respect to any Asset Backed Security that a fund's board of directors has determined, at the time of Acquisition, will not have, or is unlikely to have, Ten Percent Obligors that are deemed to be issuers of all or a portion of that Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section, and maintains a record of this determination.

(v) *Stress Testing*. Written procedures shall provide for:

(A) The periodic testing, at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions, of the money market fund's ability to maintain a stable net asset value per share based upon specified hypothetical events that include, but are not limited to, a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund.

(B) A report on the results of such testing to be provided to the board of directors at its next regularly scheduled meeting (or sooner, if appropriate in light of the results), which report shall include:

(1) The date(s) on which the testing was performed and the magnitude of each hypothetical event that would cause the deviation of the money market fund's net asset value calculated using available market quotations (or appropriate substitutes which reflect current market conditions) from its net asset value per share calculated using amortized cost to exceed ½ of 1 percent; and

(2) An assessment by the fund's adviser of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.

(11) *Record Keeping and Reporting*—

(i) *Written Procedures*. For a period of not less than six years following the replacement of such procedures with new procedures (the first two years in an easily accessible place), a written copy of the procedures (and any modifications thereto) described in paragraphs (c)(7) through (c)(10) and (e) of this section shall be maintained and preserved.

(ii) *Board Considerations and Actions*. For a period of not less than six years (the first two years in an easily accessible place) a written record shall be maintained and preserved of the board of directors' considerations and actions taken in connection with the discharge of its responsibilities, as set forth in this section, to be included in the minutes of the board of directors' meetings.

(iii) *Credit Risk Analysis*. For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks and the Designated NRSRO ratings (if any) used to determine the status of the security as an Eligible Security, First Tier Security or Second Tier Security shall be maintained and preserved in an easily accessible place.

(iv) *Determinations with Respect to Adjustable Rate Securities*. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determination required by paragraph (c)(10)(iii) of this section (that a Variable Rate or Floating Rate Security that is not subject to a Demand Feature and for which maturity is determined pursuant to paragraphs (d)(1), (d)(2) or (d)(4) of this section can reasonably be expected, upon readjustment of its interest rate at all times during the life of the instrument, to have a market value that approximates its amortized cost).

(v) *Determinations with Respect to Asset Backed Securities*. For a period of not less than three years from the date when the determination was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the determinations required by paragraph (c)(10)(iv) of this section (the number of Ten Percent Obligors (as that term is used in paragraph (c)(4)(ii)(D) of this section) deemed to be the issuers of all or a portion of the Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section). The written record shall include:

(A) The identities of the Ten Percent Obligor (as that term is used in paragraph (c)(4)(ii)(D) of this section), the percentage of the Qualifying Assets constituted by the securities of each Ten Percent Obligor and the percentage of the fund's Total Assets that are invested in securities of each Ten Percent Obligor; and

(B) Any determination that an Asset Backed Security will not have, or is unlikely to have, Ten Percent Obligor deemed to be issuers of all or a portion of that Asset Backed Security for purposes of paragraph (c)(4)(ii)(D) of this section.

(vi) *Evaluations with Respect to Securities Subject to Demand Features or Guarantees.* For a period of not less than three years from the date when the evaluation was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the evaluation required by paragraph (c)(10)(ii) (regarding securities subject to one or more Demand Features or Guarantees) of this section.

(vii) *Reports with Respect to Stress Testing.* For a period of not less than six years (the first two years in an easily accessible place), a written copy of the report required under paragraph (c)(10)(v)(B) of this section shall be maintained and preserved.

(viii) *Inspection of Records.* The documents preserved pursuant to this paragraph (c)(11) shall be subject to inspection by the Commission in accordance with section 31(b) of the Act (15 U.S.C. 80a-30(b)) as if such documents were records required to be maintained pursuant to rules adopted under section 31(a) of the Act (15 U.S.C. 80a-30(a)). If any action was taken under paragraphs (c)(7)(ii) (with respect to defaulted securities and events of insolvency) or (c)(8)(ii) (with respect to a deviation from the fund's share price of more than ½ of 1 percent) of this section, the money market fund will file an exhibit to the Form N-SAR (17 CFR 274.101) filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

(12) *Website Disclosure of Portfolio Holdings.* The money market fund shall post on its website, for a period of not less than six months, beginning no later than the fifth Business Day of the month, a schedule of its investments, as of the last Business Day of the prior month, that includes the following information:

(i) With respect to the money market fund and each class thereof:

(A) The dollar-weighted average portfolio maturity; and

(B) The dollar-weighted average portfolio maturity determined without reference to the exceptions in paragraph (d) of this section regarding interest rate readjustments;

(ii) With respect to each security held by the money market fund:

(A) Name of the issuer;

(B) Category of investment (indicate the category that most closely identifies the

instrument from among the following: Treasury Debt; Government Agency Debt; Variable Rate Demand Note; Other Municipal Debt; Financial Company Commercial Paper; Asset Backed Commercial Paper; Other Commercial Paper; Certificate of Deposit; Structured Investment Vehicle Note; Other Note; Treasury Repurchase Agreement; Government Agency Repurchase Agreement; Other Repurchase Agreement; Insurance Company Funding Agreement; Investment Company; Other Instrument);

(C) CUSIP number (if any);

(D) Principal amount;

(E) Maturity date as determined under this section;

(F) Final legal maturity date (taking into account any maturity date extensions that may be effected at the option of the issuer), if different from the maturity date as determined under this section;

(G) Coupon or yield; and

(H) Amortized cost value; and

(iii) A link to a website of the Securities and Exchange Commission where a user may obtain the most recent 12 months of publicly available information filed by the money market fund pursuant to § 270.30b1-7.

(13) *Processing of Transactions.* The money market fund (or its transfer agent) shall have the capacity to redeem and sell securities issued by the fund at a price based on the current net asset value per share pursuant to § 270.22c-1. Such capacity shall include the ability to redeem and sell securities at prices that do not correspond to a stable net asset value or price per share.

(d) *Maturity of Portfolio Securities.* For purposes of this section, the maturity of a portfolio security shall be deemed to be the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, except as provided in paragraphs (d)(1) through (d)(8) of this section:

(1) *Adjustable Rate Government Securities.* A Government Security that is a Variable Rate Security where the variable rate of interest is readjusted no less frequently than every 397 calendar days shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate. A Government Security that is a Floating Rate Security shall be deemed to have a remaining maturity of one day.

(2) *Short-Term Variable Rate Securities.* A Variable Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity equal to the earlier of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(3) *Long-Term Variable Rate Securities.* A Variable Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

(4) *Short-Term Floating Rate Securities.* A Floating Rate Security, the principal amount of which, in accordance with the terms of the security, must unconditionally be paid in 397 calendar days or less shall be deemed to have a maturity of one day.

(5) *Long-Term Floating Rate Securities.* A Floating Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

(6) *Repurchase Agreements.* A repurchase agreement shall be deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur, or, where the agreement is subject to demand, the notice period applicable to a demand for the repurchase of the securities.

(7) *Portfolio Lending Agreements.* A portfolio lending agreement shall be treated as having a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned, or where the agreement is subject to demand, the notice period applicable to a demand for the return of the loaned securities.

(8) *Money Market Fund Securities.* An investment in a money market fund shall be treated as having a maturity equal to the period of time within which the Acquired money market fund is required to make payment upon redemption, unless the Acquired money market fund has agreed in writing to provide redemption proceeds to the investing money market fund within a shorter time period, in which case the maturity of such investment shall be deemed to be the shorter period.

(e) *Delegation.* The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (a)(11)(i) (designation of NRSROs); (c)(1) (board findings); (c)(7)(ii) (defaults and other events); (c)(8)(i) (general required procedures: Amortized Cost Method); (c)(8)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), (C) (material dilution or unfair results); (c)(9) (required procedures: Penny Rounding Method); and (c)(10)(v)(A) (stress testing procedures) of this section; provided that:

(1) *Written Guidelines.* The Board shall establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this section) and procedures under which the delegate makes such determinations.

(2) *Oversight.* The Board shall take any measures reasonably necessary (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security or Event of Insolvency with respect to the issuer of the security or any Guarantee to which it is subject that requires notification of the Commission under paragraph (c)(7)(iii) of this section) to assure that the guidelines and procedures are being followed.

3. Section 270.17a-9 is revised to read as follows:

**§ 270.17a-9 Purchase of certain securities from a money market fund by an affiliate, or an affiliate of an affiliate.**

The purchase of a security from the portfolio of an open-end investment company holding itself out as a money market fund by any affiliated person or promoter of or principal underwriter for the money market fund or any affiliated person of such person shall be exempt from section 17(a) of the Act (15 U.S.C. 80a-17(a)); provided that:

(a) In the case of a portfolio security that has ceased to be an Eligible Security (as defined in § 270.2a-7(a)(12)), or has defaulted (other than an immaterial default unrelated to the financial condition of the issuer):

(1) The purchase price is paid in cash; and

(2) 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).

(b) In the case of any other portfolio security:

(1) The purchase price meets the requirements of paragraph (a)(1) and (2) of this section; and

(2) In the event that the purchaser thereafter sells the security for a higher price than the purchase price paid to the money market fund, the purchaser shall promptly pay to the fund the amount by which the subsequent sale price exceeds the purchase price paid to the fund.

4. Section 270.22e-3 is added to read as follows:

**§ 270.22e-3 Exemption for liquidation of money market funds.**

(a) *Exemption.* A registered open-end management investment company or series thereof ("fund") that is regulated as a money market fund under § 270.2a-7 is exempt from the requirements of section 22(e) of the Act (15 U.S.C. 80a-22(e)) if:

(1) The fund's board of directors, including a majority of directors who are not interested persons of the fund, determines pursuant to § 270.2a-7(c)(8)(ii)(C) that the extent of the deviation between the fund's amortized cost price per share and its current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) may result in material dilution or other unfair results to investors or existing shareholders;

(2) The fund's board of directors, including a majority of directors who are not interested persons of the fund, irrevocably has approved the liquidation of the fund; and

(3) The fund, prior to suspending redemptions, notifies the Commission of its decision to liquidate and suspend redemptions by electronic mail directed to the attention of the Director of the Division of Investment Management or the Director's designee.

(b) *Conduits*. Any registered investment company, or series thereof, that owns, pursuant to section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E)), shares of a money market fund that has suspended redemptions of shares pursuant to paragraph (a) of this section also is exempt from the requirements of section 22(e) of the Act (15 U.S.C. 80a-22(e)). A registered investment company relying on the exemption provided in this paragraph must promptly notify the Commission that it has suspended redemptions in reliance on this section. Notification under this paragraph shall be made by electronic mail directed to the attention of the Director of the Division of Investment Management or the Director's designee.

(c) *Commission Orders*. For the protection of shareholders, the Commission may issue an order to rescind or modify the exemption provided by this section, after appropriate notice and opportunity for hearing in accordance with section 40 of the Act (15 U.S.C. 80a-39).

5. Section 270.30b1-6T is amended by revising paragraph (d) to read as follows:

**§ 270.30b1-6T Weekly portfolio report for certain money market funds.**

\* \* \* \* \*

(d) *Expiration*. This section will expire on December 1, 2010.

6. Section 270.30b1-7 is added to read as follows:

**§ 270.30b1-7 Monthly report for money market funds.**

(a) *Report*. Every registered open-end management investment company, or series thereof, that is regulated as a money market fund under § 270.2a-7 must file with the Commission a monthly report of portfolio holdings on Form N-MFP (§ 274.201 of this chapter), current as of the last business day of the previous month, no later than the fifth business day of each month.

(b) *Public availability*. The Commission will make the information filed on Form N-MFP available to the public 60 days after the end of the month to which the information pertains.

**Part 274—Forms Prescribed Under the Investment Company Act of 1940**

7. The authority citation for Part 274 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

\* \* \* \* \*

8. Section 274.201 and Form N-MFP (referenced in § 274.201) are added to read as follows:

**§ 274.201 Form N-MFP, portfolio holdings of money market funds**

This form shall be used by registered open-end management investment companies that are regulated as money market funds under § 270.2a-7 of this chapter to file reports pursuant to § 270.30b1-7 of this chapter no later than the fifth business day of each month.

**Note:** The text of Form N-MFP will not appear in the Code of Federal Regulations.

**FORM N-MFP MONTHLY SCHEDULE OF PORTFOLIO HOLDINGS OF MONEY MARKET FUNDS**

Form N-MFP is to be used by registered open-end management investment companies, or series thereof, that are regulated as money market funds pursuant to rule 2a-7 under the Investment Company Act of 1940 (“Act”) (17 CFR 270.2a-7) (“money market funds”), to file reports with the Commission pursuant to rule 30b1-7 under the Act (17 CFR 270.30b1-7). The Commission may use the information provided on Form N-MFP in its regulatory, disclosure review, inspection, and policymaking roles.

## GENERAL INSTRUCTIONS

### A. Rule as to Use of Form N-MFP

Form N-MFP is the public reporting form that is to be used for monthly reports of money market funds required by section 30(b) of the Act and rule 30b1-7 under the Act (17 CFR 270.30b1-7). A money market fund must report information about the fund and its portfolio holdings as of the last business day of the preceding month. The Form N-MFP must be filed with the Commission no later than the fifth business day of each month, but may be filed any time beginning on the first business day of the month. Each money market fund, or series of a money market fund, is required to file a separate form. If the money market fund does not have any classes, the fund must provide the information required by Part I.B for the series.

A money market fund may file an amendment to a previously filed Form N-MFP at any time, including an amendment to correct a mistake or error in a previously filed form. A fund that files an amendment to a previously filed form must provide information in response to all items of Form N-MFP, regardless of why the amendment is filed.

### B. Application of General Rules and Regulations

The General Rules and Regulations under the Act contain certain general requirements that are applicable to reporting on any form under the Act. These general requirements should be carefully read and observed in the preparation and filing of reports on this form, except that any provision in the form or in these instruction shall be controlling.

### C. Filing of Form N-MFP

A money market fund must file Form N-MFP in accordance with rule 232.13 of Regulation S-T. Form N-MFP must be filed electronically using the Commission’s EDGAR system.

### D. Paperwork Reduction Act Information

A registrant is not required to respond to the collection of information contained in Form N-MFP unless the Form displays a currently valid Office of Management and Budget (“OMB”) control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. 3507.

### E. Definitions

References to sections and rules in this Form N-MFP are to the Investment Company Act of 1940 [15 U.S.C. 80a] (the “Investment Company Act”), unless otherwise indicated. Terms used in this Form N-MFP have the same meaning as in the Investment Company Act or related rules, unless otherwise indicated.

As used in this Form N-MFP, the terms set out below have the following meanings:

“Class” means a class of shares issued by a Multiple Class Fund that represents interests in the same portfolio of securities under rule 18f-3 [17 CFR 270.18f-3] or under an order exempting the Multiple Class Fund from sections 18(f), 18(g), and 18(i) [15 U.S.C. 80a-18(f), 18(g), and 18(i)].

“Fund” means the Registrant or a separate Series of the Registrant. When an item of Form N-MFP specifically applies to a Registrant or a Series, those terms will be used.

“Master-Feeder Fund” means a two-tiered arrangement in which one or more Funds (each a “Feeder Fund”) holds shares of a single Fund (the “Master Fund”) in accordance with section 12(d)(1)(E) [15 U.S.C. 80a-12(d)(1)(E)].

“Money Market Fund” means a Fund that holds itself out as money market fund and meets the maturity, quality, and diversification requirements of rule 2a-7 [17 CFR 270.2a-7].

“Securities Act” means the Securities Act of 1933 [15 U.S.C. 77a–aa].

“Series” means shares offered by a Registrant that represent undivided interests in a portfolio of investments and that are preferred over all other series of shares for assets specifically allocated to that series in accordance with rule 18f-2(a) [17 CFR 270.18f-2(a)].

UNITED STATES SECURITIES AND EXCHANGE COMMISSION WASHINGTON, DC 20549

FORM N-MFP MONTHLY SCHEDULE OF PORTFOLIO HOLDINGS OF MONEY MARKET FUNDS

Report for [Month, Day, Year]

CIK Number of Registrant:

EDGAR Series Identifier:

Total number of share classes in the series:

Do you anticipate that this will be the fund’s final filing on Form N-MFP? [Y/N]

Is the fund liquidating? [Y/N]

Is the fund merging with, or being acquired by, another fund? [Y/N]

If so, identify the successor fund by CIK, Securities Act file number, and EDGAR series identifier.

If this is not a final filing: has the fund acquired or merged with another fund since the last filing? [Y/N]

If so, identify the acquired or merged fund by CIK, Securities Act file number, and EDGAR series identifier.

## **Part I: Information about the Fund**

### **A. Series-Level Information**

Item 1. Securities Act File Number.

Item 2. Investment Adviser.

a. SEC file number of investment adviser. If a fund has one or more sub-advisers, disclose the name of each sub-adviser.

Item 3. Sub-Adviser.

a. SEC file number of each sub-adviser.

Item 4. Independent Public Accountant.

a. City and state of independent public accountant.

Item 5. Administrator. If a fund has one or more administrators, disclose the name of each administrator.

Item 6. Transfer Agent.



Releases

- a. CIK Number.
- b. SEC file number of transfer agent.

Item 7. Master-Feeder Funds. Is this a feeder fund? [Y/N]

- a. Identify the master fund by CIK.
- b. Securities Act file number of the master fund.
- c. EDGAR series identifier of the master fund.

Item 8. Master-Feeder Funds. Is this a master fund? [Y/N]

- a. If this is a master fund, identify all feeder funds by CIK or, if the fund does not have a CIK, by name.
- b. Securities Act file number of each feeder fund.
- c. EDGAR series identifier of each feeder fund.

Item 9. Is this series primarily used to fund insurance company separate accounts? [Y/N]

Item 10. Category. Indicate the category that most closely identifies the money market fund from among the following: Treasury, Government/Agency, Prime, Single State Fund, or Other Tax Exempt Fund.

Item 11. Dollar weighted average portfolio maturity.

Item 12. Dollar weighted average life maturity. Calculate the dollar weighted average portfolio maturity without reference to the exceptions in rule 2a-7(d) regarding interest rate readjustments.

Item 13. Total value of portfolio securities at amortized cost, to the nearest cent.

Item 14. Total value of other assets, to the nearest cent.

Item 15. Total value of liabilities, to the nearest cent.

Item 16. Net assets of the series, to the nearest cent.

Item 17. 7-day gross yield. Based on the 7 days ended on the last day of the prior month, calculate the fund's yield by determining the net change, exclusive of capital changes and income other than investment income, in the value of a hypothetical preexisting account having a balance of one share at the beginning of the period and dividing the difference by the value of the account at the beginning of the base period to obtain the base period return, and then multiplying the base period return by  $(365/7)$  with the resulting yield figure carried to at least the nearest hundredth of one percent. The 7-day gross yield should not reflect a deduction of shareholders fees and fund operating expenses.

Item 18. Shadow Price of the Series.

- a. The net asset value per share most recently calculated using available market quotations (or an appropriate substitute that reflects current market conditions), including the value of any capital support agreement, to the nearest hundredth of a cent;
- b. The date as of which the market-based net asset value disclosed in Item 18a was calculated;
- c. The net asset value per share most recently calculated using available market quotations (or an appropriate substitute that reflects current market conditions), excluding the value of any capital support agreement, to the nearest hundredth of a cent; and
- d. The date as of which the market-based net asset value disclosed in Item 18c was calculated.

**B. Class-Level Information.** For each Class of the Series, disclose the following:

Item 19. EDGAR Class identifier.

Item 20. Minimum initial investment.

Item 21. Net assets of the Class, to the nearest cent.

Item 22. Net asset value per share for purposes of distributions, redemptions, and repurchase, to the nearest cent.

Item 23. Net shareholder flow activity for the month ended (subscriptions less redemptions), to the nearest cent.

a. Gross subscriptions for the month ended (including dividend reinvestments), to the nearest cent.

b. Gross redemptions for the month ended, to the nearest cent.

Item 24. 7-day net yield, as calculated under Item 26(a)(1) of Form N-1A.

Item 25. Shadow Price of each Class.

a. The net asset value per share most recently calculated using available market quotations (or an appropriate substitute that reflects current market conditions), including the value of any capital support agreement, to the nearest hundredth of a cent;

b. The date as of which the market-based net asset value disclosed in Item 25a was calculated;

c. The net asset value per share most recently calculated using available market quotations (or an appropriate substitute that reflects current market conditions), excluding the value of any capital support agreement, to the nearest hundredth of a cent; and

d. The date as of which the market-based net asset value disclosed in Item 25c was calculated.

**Part 2: Schedule of Portfolio Securities.** For each security held by the money market fund, disclose the following:

Item 26. The name of the issuer.

Item 27. The title of the issue (including coupon or yield).

Item 28. The CUSIP. If the security has a CUSIP, filers must provide the security's CUSIP pursuant to this Item and may skip Items 29 and 30.

Item 29. Other unique identifier, if the security has a unique identifier. If a CUSIP is provided pursuant to Item 28, skip this Item.

Item 30. The CIK of the issuer, if the issuer has a CIK. If a CUSIP is provided pursuant to Item 28, skip this Item.

Item 31. The category of investment. Indicate the category that most closely identifies the instrument from among the following: Treasury Debt; Government Agency Debt; Variable Rate Demand Note; Other Municipal Debt; Financial Company Commercial Paper; Asset Backed Commercial Paper; Other Commercial Paper; Certificate of Deposit; Structured Investment Vehicle Note; Other Note; Treasury Repurchase Agreement; Government Agency Repurchase Agreement; Other Repurchase Agreement; Insurance Company Funding Agreement; Investment Company; Other Instrument. If Other Instrument, include a brief description.

Item 32. If the security is a repurchase agreement: is the fund treating the acquisition of the repurchase agreement as the acquisition of the underlying securities (i.e., collateral) for purposes of portfolio diversification under rule 2a-7? [Y/N]

For repurchase agreements, describe the securities subject to the repurchase agreement, including:

## Releases

- a. The name of the issuer;
- b. Maturity date;
- c. Coupon or yield;
- d. The category of investments, selected from Item 31 above;
- e. The principal amount, to the nearest cent;
- f. Value of collateral, to the nearest cent.

If multiple securities of an issuer are subject to the repurchase agreement, the securities may be aggregated, in which case disclose: (a) the total principal amount and value and (b) the range of maturity dates and interest rates.

Item 33. Rating. Indicate whether the security is a rated First Tier Security, rated Second Tier Security, an Unrated Security, or no longer an Eligible Security.

Item 34. Name of each Designated NRSRO.

a. For each Designated NRSRO, disclose the credit rating given by the Designated NRSRO. If the instrument and its issuer are not rated by the Designated NRSRO, indicate "NR."

Item 35. The maturity date as determined under rule 2a-7. Determine the maturity date, taking into account the maturity shortening provisions of rule 2a-7(d).

Item 36. The final legal maturity date, taking into account any maturity date extensions that may be effected at the option of the issuer.

Item 37. Does the security have a Demand Feature? [Y/N]

- a. The identity of the Demand Feature issuer.
- b. Designated NRSRO(s) for the Demand Feature or provider of the Demand Feature.
- c. For each Designated NRSRO, disclose the credit rating given by the Designated NRSRO. If there is no rating given by the Designated NRSRO, indicate "NR."

Item 38. Does the security have a Guarantee? [Y/N]

- a. The identity of the Guarantor.
- b. Designated NRSRO(s) for the Guarantee or Guarantor.
- c. For each Designated NRSRO, disclose the credit rating given by the Designated NRSRO. If there is no rating given by the Designated NRSRO, indicate "NR."

Item 39. Does the security have any enhancements, other than those identified in Items 37 and 38 above, on which the fund is relying to determine the quality, maturity or liquidity of the security? [Y/N]

- a. The type of enhancement.
- b. The identity of the enhancement provider.
- c. Designated NRSRO(s) for the enhancement or enhancement provider.
- d. For each Designated NRSRO, disclose the credit rating given by the Designated NRSRO. If there is no rating given by the Designated NRSRO, indicate "NR."

Item 40. The total principal amount of the security held by the series, to the nearest cent.

Item 41. The total current amortized cost, to the nearest cent.

Item 42. The percentage of the money market fund's net assets invested in the security, to the nearest hundredth of a percent.

Item 43. Explanatory notes. Disclose any other information that may be material to other disclosures related to the portfolio security.

Item 44. Is this an Illiquid Security as of the date of this report? [Y/N]

Item 45. The value of the security, calculated using available market quotations (or an appropriate substitute that reflects current market conditions), including the value of any capital support agreement, to the nearest cent.

Item 46. The value of the security, calculated using available market quotations (or an appropriate substitute that reflects current market conditions), excluding the value of any capital support agreement, to the nearest cent.

By the Commission.

Dated: February 23, 2010

Elizabeth M. Murphy

Secretary

# STAFF GUIDANCE

## INVESTMENT COMPANY INSTITUTE

### Staff Response

October 10, 2008

Ms. Karrie McMillan  
General Counsel  
Investment Company Institute  
1401 H Street, NW  
Washington, DC 20005-2148

Dear Ms. McMillan:

You have requested that the staff provide assurances that it would not recommend enforcement action to the Commission under Section 2(a)(41) of the Investment Company Act of 1940 and Rules 2a-4 and 22c-1 thereunder, if a money market fund complies with Rule 2a-7 by “shadow pricing” certain of its portfolio securities by reference to their amortized cost value rather than using available market quotations (or an appropriate substitute that reflects current market conditions).

Open-end management investment companies (mutual funds) must calculate their current net asset value by reference to (i) the market values of their securities or (ii) in the absence of readily available quotations for their securities, their fair value as determined in good faith by the board of directors.<sup>1</sup> The Commission has stated its view, however, that it would not object if a mutual fund board of directors determined, in good faith, that the value of debt securities with remaining maturities of 60 days or less is their amortized cost, unless the particular circumstances warrant otherwise.<sup>2</sup> The Commission concluded that the difference between the amortized cost value and the value of portfolio securities with short maturities is unlikely to be of significant magnitude to affect the share price of the fund. It noted, however, that the amortized cost value may not always accurately reflect the fair value of the securities due to the impairment of the creditworthiness of an issuer or other factors.

Since 1983, this interpretive position has had relevance only with respect to the valuation of portfolio securities of mutual funds other than money market funds. This is because in 1983 the Commission adopted Rule 2a-7, which permits money market funds to use the amortized cost method of valuing their securities for securities with remaining maturities of 397 days (thirteen months) or less. Use of the amortized cost method is important to money market funds because it facilitates their ability to maintain a stable net asset value, typically \$1.00 per share.

Use of the amortized cost method for portfolio securities with longer maturities increases the likelihood that a significant deviation will occur between the amortized cost value of the securities and their market value potentially resulting in dilution of shareholder value. Rule 2a-7, therefore, requires money market funds to adopt written procedures (“monitoring procedures”) requiring the fund to periodically calculate “the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market

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<sup>1</sup> Section 2(a)(41) of the Act and Rule 2a-4.

<sup>2</sup> Investment Company Act Release No. 9786 (May 31, 1977). Under the amortized cost method of valuation, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accumulation of discount.

conditions) from the money market fund's amortized cost price per share."<sup>3</sup> This process is referred to in the rule as "shadow pricing." The monitoring procedures must also provide that the fund's board of directors periodically "review[s] ... the amount of the deviation as well as the methods used to calculate the deviation."<sup>4</sup> If the board of directors of a money market fund believes that the extent of any deviation from the fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, the board must "cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results."<sup>5</sup>

When it adopted Rule 2a-7, the Commission stated that when shadow pricing a money market fund portfolio, the fund should value "all portfolio instruments, regardless of the time to maturity ... based upon market factors and not their amortized cost value."<sup>6</sup> Therefore, in shadow pricing their portfolios under their monitoring procedures, money market funds relying on Rule 2a-7 cannot take advantage of the 1977 interpretive position permitting use of amortized cost for debt securities with remaining maturities of 60 days or less.

You state that under current market conditions, the shadow pricing provisions of Rule 2a-7 are not working as intended. You believe that the markets for short-term securities, including commercial paper, may not necessarily result in discovery of prices that reflect the fair value of securities the issuers of which are reasonably likely to be in a position to pay upon maturity. You further assert that pricing vendors customarily used by money market funds are at times not able to provide meaningful prices because inputs used to derive those prices have become less reliable indicators of price.

Based on these representations and in light of the current conditions in the market for short-term securities, the Division of Investment Management would not recommend enforcement action to the Commission under Section 2(a)(41) of the Investment Company Act of 1940 and Rules 2a-4 and 22c-1 thereunder if, for purposes of shadow pricing under their monitoring procedures through January 12, 2009, money market funds comply with Rule 2a-7 by using the amortized cost method for valuing certain of their portfolio securities in accordance with the Commission's 1977 interpretation, unless the particular circumstances, *i.e.*, the impairment of the creditworthiness of the issuer, suggest that amortized cost is no longer appropriate. This position is limited to portfolio securities that (i) have a remaining maturity of 60 days or less, (ii) are First Tier Securities as that term is defined in paragraph (a)(12) of Rule 2a-7, and (iii) the fund reasonably expects to hold to maturity. For purposes of this letter, the remaining maturity of a security is measured without regard to paragraph (d) of Rule 2a-7.

Robert E. Plaze  
Associate Director

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<sup>3</sup> Rule 2a-7(c)(7)(ii)(A)(1) under the Act.

<sup>4</sup> Rule 2a-7(c)(7)(ii)(A)(2) under the Act.

<sup>5</sup> Rule 2a-7(c)(7)(ii)(C) under the Act.

<sup>6</sup> Investment Company Act Release No. 13380 (July 11, 1983) at text accompanying n.44.

# SEC ENFORCEMENT ACTIONS ON VALUATION

## IN THE MATTER OF JOHN E. BACKLUND, ET AL.

Release Nos. 7626; IA-1783; IC-23639

Administrative Proceeding File No. 3-9805

January 11, 1999

### ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE AND DESIST ORDERS

#### I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that:

A. public administrative proceedings pursuant to Section 9(b) of the Investment Company Act of 1940, as amended (“Investment Company Act”) and Section 203(f) of the Investment Advisers Act of 1940, as amended (“Advisers Act”), and public cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933, as amended (“Securities Act”) and Section 9(f) of the Investment Company Act, be instituted against John E. Backlund (“Backlund”); and

B. public administrative proceedings pursuant to Section 9(b) of the Investment Company Act, and public cease-and-desist proceedings pursuant to Section 8A of the Securities Act and Section 9(f) of the Investment Company Act, be instituted against John H. Hankins (“Hankins”), Howard L. Peterson (“Peterson”), and John G. Guffey (“Guffey”).

#### II.

In anticipation of the institution of these proceedings, Backlund, Hankins, Peterson, and Guffey (“Respondents”) have submitted Offers of Settlement (“Offers”) which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except the findings in:

- A. paragraphs III.A. and III.C. below, which Backlund admits;
- B. paragraphs III.A. and III.D. below, which Hankins admits;
- C. paragraphs III.A. and III.E. below, which Peterson admits; and
- D. paragraphs III.A. and III.F. below, which Guffey admits;

Respondents, each of whom admits the Commission’s jurisdiction over him and over the subject matter of this proceeding, hereby consent to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders (“Order”) making the findings and imposing the remedial sanctions set forth below.

Accordingly, IT IS ORDERED that proceedings pursuant to Section 8A of the Securities Act, Sections 9(b) and 9(f) of the Investment Company Act, and Section 203(f) of the Advisers Act be, and they hereby are, instituted.

### III.

On the basis of this Order and the Offers, the Commission makes the following findings:

#### Background

A. Community Bankers Mutual Fund, Inc. (“Community Bankers”), of Boston, Massachusetts, is a now-defunct open-end management investment company organized as a series company and offering a single series known as the U.S. Government Money Market Fund (“the Fund”). Community Bankers has been registered with the Commission since 1989. The Fund’s prospectus and Statement of Additional Information (“SAI”) stated that it would attempt to maintain a constant net asset value (“NAV”) of \$1.00 per share. The Fund’s assets were valued at amortized cost, as permitted by Rule 2a-7 under the Investment Company Act.

B. Community Assets Management, Inc. (“CAM”), a registered investment adviser since 1988, is owned by about 70 bank holding companies and state banks. From 1989 to 1994, CAM’s only client was Community Bankers. As investment adviser for the Fund, CAM made the day-to-day investment decisions for the Fund at all times except from May 1993 to July 1994, when a sub-adviser, Prospect Hill Advisers, Inc. (“Prospect Hill”), performed that function. CAM ceased operations in the fall of 1994, shortly after Community Bankers’ liquidation, but has not withdrawn its registration.

C. Backlund, age 48, served as president and a director of both CAM and Community Bankers. Backlund managed CAM’s daily activities, including supervising CAM’s sales staff that marketed shares of the Fund. Prior to forming a sales staff, he made presentations to banks which were considering investing in the Fund. After forming the sales staff, Backlund personally prepared or approved the written sales materials distributed by them. All actions by CAM referred to herein were under Backlund’s direction and control.

D. Hankins, age 57, served as an independent director of Community Bankers from 1989 until its liquidation. He has been a practicing lawyer in West Virginia since 1966.

E. Peterson, age 83, served as an independent director of Community Bankers from 1991 until its liquidation. He retired in 1975 as executive vice president of a local bank in Grand Island, Nebraska. Peterson was mayor of the city of Grand Island from 1964 to 1968, and a state senator in Nebraska from 1980 to 1984.

F. Guffey, age 50, served as an independent director of Community Bankers from 1990 until its liquidation. He has been a consultant to a mutual fund sponsor and is currently self-employed as a partner in a venture capital firm.

G. The Fund “broke the dollar” (i.e., failed to maintain a \$1.00 per share NAV) as a result of having a substantial percentage (about 27½%) of its assets invested in adjustable-rate derivative securities that declined in value during mid-1994 due to rising interest rates. As a result, the Fund liquidated beginning September 26, 1994, eventually paying investors \$0.961 per share. The total loss to shareholders was approximately \$2.5 million.

#### Purchase of Improper Investments

H. CAM marketed Fund shares, targeting as investors for the Fund small community banks and their holding companies. CAM represented that an investment in the Fund was comparable, in safety and yield, to lending money at the Federal funds rate—the interest rate at which depository institutions’ (such as commercial banks’) deposits at Federal Reserve Banks may be lent overnight. CAM hired Prospect Hill as a consultant and later, in May 1993, the Fund’s shareholders elected Prospect Hill as sub-adviser to make the day-to-day investment decisions for the Fund. From February 1993 to March 1994, officers of Prospect Hill caused the Fund to acquire certain adjustable-rate derivative securities, called structured notes, for the Fund’s portfolio. By March 1994 approximately 27½% of the Fund’s net assets was invested in the structured notes. At this level, the structured notes were unsuitable for a money market fund because of the high risk that their market prices would fall substantially below their par values.

I. In late March 1994, after the Federal Reserve had raised the Federal funds rate for the second time in fewer than two months,<sup>1</sup> the structured notes became illiquid when many of the broker-dealers who made a market in them lowered their

<sup>1</sup> On February 4 the Federal Reserve had raised the rate from 3% to 3.25%; and, on March 22, from 3.25% to 3.5%



bids for the notes substantially or discontinued making a market in them altogether. As a result, the market value of the structured notes and the Fund's portfolio value both decreased significantly.

J. As the values of the structured notes fell, they became illiquid when they could no longer be sold within seven days at the price at which the Fund carried them.

K. After the structured notes dropped in value, CAM, with the knowledge and approval of the Community Bankers board, including Respondents, continued to market Fund shares to prospective and existing shareholders, representing to them that each Fund share continued to be worth \$1.00 and that the Fund would not invest more than 10% of its assets in illiquid securities. Purchasers were unaware of the loss in value of the Fund's portfolio securities, a loss in value known to the Community Bankers board.

### **Fair Value Shadow Pricing Adopted**

L. In late March or early April 1994, officers of Prospect Hill advised CAM that, due to interest-rate volatility, there were "anomalies" associated with determining market prices for the structured notes. Quoted spreads between bid and asked prices, which historically had ranged from 25 to 50 basis points, rose to between 200 and 400 basis points. At its April 12, 1994, meeting, as permitted by then Rule 2a-7(c)(6)(ii)(A),<sup>2</sup> the Community Bankers board amended its shadow pricing procedures to allow the use of fair value<sup>3</sup> as well as market quotations.<sup>4</sup> Use of fair value shadow pricing resulted in a claimed \$1.00 NAV per share. The rule permits the substitution of the fair value of a security for the security's market quotation for shadow-pricing purposes so long as the fair value reflects current market conditions. Use of fair value shadow pricing permitted the board to come to the conclusion that the amortized cost method continued to fairly reflect the market-based NAV per share. This, in turn, resulted in a claimed \$1.00 NAV per share. Use of the old methodology (shadow pricing using market quotations) would have caused the board to conclude that the continued use of amortized cost no longer fairly reflected the market-based NAV per share, which would have required the board to mark to market under Rule 22c-1. The board knew at this meeting that the structured notes were illiquid but believed that the market anomaly was temporary.

M. By June 1994, market bid prices of the structured notes indicated a total shortfall in portfolio value of about \$2.1 million from the amortized cost of those securities. The Fund's continued use of amortized cost and its fair value method of shadow pricing its portfolio, however, resulted in daily NAVs per share within the general range of \$0.995 to \$0.997, which the Fund then rounded up to \$1.00 per share. About 27 ½% of the Fund's \$130 million in net assets, as of June 17, 1994, consisted of the structured notes, with par values totalling about \$37 million. With the drop in market value of the structured notes, the overall value of the Fund's portfolio fell proportionately.

### **Knowledge of Respondents**

N. By the Community Bankers board meeting conducted June 17, 1994, fair value shadow pricing had been in use for a substantial length of time without any recovery in the market quotations for the structured notes. By that date also, the Federal funds rate had increased four times during 1994, twice while the Fund was using fair value shadow pricing. At Community Bankers' previous board meeting, on May 10, 1994, Backlund advised the board that the structured notes would continue to be valued as they were "until market makers in these securities perceived that the Federal Reserve Board had moved away from its current credit-tightening posture." Also on May 10 the board: directed CAM and Prospect Hill to identify financial arrangements to be made should fair value shadow pricing be discontinued; stopped further purchases of structured notes; and directed Prospect Hill to reduce by \$10 million the Fund's current position of \$37.5 million in structured notes. At the June 17, 1994, board meeting, officers of Prospect Hill gave their opinion that the market value of the structured notes likely would not revert to par until they had reached final maturity, years away; Prospect Hill also notified the board that it would resign as sub-adviser effective July 31, 1994. At the same meeting, the board: reviewed proposed solutions, including sale of the structured notes to the banks that owned CAM, or CAM borrowing from those banks to buy the structured notes at amortized cost; and directed CAM to attempt to obtain

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<sup>2</sup> Now Rule 2a-7(c)(7)(ii)(A); see Investment Company Act Release No. 22921 (Dec. 3, 1997).

<sup>3</sup> It is permissible to shadow price securities under Rule 2a-7 using a fair value methodology, but the fair value shadow price must be determined "in good faith by the [investment company's] board of directors." See Investment Company Act Section 2(a)(41).

<sup>4</sup> All of the Fund's portfolio securities had previously been valued for shadow pricing by obtaining "quotations of value" from dealers in these securities.

competitive quotes to facilitate orderly liquidation of the structured notes. Respondents were aware of the above facts by the time of the Community Bankers June 17, 1994, board meeting and as a result should have known that the continued use of the Fund's fair value shadow pricing methodology was inappropriate.

O. At the June 17, 1994, board meeting Respondents knew: that the board needed to seek financial assistance for the Fund; and that the market conditions that caused the board to adopt fair value shadow pricing had been ongoing for a significant period of time with no change beneficial to the Fund and were continuing to adversely affect the Fund's portfolio. As of June 17, 1994, the board had no reasonable basis for believing that the structured note valuation problem could be solved merely by the passage of time or that the adverse market conditions were temporary. After the June 17, 1994, board meeting: the Fund's continued use of fair value shadow pricing was no longer appropriate because it did not reflect current market conditions; the board could no longer determine that the use of amortized cost to calculate the Fund's NAV per share fairly reflected the Fund's market-based NAV per share; and the board was required to calculate the Fund's NAV per share pursuant to Rule 22c-1 under the Investment Company Act.

### **Misleading Prospectus and SAI**

P. As a result of the foregoing, since at least the June 17, 1994, board meeting the Fund's prospectus and SAI were materially misleading regarding (1) the liquidity of the Fund's portfolio, and (2) the value of shares being sold. The SAI at all times stated that "no more than 10% of the Fund's assets may be invested in repurchase agreements not terminable within seven days and other illiquid securities." As noted, the structured notes, constituting about 27½% of the Fund's assets, were being carried on the books of the Fund at a price substantially higher than the price at which they could be sold, according to available market quotations. They could not be sold within seven days at the price at which the Fund carried them and thus were illiquid. Also, the Fund was offering, selling and redeeming its shares at \$1.00 per share, representing in its prospectus and otherwise that its NAV was \$1.00 per share, when in reality, according to available market quotations for the structured notes, the NAV was less than \$1.00 per share.

Q. On July 25, 1994, at the direction of its board, Community Bankers filed with the Commission a combined 1933-Act and 1940-Act registration statement (including a prospectus that had been amended by sticker on July 15), which once again made the material misrepresentations noted above regarding portfolio liquidity and NAV.

R. On September 26, 1994, the board recommended that Community Bankers' shareholders approve the liquidation of the corporation.

### **Violations**

S. Sections 17(a)(2) and 17(a)(3) of the Securities Act provide that it is unlawful for any person, directly or indirectly, in the offer or sale of securities, by the use of the means or instruments of transportation or communication in interstate commerce or by the use of the mails, (1) to obtain money or property by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (2) to engage in a transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser of such securities.<sup>5</sup> From about June 17, 1994, to about September 26, 1994, at the direction of the board, Fund shares were sold while omitting to disclose, or while making false and misleading disclosure of, material facts concerning:

1. the percentage of illiquid securities in the Fund's portfolio; and
2. the value of the Fund's shares being sold.

<sup>5</sup> *Scienter*, the intent to deceive, manipulate, or defraud, is not an element of a Section 17(a)(2) or Section 17(a)(3) violation. *Aaron v. SEC*, 446 U.S. 680 (1980). Violations of these sections may be established by showing negligence. *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997); *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).

Respondents, as members of the Fund's board, should have known that the statements in the Fund's prospectus and SAI were materially false and misleading as described above. Therefore, they willfully<sup>6</sup> violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

T. From about June 17, 1994, to about September 26, 1994, Respondents willfully aided and abetted and caused a violation of Rule 22c-1 under Section 22(c) of the Investment Company Act, in that, at the direction of the board, Fund shares were sold or redeemed at a price not based on the current net asset value of such shares which was next computed after receipt of a tender of such shares for redemption or of an order to purchase or sell such shares, by selling or redeeming Fund shares at a net asset value from about 1-½ [cent] to about 4 [cent] higher than the current net asset value based on market quotations for the Fund's portfolio securities.

U. On or about July 25, 1994, Respondents willfully violated Section 34(b) of the Investment Company Act, in that, at the direction of the board, a registration statement for Community Bankers was filed that made untrue statements of material facts, or omitted to state therein facts necessary in order to prevent the statements made, in the light of the circumstances under which they were made, from being materially misleading, by omitting to disclose, or by making false and misleading disclosure of, material facts concerning the matters set forth in paragraphs III.S.1. and III.S.2., above.

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions specified by Respondents in their respective Offers.

Accordingly, IT IS ORDERED that:

A. Respondents Backlund, Hankins, Peterson, and Guffey cease and desist from committing or causing any violation and any future violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 34(b) of the Investment Company Act, and from causing any violation of and any future violation of Rule 22c-1 under Section 22(c) of the Investment Company Act;

B. Respondent Backlund shall, within ten days of the entry of this Order, pay a civil money penalty pursuant to Section 9(d)(2)(A) of the Investment Company Act, in the amount of \$10,000 to the United States Treasury. Such payment shall be (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Backlund as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Daniel F. Shea, Securities and Exchange Commission, 1801 California St., Suite 4800, Denver, CO 80202;

C. Respondents Hankins, Peterson, and Guffey shall, within ten days of the entry of this Order, each pay a civil money penalty pursuant to Section 9(d)(2)(A) of the Investment Company Act, in the amount of \$5,000 to the United States Treasury. Such payment shall be (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Hankins, Peterson, or Guffey, respectively, as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Daniel F. Shea, Securities and Exchange Commission, 1801 California St., Suite 4800, Denver, CO 80202; and

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<sup>6</sup> In applying the term "willful" in Commission administrative proceedings instituted pursuant to Section 9 of the Investment Company Act, the Commission evaluates on a case-by-case basis whether the Respondent knew or reasonably should have known under the particular facts and circumstances that his conduct was improper. In this case, as in all Commission administrative proceedings charging a willful violation under this statutory provision, the Commission applies this standard to persons specifically, securities industry professionals—who are directly subject to Commission jurisdiction and who have a responsibility to understand their duties to the investing public and to comply with the applicable rules and regulations which govern their behavior.

D. Beginning on the second Monday following entry of this Order, Respondent Backlund be, and he hereby is, suspended from association with any investment company or investment adviser for a period of twelve months. Backlund shall provide to the Commission, within 30 days after the end of the twelve-month suspension period described above, an affidavit that he has complied fully with the suspension described in this paragraph D.

By the Commission.

## IN THE MATTER OF MICHAEL P. TRABA

Release Nos. 33-7727; 34-41761; IC-23952

Administrative Proceeding File No. 3-9788

August 19, 1999

### Order Making Findings and Imposing Remedial Sanctions

#### I.

On December 10, 1998, the Securities and Exchange Commission (“Commission”) deemed it appropriate and in the public interest to institute proceedings pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), and Section 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Michael P. Traba (“Traba”).

In response to the institution of these proceedings, Traba has submitted an Offer of Settlement (“Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the allegations, findings of fact or conclusions of law contained herein, except for jurisdiction and the findings contained in Sections II.4. and II.18. which are admitted, Traba, by his Offer, consents to the issuance of this Order Making Findings and Imposing Remedial Sanctions.

#### II.

On the basis of this Order and the Offer submitted by Traba, the Commission makes the following findings:

1. The First Prairie Cash Management Fund (“Cash Management Fund”), is an open-end, diversified, management investment company, marketed as a money market fund. The Cash Management Fund has been registered with the Commission as an investment company since September 6, 1991.
2. The First Prairie Money Market Fund is an open-end, diversified, management investment company comprised of two portfolios, the Money Market Series (the “MM Series Fund”) and the Government Series Fund. The First Prairie Money Market Fund has been registered with the Commission as an investment company since January 29, 1985.
3. From at least January 1993 through at least October 1994, The First National Bank of Chicago (“First Chicago”), a wholly owned subsidiary of First Chicago Corporation, served as the investment adviser to the Cash Management Fund and the MM Series Fund (collectively the “Funds”) through its Investment Management Group, a division of First Chicago’s Trust Department. As a bank, First Chicago was not subject to registration or regulation as an investment adviser.
4. Traba was associated with First Chicago Investment Services, Inc., a registered broker-dealer, from March, 1979, until October, 1994. From at least January until August 1993, Traba was employed by First Chicago as a senior portfolio manager. From at least August 1993 until October 1994, Traba was employed by First Chicago as a senior fixed income portfolio manager in the Investment Management Group of First Chicago’s Trust Department.
5. While senior portfolio manager, Traba was responsible for managing the Funds. As a senior fixed income portfolio manager, Traba continued to act as the portfolio manager for the Funds and continued to be responsible for managing the Funds.
6. At all relevant times, the Funds were marketed as money market funds, seeking to maintain a stable net asset value (“NAV”) per share and valuing their portfolio securities at amortized cost, as permitted by Rule 2a-7 under the Investment Company Act of 1940 (“Investment Company Act”).

7. Between March and August 1993, Traba caused the Cash Management Fund to purchase for its portfolio two adjustable-rate derivative securities known as structured notes (“derivatives”). As of October 1993, the total face value of these two derivatives was \$35 million. Between March and April 1993, Traba caused the MM Series Fund to purchase for its portfolio two derivatives. As of October 1993, the total face value of these two derivatives was \$15 million. The market value of the derivatives had the potential to move substantially away from par.
8. Between February and May 1994, the Federal Reserve raised the Federal funds rate four times, from 3% to 4.5%. During this time period, the market value of the derivatives fell substantially.
9. Between February and May 1994, Traba instructed the Funds’ administrator to value the derivatives at amortized cost for purposes of calculating the Funds’ NAV. In addition, based on Traba’s instruction, the market value of the derivatives was recorded on the Funds’ daily pricing sheets at amortized cost. The continued use of amortized cost in the face of the steep market decline for these instruments was inconsistent with Rule 2a-7’s requirement that the deviation between amortized cost and market value of a money market fund’s portfolio be tracked using market quotations (or an appropriate substitute). Traba knew, or was reckless in not knowing, that the market value of the derivatives was substantially lower than their amortized cost.
10. As a result, during this time period, the Funds sold and redeemed shares at the price of \$1.00 per share, when in fact, the Funds were no longer eligible to rely on Rule 2a-7 to price their shares using amortized cost instead of current net asset value. The MM Series Fund broke the dollar (the NAV fell below the fixed \$1.00 per share price) on at least March 15, March 31, April 15, April 29, May 31, and June 15, 1994. The Cash Management Fund broke the dollar on at least April 4 and 5, 1994.
11. Between about June 25 and August 4, 1994, Traba caused the derivatives to be sold out of the Funds and into approximately four commingled trust accounts at First Chicago at materially inflated prices.
12. Between September 23 and September 27, 1994, Traba caused one of the derivatives to be sold from a commingled trust account into a First Chicago custody account (the “Custody Account”) at a materially inflated price. On the same day, Traba caused this derivative to be sold out of the Custody Account at its then current market value. During this same time period, Traba caused the Custody Account to purchase a Tennessee Valley Authority Note (“TVA Note”) at its then current market value. On the same day, Traba caused the TVA Note to be sold from the Custody Account into a commingled trust account at a materially inflated price.
13. Between October 4 and October 5, 1994, Traba caused another one of the derivatives to be sold from a commingled trust account into the Custody Account at a materially inflated price. On the same day, Traba caused this derivative to be sold out of the Custody Account at its then current market value. During this same time period, Traba caused the Custody Account to purchase a TVA Note at its then current market price. On the same day, Traba caused the TVA Note to be sold from the Custody Account into a commingled trust account at a materially inflated price.
14. Traba willfully violated Section 34(b) of the Investment Company Act and willfully aided and abetted and caused violations of Section 31(a) and Rule 31a-1 of the Investment Company Act by making an untrue statement of material fact, or omitting to state a material fact that renders a stated fact misleading, in documents required to be kept under the Investment Company Act, as set forth in paragraph II. 9. above.
15. Traba willfully aided and abetted and caused violations of Rule 22c-1 under Section 22(c) of the Investment Company Act in that, on at least March 15, March 31, April 15, April 29, May 31, and June 15, 1994, the MM Series Fund sold or redeemed Fund shares at a price not based on the accurate current net asset value of such shares; and on at least April 4 and 5, 1994, the Cash Management Fund sold or redeemed Fund shares at a price not based on the accurate current net asset value of such shares, as set forth in paragraphs II. 6. through II. 10., above.
16. Traba willfully violated Section 17(a) of the Securities Act of 1933 (“Securities Act”) in that, directly or indirectly, in the offer and sale of the derivatives and TVA Notes, by the use of the means and instruments of transportation and communication in interstate commerce or by the use of the mails, he: (i) employed devices, schemes or artifices to defraud; or (ii) obtained money and property by means of untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were

made, not misleading; or (iii) engaged in transactions, practices, and courses of business which operated, or would operate, as a fraud or deceit upon the purchasers of such securities. As part of this conduct, Traba engaged in the conduct set forth in paragraphs II. 11. through II. 13., above.

17. Traba willfully violated Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 10b-5 thereunder in that, directly or indirectly, in connection with the purchase and sale of the derivatives and TVA Notes, by the use of the means and instrumentalities of interstate commerce or by the use of the mails, he: (i) employed devices, schemes or artifices to defraud; (ii) made untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; and (iii) engaged in acts, practices, and courses of business which operated, or would operate, as a fraud or deceit. As part of this conduct, Traba engaged in the conduct set forth in paragraphs II. 11. through II. 13., above.

18. Traba has entered into a settlement agreement with the Office of the Comptroller of the Currency where, without admitting or denying the allegations, he has agreed to the entry of an order prohibiting him from participating in the conduct of the affairs of an insured depository institution and ordering the payment of a \$15,000 civil money penalty.

### III.

Accordingly, IT IS HEREBY ORDERED that:

1. Traba cease and desist from committing or causing violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 34(b) of the Investment Company Act, and from causing violations and any future violations of Section 31(a) and Rules 22c-1 and 31a-1 of the Investment Company Act;
2. Traba be, and hereby is, barred from association with any broker, dealer, or investment company;
3. Traba shall pay a civil money penalty in the amount of \$15,000 to the United States Treasury. \$7,500 shall be paid within ten days of the entry of this order, \$3,750 shall be paid within 45 days of the entry of this order, and the remaining \$3,750 shall be paid within 90 days of the entry of this order. Such payments shall be (A) made by United States postal money order, certified check, bank cashier’s check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Traba as the Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Christine Berry, Securities and Exchange Commission, 500 West Madison, Suite 1400, Chicago, Illinois 60661.

By the Commission.

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## OTHER VALUATION RESOURCES

### ICI PUBLICATIONS:

- » An Introduction to Fair Valuation (May 2005)
- » Fair Valuation: The Role of the Board (January 2006)

*Available to ICI members at [www.ici.org](http://www.ici.org):*

- » Valuation and Liquidity Issues for Mutual Funds (February 1997)
- » Valuation and Liquidity Issues for Mutual Funds, Supplement (March 2002)

### ACCOUNTING GUIDANCE:

- » FASB Accounting Standards Codification Topic 820—Fair Value Measurement
- » FASB Accounting Standards Codification Topic 946—Investment Companies
- » AICPA Audit and Accounting Guide: Investment Companies (May 1, 2011)  
(available from the AICPA)

### SEC GUIDANCE:

- » Valuation of Portfolio Securities and Other Assets Held by Registered Investment Companies—Select Bibliography of the Division of Investment Management



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