SECURITIES AND EXCHANGE COMMISSION

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[Release Nos. 33–7275; IC–21837; S7–34–93]

RIN 3235–AE17

Revisions to Rules Regulating Money Market Funds

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

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.

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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'').[1] 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.

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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

[1] 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.

single state fund's 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.[2] 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'').[3] 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'').[4] 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 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.[5]

To maintain a stable share price, most money funds use the amortized cost method of valuation (''amortized cost method'')[6] or the penny-rounding method of pricing (''penny-rounding method'')[7] 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.[8] 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.[9] If the deviation does become significant, the fund may be required to take certain steps to address the

[2] *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.

[3] *Money Fund Report, supra* note 2, at 2.

[4] 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.*

[5] 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'').

[6] 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.

[7] 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.

[8] *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).

[9] 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.

deviation, including selling and redeeming its shares at less than $1.00 (''breaking a dollar'').[10]

In February 1991, the Commission amended rule 2a–7 (the ''1991 Amendments'')[11] to respond to developments in the commercial paper market since the rule was adopted in 1983.[12] 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,''[13] or comparable unrated securities. Taxable funds must further limit their investments in the securities of any one issuer (other than Government securities)[14] to five percent of fund assets (''Five Percent Diversification Test''),[15] and limit fund investment in second tier securities[16] 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'').[17]

The 1991 Amendments did not apply the Five Percent Diversification Test and the Second Tier Securities Tests to tax exempt funds.[18] 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.[19] 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'').[20] 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.

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.[21] 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.[22] At the time of

[10] Paragraphs (c)(6) and (c)(7) of rule 2a–7, as amended.

[11] 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.

[12] 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.

[13] ''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)].

[14] 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.

[15] 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.

[16] 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.

[17] 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].

[18] 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.

[19] Release 17589, *supra* note 2, at Section II.6.

[20] Investment Company Act Rel. No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] at Section I.A.

[21] 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.

[22] 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

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.[23]

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.[24] 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.[25] 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 value or share price.[26] 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.[27] 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.[28] 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.[29]

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,[30] and

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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.

[23] 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 no 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.

[24] *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).

[25] *See* Investment Company Act Rel. No. 13380, *supra* note 7, at nn. 40–42 and accompanying text.

[26] Paragraphs (c)(6)(i) and (c)(7) of rule 2a–7, as amended.

[27] Release 18005, *supra* note 11, at Section II.A.

[28] *See infra* Section II.F.4.a. of this Release.

[29] *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.

[30] 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

Continued

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 mutual fund commenters, supported the extension of the Five Percent Diversification Test to national funds, which the Commission is adopting as proposed.[31]

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.[32] 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.[33] The Commission also asked commenters to consider whether single state funds should be required to satisfy a diversification standard under the rule.[34]

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.[35] 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.[36] 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.[37] 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 several times, no adviser is required to guarantee its fund against the possibility of breaking a dollar,[38] 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.[39]

The Commission has decided to exclude from the application of the

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.

[31] Paragraph (c)(4)(i) of rule 2a–7, as amended.

[32] Proposing Release, *supra* note 20, at Sections II.A. and II.A.2.

[33] 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.

[34] Proposing Release, *supra* note 20, at Section II.A.2.

[35] Release 17589, *supra* note 2, at Section II.1.

[36] 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.

[37] 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.

[38] *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).

[39] 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.

diversification requirement securities that are subject to an unconditional demand feature from a non-controlled person, as defined in the rule.[40] 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.[41] 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.[42] 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.[43]

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.[44] 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 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.[45]

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.[46] 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.[47] 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.[48] 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,[49] 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.[50] Therefore, the Commission proposed to treat a national fund's 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.[51] Many conduit securities in which money funds invest are subject to unconditional demand features. Because the Second Tier

[40] Paragraphs (c)(4)(i) and (ii) of rule 2a–7, as amended.

[41] Proposing Release, *supra* note 20, at Section I.B.

[42] 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.

[43] The commenters discussed this issue within the context of the rule's put diversification standards. *See infra* Section II.C.2. of this Release.

[44] 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.

[45] 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.

[46] 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.

[47] 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.

[48] *See supra* nn. 12 and 13 and accompanying text and paragraph (a)(19) of rule 2a–7, as amended.

[49] *See supra* Section II.B.1.a. of this Release and paragraph (c)(4)(iii) of rule 2a–7, as amended.

[50] *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.

[51] *See supra* note 29 and accompanying text.

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.[52]

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.[53] 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.[54] 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.[55] 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.[56]

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 in excluding from the Second Tier Securities Tests a security for which the ultimate obligor is a private entity.[57] The Commission has modified the definition of the term ''conduit security'' to reflect some of these concerns.[58]

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.[59] 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.[60]

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.[61] 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.[62] 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.[63] Demand features can serve three different purposes: (1) to shorten the maturity of a variable or floating rate security; [64] (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.[65]

Demand features may be conditional or unconditional.[66] Under rule 2a–7, a demand feature used as a substitute for

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[52] 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.

[53] Paragraph (c)(4)(vi)(A)(3) of rule 2a–7, as amended.

[54] Paragraph (c)(4)(iv)(B) of rule 2a–7, as amended.

[55] *See infra* Section II.B.2.b. of this Release and paragraph (c)(3)(iii) of rule 2a–7, as amended.

[56] *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.

[57] 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.

[58] 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.''

[59] 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)].

[60] Paragraph (a)(6) of rule 2a–7, as amended.

[61] Proposing Release, *supra* note 20, at Section I.B.

[62] Paragraph (a)(16) of rule 2a–7, as amended.

[63] Paragraph (a)(7) of rule 2a–7, as amended.

[64] 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'').

[65] 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'').

[66] 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.

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.[67] 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.[68]

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.[69]

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.[70] 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.[71]

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,[72] 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.[73] 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.'' [74] In the Proposing Release, the Commission requested comment on the treatment of puts by the issuer of the underlying securities (''issuer-provided demand features'').[75] 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.[76]

[67] Paragraph (a)(27) of rule 2a–7, as amended.

[68] Paragraph (c)(3)(iii)(B) of rule 2a–7, as amended.

[69] *See* Proposing Release, *supra* note 20, at Section II.C.2.

[70] Paragraph (c)(4)(v)(B) of rule 2a–7, as amended.

[71] Proposing Release, *supra* note 20, at Section II.C.2.b.

[72] *See infra* Section II.C.2.b. of this Release.

[73] 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.

[74] Paragraph (c)(4)(v)(A) of rule 2a–7, as amended.

[75] *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.

[76] 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

Continued

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.[77] 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.[78]

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[79] or maturity standards,[80] or for liquidity, to exclude that put when determining its compliance with the rule's put diversification standards.[81] The fund must document this determination in its records.[82]

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.[83] 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,[84] 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.[85]

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.[86] 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 the determination permitted under the rule in connection with the purchase of unrated securities.[87] 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.[88]

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

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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].

[77] 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.

[78] Paragraph (c)(4)(vi)(B)(*2*) of rule 2a–7, as amended.

[79] 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.

[80] 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.

[81] 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.

[82] 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.

[83] Proposing Release, *supra* note 20, at note 81.

[84] Eli Nathans, *Municipal Bond Insurance—The Economics of the Market*, 13 Mun. Fin. J., No.2 (Summer 1992) 1, 2.

[85] 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.

[86] Paragraph (c)(4)(vi)(B)(3) of rule 2a–7, as amended.

[87] 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.

[88] 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).

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.[89] In addition, funds may have limited ability to monitor the credit quality of some demand feature providers, such as foreign banks.[90] The Commission is adopting the rating requirement for demand features as proposed.[91]

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.[92]

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.[93]

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 expanded this provision to accommodate long-term ratings within the top three ratings categories.[94] Funds will continue to be required to determine that such a security is of ''comparable quality'' to rated eligible securities.[95]

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,[96] 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.[97] 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.[98]

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.[99] 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

[89] *See supra* Section II.B.1.b. of this Release.

[90] Proposing Release, *supra* note 20, at Section II.C.2.d.(2).

[91] 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.

[92] Paragraph (c)(4)(v)(B) of rule 2a–7, as amended.

[93] 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.

[94] Paragraph (a)(9)(iii)(B) of rule 2a–7, as amended.

[95] Paragraph (a)(9)(iii) of rule 2a–7, as amended.

[96] 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.

[97] 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.

[98] Proposing Release, *supra* note 20, at Section II.C.3.

[99] *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.

would result in the demand feature not being exercisable.[100] 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.[101]

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 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.[102]

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.[103]

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.[104] 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.[105]

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.[106]

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.[107] The limit on money fund holdings of illiquid securities is ten percent of fund assets.[108]

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.[109] 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.[110] This issue is significant for money funds, because a large percentage of money fund assets consist of securities with a seven day demand feature.[111]

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

[100] Paragraph (c)(3)(iii)(B) of rule 2a–7, as amended.

[101] *Id.*

[102] Paragraph (c)(3)(iii)(C)(*1*) of rule 2a–7, as amended.

[103] Paragraph (a)(16) of rule 2a–7, as amended.

[104] Proposing Release, *supra* note 20, at Section II.D.1.c.

[105] 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.

[106] 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.

[107] 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).

[108] Release 14983, *supra* note 64 at Section A.4.; Investment Company Institute (pub. avail. Dec. 9, 1992).

[109] 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)].

[110] *See* T+3 Letter, *supra* note 65.

[111] *Id.*

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.[112] 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.[113] 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.'' [114] 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.[115] The Commission is adopting, as proposed, amendments to permit a fund to treat the repo as collateralized fully only if it is collateralized by securities that would qualify the repo for preferential treatment under the Federal Deposit Insurance Act [116] or the Federal Bankruptcy Code.[117] 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.[118] 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.[119]

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.[120] 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.[121] The Commission agrees, and has eliminated this limitation.[122] The Commission has decided to make additional technical modifications to the conditions applicable to the escrow arrangements that were suggested by the commenters.[123] 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 agreement.[124] 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).

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[112] *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).

[113] 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.

[114] 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.

[115] *See* Proposing Release, *supra* note 20, at Section II.D.3.

[116] *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.

[117] 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].

[118] Proposing Release, *supra* note 20, at n. 172.

[119] *Id.*

[120] *Id.*

[121] 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.

[122] 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.

[123] 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.

[124] 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.*

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.[125] 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).[126] 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.[127]

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.[128]

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.[129] The ABS is structured to assure that the issuer of the ABS will not be affected by the bankruptcy of the sponsor. In 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.[130]

Synthetic securities are another form of ABSs that have been developed to address the shortage in the supply of short-term tax exempt securities.[131] 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,[132] 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

[125] *See supra* note 30; Proposing Release, *supra* note 20, at n. 29 and accompanying text.

[126] 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.

[127] Paragraph (c)(4)(vii) of rule 2a–7, as amended.

[128] 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.

[129] 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.

[130] 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.

[131] *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.

[132] *See, e.g.,* Donaldson, Lufkin & Jenrette Securities Corporation (pub. avail. Sept. 23, 1994); Orrick, Herrington & Sutcliffe (pub. avail. July 27, 1994).

''qualifying assets.'' [133] 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.[134] 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.[135]

3. Diversification Standards

a. *Diversification: General.* 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),[136] 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.[137] 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.[138]

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.[139]

(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.[140] As amended, the rule provides that a special purpose entity whose qualifying assets are themselves ABSs (''secondary ABSs'') will be treated as the issuer of the secondary ABSs.[141] 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.[142]

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).[143] 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

[133] Paragraph (a)(2) of rule 2a–7, as amended.

[134] This term excludes investment companies. *Id.*

[135] *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.

[136] *See* Proposing Release, *supra* note 20, at Section II.C.4.d.

[137] *Id.*

[138] 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'').

[139] Paragraph (c)(4)(vi)(A)(*4*) of rule 2a–7, as amended.

[140] *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.

[141] Paragraph (c)(4)(vi)(A)(*4*) of rule 2a–7, as amended.

[142] 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.

[143] Proposing Release, *supra* note 20, at Section II.C.4.e.

by contract.[144] 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.[145] 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.[146] 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.[147]

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 independently of any determination of a security's credit quality made by a NRSRO.[148] 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.[149] 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.[150]

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.[151]

[144] 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.

[145] *See* Proposing Release, *supra* note 20, at Section II.A.

[146] 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.

[147] 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.

[148] 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)].

[149] Proposing Release, *supra* note 20, at Section II.C.4.b.

[150] Paragraph (a)(9)(iii)(C) of rule 2a–7, as amended.

[151] 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

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.[152]

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.[153] 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.[154] 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.[155]

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.[156] 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.[157] This change makes explicit that Government securities are treated the same way as other adjustable rate securities under the rule.[158]

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.[159]

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

redeem), other than physically delivering the notes or bonds for redemption.

[152] 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.

[153] *See* Release 13380, supra note 7, at n.14 and accompanying text; State of Wisconsin (pub. avail. Mar. 3, 1983).

[154] 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.

[155] Paragraph (d)(2) of rule 2a–7, as amended.

[156] 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.

[157] 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.

[158] The amendments also make clear that this provision applies to floating rate Government securities. Paragraph (d)(1) of rule 2a–7, as amended.

[159] 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).

rate.[160] 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.[161]

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 security can expose the fund to substantial interest rate risk.[162] 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.[163]

G. Other Amendments to Rule 2a–7

1. U.S. Dollar Denominated Instruments

To avoid exposure to foreign currency risk, rule 2a–7 limits fund investment to ''United States dollar-denominated securities.'' [164] 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

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[160] 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.

[161] Paragraphs (a)(12) and (a)(30) of rule 2a–7, as amended.

[162] 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 U.S. 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.

[163] Paragraphs (c)(8)(iii) and (c)(9)(iv) of rule 2a–7, as amended.

[164] Paragraph (c)(3)(i) of rule 2a–7, as amended.

''United States dollar-denominated'' as proposed.[165]

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;[166] 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.[167] 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.[168]

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).[169] 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.[170] 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.[171] 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.[172]

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.[173]

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 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.[174] 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.[175]

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.[176] 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.[177] 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.[178] 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.[179]

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.[180] 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.[181] The definition of ''first tier security'' is also being amended to include government securities.[182]

III. Amendments to Disclosure Rules

The Commission is adopting amendments to the forms and advertising rules used by tax exempt

[165] Paragraph (a)(28) of rule 2a–7, as amended.

[166] Paragraph (a)(11)(iv) of rule 2a–7, as amended.

[167] 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.

[168] *Id.*

[169] 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.

[170] 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)].

[171] 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.

[172] 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.

[173] Paragraph (c)(3) of rule 2a–7, as amended.

[174] Proposing Release, *supra* note 20, at Section II.D.6.

[175] Paragraphs (c)(5)(i)(A) and (e) of rule 2a–7, as amended.

[176] Paragraph (c)(9)(iii) of rule 2a–7, as amended.

[177] *See* Proposing Release, *supra* note 20, at Section II.D.8.

[178] Paragraphs (a)(10) and (c)(5)(ii) of rule 2a–7, as amended.

[179] Paragraph (c)(5)(iv) of rule 2a–7, as amended.

[180] 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).

[181] Paragraph (a)(29) of rule 2a–7, as amended.

[182] 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.

funds and is publishing a 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, proposed amendments to Form N–1A would have a 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.[183] 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.[184]

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 [185] to reflect the approach taken by the Commission in proposing to simplify money market fund prospectuses.[186]

Under the proposed amendments, money fund portfolio schedules would have been required to include information regarding put providers.[187] 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.[188] The amendments extend this requirement to ''tombstone'' advertisements under rule 134 of the 1933 Act.[189]

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.[190] 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 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.[191] 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,[192] 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.[193] 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

[183] *See supra* Section II.B.1.a. of this Release and paragraph (c)(4)(ii) of rule 2a–7, as amended.

[184] Item 4(c) of Form N–1A, as amended.

[185] Guide 21 to Form N–1A, as amended.

[186] Investment Company Act Rel. No. 21216 (July 19, 1995) [60 FR 38454 (July 26, 1995)].

[187] Proposing Release, *supra* note 20, at Section III.C.

[188] *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].

[189] Paragraph (e) or rule 134, as amended [17 CFR 230.134(e)].

[190] Proposing Release, *supra* note 20, at nn.12 and 28 and accompanying text.

[191] 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.

[192] *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).

[193] *See* Release 18005, *supra* note 11, at Section II.H. (adopting amendments to Item 1(a)(ix) of Form N–1A).

case, including accrued interest).[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 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.[195] 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.[196] 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 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; [197]

(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; [198]

(3) new requirements for ABSs regarding maturity determinations and ratings; [199]

(4) revised definition of ''put'' to include ability to recover principal *and* any accrued interest; [200] and

(5) requirement that security subject to conditional demand feature is an eligible security only if board of directors or its delegate makes certain determinations regarding the demand feature's exercisability.[201]

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.

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, 78*l*, 78m, 78n, 78o, 78w, 79*ll*(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

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[194] *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.

[195] 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.

[196] 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.

[197] Paragraph (a)(9)(iii)(D)(*1*) of rule 2a–7, as amended.

[198] Paragraph (a)(9)(iii)(D)(*2*) of rule 2a–7, as amended.

[199] 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).

[200] Paragraph (a)(16) of rule 2a–7, as amended.

[201] Paragraph (c)(3)(iii)(B) of rule 2a–7, as amended.

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 depositary 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)(9)].

(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.

(iv) *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 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, 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 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.

(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) introductory text 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, 78*l*, 78m, 78n, 78o(d), 78w(a), 78*ll*(d), 79e, 79f, 79g, 79j, 79*l*, 79m, 79n, 79q, 79t, 80a–8, 80a–29, 80a–30 and 80a–37, unless otherwise noted.

* * * * *

10. The authority citation for Part 274 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 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.

§§ 239.15A and 274.11A [Amended]

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.

* * * * *

§§ 239.15A and 274.11A [Amended]

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.

§§ 239.17a and 274.11b [Amended]

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.

§ 274.101 [Amended]

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.

§§ 239.15A and 274.11A [Amended]

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.[45] 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.

§§ 239.17a and 274.11b [Amended]

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

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.[45] 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.

Margaret H. McFarland,

Deputy Secretary.

Dated: March 21, 1996.

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[45] See Investment Company Act Rel. No. 21837 (March 21, 1996) at Section II.G.2.

[45] See Investment Company Act Rel. No. 21837 (March 21, 1996) at Section II.G.2.