SECURITIES AND EXCHANGE COMMISSION

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Technical Revisions to the Rules and Forms Regulating Money Market Funds

AGENCY: Securities and Exchange Commission.

ACTION: Final rules.

SUMMARY: The Commission is adopting amendments to rules and forms under the Securities Act of 1933 and the Investment Company Act of 1940 that govern money market funds. Technical amendments to rule 2a–7 under the Investment Company Act of 1940, the rule regulating money market funds, among other things, revise terminology used in the rule to reflect common market usage and resolve certain interpretive issues under the rule. Amendments to the advertising rules applicable to money market funds, among other things, clarify the formula used by money market funds to calculate yield.

DATES: *Effective Date:* The rule and form amendments adopted in this Release will become effective February 10, 1998. *Compliance Date:* See Section III of this Release.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'') is adopting technical amendments to rule 2a–7 [17 CFR 270.2a–7] (''rule 2a–7'' or the ''rule'') under the Investment Company Act of 1940 [15 USC 80a–1, *et seq.*] (''1940 Act''), the rule governing the operations of money market funds (''funds'').[1] The Commission is adopting conforming amendments to rules 2a41–1, 12d3–1, 17a–9 and 31a–1 under the 1940 Act [17 CFR 270.2a41–1, 270.12d3–1, 270.17a–9 and 270.31a–1] to reflect the amendments to rule 2a–7. The Commission also is adopting amendments to rule 482 [17 CFR 230.482] under the Securities Act of 1933 [15 USC 77a, *et seq.*] (''1933 Act'') and rule 34b–1 under the 1940 Act [17 CFR 270.34b–1]; and to Forms N–1A [17 CFR 239.15A and 274.11A], N–3 [17 CFR 239.17a and 274.11b] and N–4 [17 CFR 239.17b and 274.11c].

I. Technical Amendments to Rule 2a–7

A. Background

On March 21, 1996, the Commission adopted amendments to rule 2a–7 under the 1940 Act (''1996 Amendments'') to tighten the rule's risk-limiting conditions imposed on tax exempt money market funds and to address the treatment under the rule of certain instruments, such as asset backed securities.[2] These risk-limiting conditions include requirements that a fund limit itself to investing in high quality securities [3] and that the fund's portfolio be diversified.[4] After the adoption of the 1996 Amendments, industry participants raised numerous questions concerning the application of the amendments in different contexts. The Commission thereafter suspended the compliance date of certain of the 1996 Amendments pending the proposal and adoption of technical amendments to address these concerns.[5]

On December 10, 1996, the Commission issued a release proposing technical amendments to rule 2a–7 (''Proposing Release'').[6] The proposed amendments would: (1) codify certain interpretive views expressed by the Division of Investment Management;[7] (2) revise terminology used in the rule to reflect common market usage; (3) modify certain of the 1996 Amendments so that the rule's treatment of certain instruments (*e.g.*, guarantees) more closely reflects the treatment of those instruments by the financial markets; and (4) make certain other technical corrections. The Commission also proposed amendments to clarify the Commission's advertising rules regarding how money market funds calculate current yield and represent short-term total return in conjunction with current yield quotations.

The Commission received comments on the proposed amendments from seventeen commenters, including nine mutual fund complexes.[8] Commenters supported the proposed technical amendments to rule 2a-7, and suggested further amendments to certain provisions of the rule primarily relating to the treatment of asset backed securities. Most commenters that addressed the proposed amendments to the Commission's advertising rules relating to money market fund yield and total return generally supported them. The Commission is adopting the technical amendments substantially as proposed, with certain modifications that reflect, in part, many of the commenters' suggestions. The Commission also is establishing a new compliance date for the 1996 Amendments, as further amended by the technical amendments adopted in this Release.[9]

B. Discussion

1. Guarantees

a. Definition of ''Guarantee''. Rule 2a-7 currently characterizes certain features that enhance the credit or liquidity of portfolio securities as ''puts'' and ''unconditional puts.''[10] To clarify

[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.

[2] Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] (''Release 21837''). Unless otherwise noted, all references to the ''1996 Amendments'' in this Release are to rule 2a–7 as adopted in Release 21837. The compliance date for the 1996 Amendments to rule 2a–7 was suspended pending the adoption of technical amendments. See *infra* note 5 and accompanying text.

[3] The portfolio or credit quality provisions of the rule generally limit funds to investments in U.S. dollar-denominated securities that present minimal credit risks and that are, at the time of acquisition, ''eligible securities'' as defined by the rule. See paragraph (c)(3) of rule 2a–7, as amended (''portfolio quality standards'' or ''credit quality standards''). ''Eligible security'' is defined in paragraph (a)(10) of rule 2a–7, as amended.

[4] The diversification provisions of the rule generally limit the amount of assets that a fund may invest in a single issuer of securities, and the amount of assets that may be subject to credit enhancements, such as letters of credit or puts, provided by the same credit enhancement provider. See paragraph (c)(4) of rule 2a–7, as amended (''diversification standards'').

[5] Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 22135 (Aug. 13, 1996) [61 FR 42786 (Aug. 19, 1996)]. The Commission suspended the 1996 Amendments' compliance date for rules 2a–7, 2a41–1, 12d3–1 and 31a–1 under the 1940 Act. [17 CFR 270.2a–7, 2a41–1, 12d3–1 and 31a–1]. The compliance date was not suspended with respect to the adoption of rule 17a–9 under the 1940 Act [17 CFR 270.17a–9] and the 1996 Amendments' revisions of the rules and forms relating to money market fund disclosure, advertising and reporting.

[6] Technical Revisions to the Rules and Forms Regulating Money Market Funds, Investment Company Act Release No. 22383 (Dec. 10, 1996) [61 FR 66621 (Dec. 18, 1996)] (''Proposing Release'').

[7] See Investment Company Institute (pub. avail. May 9, 1996).

[8] The comment letters and a summary of the comments prepared by the Commission staff are available to the public and are included in File No. S7–29–96.

[9] The new compliance date is discussed *infra* in Section III.B. of this Release.

[10] The 1996 Amendments defined a ''put'' as the right to sell a specified underlying security within a specified period of time at a specified exercise price that may be sold, transferred or assigned only with the underlying security. An ''unconditional put'' was defined as a put (including any guarantee, financial guarantee (bond) insurance, letter of credit or similar unconditional credit enhancement) that

terminology used in rule 2a-7, the Commission proposed to replace these terms with a new term—''guarantee''—that would include a wide-range of arrangements designed to unconditionally support the credit of the issuer of a security.[11] Commenters generally supported the proposed amendments, which the Commission is adopting substantially as proposed.[12]

b. Credit Substitution. Since 1986, rule 2a-7 has permitted a fund to rely exclusively on the credit quality of the issuer of an ''unconditional demand feature'' in determining whether a security meets the rule's credit quality standards.[13] The 1996 Amendments also permitted a fund to exclude from the rule's issuer diversification standards a security subject to an unconditional demand feature provided by a person that does not control, or is not controlled by or under common control with, the issuer of the security (''non-controlled person'').[14] Reflected in this approach is the recognition that the holder of a security typically relies exclusively on the credit quality of the issuer of the unconditional demand feature in deciding to invest in the security.

In addition to enhancing credit quality, money market funds also rely on demand features to shorten the maturities of adjustable rate securities or provide a source of liquidity.[15] Because of the significance of demand features to a money market fund's ability to maintain a stable net asset value, the 1996 Amendments further provided that a demand feature is not eligible for fund investment unless (i) The demand feature (or the issuer of the demand feature) is rated by an NRSRO (''Rating Requirement'');[16] and (ii) arrangements are in place for a fund holding a security subject to a demand feature to be given notice in the event of a change in the identity of the issuer of the demand feature (''Notification Requirement'').

The Commission proposed to extend these provisions to other types of guarantees commonly held by funds, such as bond insurance, letters of credit and similar unconditional guarantees.[17] Like securities subject to unconditional demand features, securities subject to guarantees typically trade on the basis of the credit of the guarantor, rather than the issuer. Commenters strongly supported the proposed amendments, which the Commission is adopting as proposed.[18]

Under the rule as amended, a fund holding a security subject to a guarantee (as defined in the rule) may rely exclusively on the credit quality of the issuer of the guarantee in determining whether the security meets the rule's credit quality standards.[19] In addition, securities subject to guarantees issued by non-controlled persons are not subject to the rule's issuer diversification standards.[20]

c. Rating Requirement for Guarantees. The 1996 Amendments precluded funds from investing in securities subject to demand features (whether unconditional or conditional) that have not received a short-term rating from an NRSRO. The Commission proposed, in light of its proposal to extend the rule's treatment of unconditional demand features to all guarantees, to extend the Rating Requirement to guarantees, subject to certain exceptions.[21] Commenters generally supported the proposal, which the Commission is adopting substantially as proposed.

Under rule 2a–7, as amended, all guarantees must be rated by an NRSRO,[22] except (i) a guarantee issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the guarantee,[23] (ii) a guarantee with respect to a repurchase agreement (''repo'') that is collateralized fully,[24] (iii) a guarantee issued by the

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by its terms would be readily exercisable in the event of default in payment of principal or interest on the underlying security. *See* paragraphs (a)(16) and (a)(27) of rule 2a-7, as adopted by the 1996 Amendments.

[11] See Proposing Release, *supra* note , at n.7 and accompanying text.

[12] Under the new definition, a guarantee is any unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the guarantee (if required), principal plus accrued interest when due upon default. Paragraph (a)(15) of rule 2a-7, as amended. In order to permit guarantees that are payable at any time, the Commission has eliminated a requirement in the proposed definition that the issuer of the guarantee be obligated to pay upon default ''at a specified time.'' The Commission also is adopting amendments to the credit quality and diversification provisions of the rule to incorporate the new term ''guarantee,'' as discussed *infra* in Sections I.B.1.b. and c. of this Release. The definition of ''guarantee'' is for purposes of rule 2a-7 only, and is not intended to have any effect on the status of these investments under other provisions of the 1940 Act or under other federal securities laws.

[13] See Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)]. A ''demand feature'' means (i) a feature exercisable either: (A) at any time on no more than 30 calendar days' notice, or (B) at specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice; or (ii) a feature permitting the holder of an asset backed security unconditionally to receive principal and interest within 397 calendar days of making demand. An ''unconditional demand feature'' is a demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities. See paragraphs (a)(8) and (a)(26) of rule 2a-7, as amended.

[14] Under the 1996 Amendments, a security subject to an unconditional demand feature from a person in a control relationship with the issuer of the security (*i.e.*, one that controls, is controlled by or under common control with the issuer) remains subject to the issuer diversification standards in order to reduce a fund's exposure to credit risks presented by a single economic enterprise. See Release 21837, *supra* note 2, at nn.42–47 and accompanying text.

[15] Tax exempt funds, for example, typically invest in long-term adjustable rate securities subject to demand features. The interest rates on these securities periodically adjust to reflect short-term rates. The demand features permit funds to demand payment of the security at relatively short intervals, and if unconditional, also serve to enhance credit quality—thus providing the basis for making the securities eligible for money market fund investment.

[16] ''NRSRO'' is the acronym used in rule 2a–7 to stand for a ''nationally recognized statistical rating organization.'' See paragraph (a)(17) of rule 2a–7, as amended. NRSROs are designated as such by the Commission's Division of Market Regulation through the no-action letter process for purposes of the Commission's net capital rule [17 CFR 240.15c3–1].

[17] Proposing Release, *supra* note 6, at nn. 8–16 and accompanying text.

[18] See paragraphs (c)(3)(iii) (determination of whether a security meets the rule's credit quality standards may be based exclusively on the credit quality of the security's guarantee); (c)(4)(i) (excluding securities subject to guarantees from non-controlled persons from the rule's issuer diversification standards); (a)(10)(iii)(A) (extending the Rating Requirement to guarantees); (a)(10)(iii)(B) (extending the Notification Requirement to guarantees); and (a)(16) (definition of ''guarantee issued by a non-controlled person'') of rule 2a–7, as amended. The amended rule also permits a fund that holds a security subject to a guarantee and a conditional demand feature to substitute the rating of the guarantee for the rating of the underlying security. Paragraph (c)(3)(iv)(C) of rule 2a–7, as amended. Consistent with the amended rule, however, a fund must also consider the rating of the conditional demand feature in evaluating the credit quality of the entire instrument. Paragraph (c)(3)(iv)(A) of rule 2a–7, as amended.

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

[20] Paragraph (c)(4)(i) of rule 2a–7, as amended. Guarantees, however, are subject to the guarantee and demand feature diversification standards of paragraphs (c)(4)(iii), (c)(4)(iv) and (c)(5) of rule 2a–7, as amended. A security subject to a guarantee that is provided by a person in a control relationship with the issuer of the security remains subject to the rule's issuer diversification standards. See paragraphs (a)(16) (definition of ''guarantee issued by a non-controlled person'') and (c)(4)(i) of rule 2a–7, as amended.

[21] Proposing Release, *supra* note 6, at nn. 17–24 and accompanying text.

[22] Paragraph (a)(10)(iii)(A) of rule 2a–7, as amended. Unlike the 1996 Amendments, which required a short-term rating, the amended rule allows any rating from an NRSRO to satisfy the Rating Requirement.

[23] Paragraph (a)(10)(iii)(A)(*1*) of rule 2a–7, as amended. The Commission proposed to exclude this type of guarantee from the Rating Requirement because a guarantor that guarantees securities issued by a person in a control relationship with the guarantor may not be in the business of lending its credit, and such a requirement may be burdensome and result in a diminished supply of high quality, eligible securities available for money market fund investment.

[24] Paragraph (a)(10)(iii)(A)(*2*) of rule 2a–7, as amended. The Commission has relaxed the Rating

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U.S. Government,[25] or (iv) a guarantee not relied upon for quality, maturity or liquidity purposes.[26] Conditional demand features, which are not within the definition of a ''guarantee'' under the amended rule, are not subject to the Rating Requirement.[27]

d. Demand Features and Guarantees Not Relied Upon. The 1996 Amendments permitted a fund that is not relying on a particular put to disregard that put for purposes of meeting rule 2a–7's put and demand feature diversification standards. The Commission is revising the rule to extend this provision to guarantees, and to expand the provision to permit funds to disregard a demand feature or a guarantee that is not relied upon to satisfy the rule's credit quality or maturity standards, or for liquidity, for all purposes under the rule.[28]

2. Diversification and Credit Quality Standards Applicable to Issuers

a. Second Tier Securities. Rule 2a–7 provides that a taxable fund may not invest more than one percent of its total assets in second tier securities issued by a single issuer.[29] In the case of tax exempt funds, this one percent limitation on investments in second tier securities applies only to second tier ''conduit securities'' that are issued by municipalities, but whose ultimate obligors are not government or municipal entities.[30] The Commission is adopting the proposed amendments to the rule that clarify that these limitations are not applicable to a security that is guaranteed by a non-controlled person.[31] Securities subject to guarantees from non-controlled persons are subject only to the rule's guarantee and demand feature diversification standards.[32]

b. Repurchase Agreements. Rule 2a–7 permits a fund to ''look-through'' a repo to the underlying collateral and disregard the counterparty in determining compliance with the rule's diversification standards if the obligation of the counterparty is ''collateralized fully.'' The 1996 Amendments sought to define ''collateralized fully'' to limit the collateral to that which could be liquidated promptly even in the event of bankruptcy of the counterparty.

Because of questions concerning the treatment of cash and other types of collateral not specifically addressed in the 1996 Amendments, the Commission proposed to revise the ''look-through'' provisions of the rule to focus on the treatment of the repo under applicable insolvency law rather than exclusively on the type of collateral. Under the proposed amendments, a repo would be ''collateralized fully'' if (i) the collateral consists entirely of cash, Government securities, or other securities that are rated in the highest rating category by the requisite NRSROs, and (ii) upon an event of insolvency with respect to the seller, the repo qualifies under a provision of applicable insolvency law providing an exclusion from any ''general stay'' of creditors rights against the seller.[33]

Commenters supported the proposed revisions, but three commenters urged that the rule's language be modified to refer to an ''automatic stay'' rather than a ''general stay.'' These commenters pointed out that even repos protected from automatic stays under federal insolvency law may be subject to a court-ordered general stay obtained by the Securities Investor Protection Corporation (''SIPC'') or the Federal Deposit Insurance Corporation (''FDIC''). Because no provision of insolvency law protects a purchaser of a repo from such orders, the proposed amendments might have precluded money market funds from relying on the rule's ''look-through'' provision for most repos, even though it is the policy of both SIPC (as to broker-dealer counterparties) and FDIC (as to bank counterparties) generally to allow the prompt liquidation of repos in insolvency proceedings.[34]

The Commission is adopting the proposed amendments, revised in part to reflect the commenters' suggestions.[35] The Commission notes that, under the revised rule, a fund entering into a repo collateralized by Government securities (which most are) should be able to conclude that the repo qualifies for ''look-through'' treatment (assuming the

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Requirement with respect to guarantees of repos that are ''collateralized fully.'' One commenter noted that funds often rely on unconditional puts (*i.e.*, ''guarantees'' under the amended rule's terminology) with respect to ''term repos''—which are repos for periods longer than one day. The puts could be exercised if a repo counterparty's credit quality deteriorated or to cover short-term cash outflows. The issuers of unconditional puts with respect to term repos are typically government securities dealers that are not rated by NRSROs. Since a repo that is ''collateralized fully'' already has significant protection from the risk of a counterparty's default or insolvency, requiring puts (or guarantees) of such repos to be rated would add little additional protection, and could cause funds to forgo a beneficial method of liquidity enhancement. See *infra* Section I.B.2.b. of this Release (treatment of repos that are ''collateralized fully'').

[25] Paragraph (a)(10)(iii)(A)(*3*) of rule 2a–7, as amended; see *infra* Section I.B.2.e. of this Release (discussing guarantees issued by the U.S. Government).

[26] Paragraph (c)(5) of rule 2a–7, as amended; see also *infra* Section I.B.1.d. of this Release (demand features and guarantees not relied upon).

[27] A conditional demand feature is any demand feature that is not an unconditional demand feature. Paragraph (a)(6) of rule 2a–7, as amended.

[28] Paragraph (c)(5) of rule 2a–7, as amended. A fund holding securities subject to demand features or guarantees that are not being relied upon for credit quality, maturity or liquidity must establish written procedures requiring periodic re-evaluations of this determination. Paragraph (c)(9)(ii) of rule 2a–7, as amended. Funds are not required to establish procedures concerning demand features and guarantees not relied upon if they do not hold such instruments. *Id.*

[29] A ''second tier security'' is an eligible security that is not a first tier security. Paragraph (a)(22) of rule 2a–7, as amended. ''First tier securities'' are (i) securities that have received short-term debt ratings in the highest category from the requisite NRSROs; (ii) comparable unrated securities; (iii) securities issued by money market funds; and (iv) Government securities. Paragraph (a)(12) of rule 2a–7, as amended. ''Requisite NRSROs'' means (i) any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or (ii) if only one NRSRO has issued a rating with respect to a security or class of debt obligations of an issuer, that NRSRO. Paragraph (a)(21) of rule 2a–7, as amended.

[30] ''Conduit securities'' are issued to finance non-government projects, such as private hospitals, housing projects, or industrial development projects. See paragraph (a)(7) of rule 2a–7, as amended (definition of ''conduit security'').

[31] Paragraphs (c)(4)(i)(C) (*1*) and (*2*) of rule 2a–7, as amended. Rule 2a–7 also limits a taxable fund and a tax exempt fund to investing no more than five percent of total assets in second tier securities and second tier conduit securities respectively (''five percent quality test''). Paragraph (c)(3)(ii) of rule 2a–7, as amended (portfolio quality standards—second tier securities). The amendments do not make substantive changes to the five percent quality test. Thus, a taxable fund, for example, could not invest more than five percent of its total assets in second tier securities subject to a second tier demand feature. The amendments, however, reorganize the rule text to include the five percent quality test in paragraph (c)(3) of the rule, which addresses portfolio quality standards, rather than paragraph (c)(4), which addresses diversification standards.

[32] Paragraphs (c)(4)(iii) and (c)(4)(iv) of rule 2a–7, as amended.

[33] Proposing Release, *supra* note 6, at nn. 30–36 and accompanying text.

[34] The United States Bankruptcy Code [11 U.S.C. 559] protects certain repos from the automatic stay provision, but provides that SIPC may obtain a court order barring the closeout of repo transactions with member broker-dealer firms. As a matter of policy, however, SIPC honors repos and allows their liquidation under most circumstances. See Letter dated February 4, 1986, from Michael E. Don, Deputy General Counsel of SIPC, to Robert A. Portnoy, Deputy Executive Director and General Counsel of the Public Securities Association. FDIC, as conservator or receiver for insolvent depository institutions, similarly has the ability to avoid contracts entered into by such institutions, but may not avoid transfers of property in connection with repos under most circumstances. See 12 U.S.C. 1821(e)(8)(A), (C) and (D); FDIC Statement of Policy on Qualified Financial Contracts (Dec. 12, 1989).

[35] Paragraph (a)(5)(iv) of rule 2a–7, as amended. Commenters also suggested that the text of this provision refer only to applicable ''federal'' insolvency law. Although repos entered into by funds typically involve domestic counterparties subject to federal insolvency law, funds may enter into repos with non-U.S. counterparties that are not subject to federal insolvency laws. Therefore, the amended rule continues to apply to any applicable insolvency law.

other requirements of the rule are met), while funds wishing to enter into repos using less traditional forms of collateral may rely on opinions of bankruptcy counsel.[36]

c. Refunded Securities. Money market funds often invest in ''refunded securities,'' which are securities the payment for which is funded and secured by Government securities placed in an escrow account. Rule 2a–7 permits a fund to ''look-through'' refunded securities to the escrowed Government securities in determining its compliance with the rule's issuer diversification standards under certain conditions.[37] One condition contained in the 1996 Amendments required certification by an independent public accountant that the escrowed Government securities, or any subsequent substitution of the escrowed securities, would satisfy all payments of principal, interest and applicable premiums on the refunded securities (collectively, the ''accountant's certification''). The Proposing Release noted that NRSROs, in rating refunded securities, typically require an independent third party to make the same determination.[38] Therefore, the Commission proposed, and is now adopting, an amendment to the rule eliminating the accountant's certification requirement if a refunded security has received a rating from an NRSRO in the highest category for debt obligations.[39]

d. Three-Day Safe Harbor. Rule 2a–7 permits a taxable or national fund to invest up to twenty-five percent of its total assets in the first tier securities of a single issuer for up to three business days (''three-day safe harbor''). The Commission proposed, and is adopting, amendments that restore unintentionally omitted language from the rule text stating that a fund relying on the three-day safe harbor may not make more than one investment in reliance on the safe harbor at any time during the three day period.[40]

e. Government Guarantees. Two commenters suggested that the Commission exclude guarantees issued by the U.S. Government from the rule's guarantee and demand feature diversification standards as finally amended, and thus treat government guarantees in the same manner as securities issued directly by the U.S. Government.[41] The Commission is amending the demand feature and guarantee diversification standards accordingly.[42]

f. Definition of ''Rated Security''. Two commenters recommended that the Commission adopt a new defined term, ''rated security,'' which would permit rule 2a–7's definitions of ''unrated security,'' ''eligible security'' and ''first tier security'' to be shortened and clarified. The Commission is adopting the new term ''rated security'' and amending other provisions in the rule to incorporate the new term.[43]

3. Asset Backed Securities and Synthetic Securities

The 1996 Amendments revised rule 2a–7 to accommodate asset backed securities and synthetic securities (collectively ''ABS''). Rule 2a–7 defines an ABS as a fixed income security[44] issued by a ''special purpose entity'' substantially all of the assets of which consist of ''qualifying assets.''[45] Rule 2a–7 provides separate credit quality,[46] diversification[47] and maturity[48] standards for ABSs. The ABSs covered by the rule include interests in pools of receivables, such as credit card debt, as well as short-term synthetic tax exempt securities.[49]

a. Rating Requirement. In recognition of the independent legal, structural and credit analysis conducted by NRSROs before assigning a rating to an ABS, the

[36] In addition, a money market fund must evaluate the repo counterparty's creditworthiness in order to minimize the risk that money market funds will enter into repos with parties that present a serious risk of becoming involved in bankruptcy proceedings. The Commission previously published a release setting forth the conditions under which the Division of Investment Management would not recommend enforcement action under section 12(d)(3) of the 1940 Act [15 U.S.C. 80a–12(d)(3)] (limiting fund investments in certain securities-related businesses) if an investment company entered into a repo with persons engaged in securities-related businesses. Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 13005 (Feb. 2, 1983) [48 FR 5824 (Feb. 9, 1983)] (''Repo Release''). Among other things, the Repo Release requires that the repo be ''fully collateralized.'' The definition of ''fully collateralized'' in the Repo Release does not include all of the conditions in rule 2a–7. A money market fund entering into a repo that is ''collateralized fully'' within the meaning of paragraph (a)(5) of rule 2a–7, as amended, will be deemed to meet the ''fully collateralized'' requirement of the Repo Release. Investment companies other than money market funds are not required to comply with this provision of rule 2a–7 to be deemed to hold repos that are ''fully collateralized'' for purposes of the Repo Release.

[37] Paragraph (c)(4)(ii)(B) of rule 2a–7, as amended. This ''look-through'' treatment would not be available to refunded securities subject to a swap agreement (*i.e.*, the payments from the escrowed Government securities are exchanged for payments made by a swap counterparty) because the swap counterparty, rather than the escrowed Government securities, acts as the ultimate source of payment for the refunded securities. See J.P. Morgan Structured Obligations Corp. (pub. avail. July 27, 1994); see generally *infra* Section I.B.3.d. of this Release (swap arrangements).

[38] See, *e.g.*, Standard & Poor's Municipal Finance Criteria, 176–77 (1996).

[39] Paragraph (a)(20)(iii) of rule 2a–7, as amended (definition of ''refunded security'').

[40] Paragraph (c)(4)(i)(A) of rule 2a–7, as amended. The three-day safe harbor is not available for single state funds. Single state funds, however, are required to be diversified only as to seventy-five percent of their assets, and so have available a twenty-five percent basket to accommodate purchases in excess of five percent of fund assets. Paragraph (c)(4)(i)(B) of rule 2a–7, as amended.

[41] A security guaranteed as to principal and interest by a U.S. Government agency is a ''Government security'' as defined in section 2(a)(16) of the 1940 Act [15 U.S.C. 80a–2(a)(16)] and paragraph (a)(14) of rule 2a–7, as amended. Investments in Government securities are excluded from the rule's issuer diversification standards because they are presumed to present little, if any, credit risks. The same rationale applies to a security guaranteed by a U.S. Government agency, which by definition also is a ''Government security.''

[42] Paragraph (c)(4)(iii) of rule 2a–7, as amended. Guarantees issued by the U.S. Government are deemed to be first tier securities. Paragraph (a)(12)(iv) of rule 2a–7, as amended (definition of ''first tier security'').

[43] A ''rated security'' is defined generally as (i) a security (or the issuer with respect to a comparable security) that has received a short-term rating from an NRSRO; or (ii) a security subject to a guarantee if the guarantee (or the guarantor with respect to a comparable guarantee) has received a short-term rating from an NRSRO. A security is not a rated security, however, if it is subject to an external credit support agreement that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement, or the credit support agreement has received a short-term rating. Paragraph (a)(19) of rule 2a–7, as amended. The Commission is making conforming amendments to paragraphs (a)(10) (definition of ''eligible security'') and (a)(12) (definition of ''first tier security'') of rule 2a–7, as amended, and amending the definition of ''unrated security.'' Under the amended definition, an ''unrated security'' is a security that is not a ''rated security.'' Paragraph (a)(28) of rule 2a–7, as amended.

[44] For purposes of rule 2a–7's definition of ''asset backed security,'' the term ''fixed income security'' has the same meaning as that term is defined in rule 3a–7(b)(2) under the 1940 Act [17 CFR 270.3a–7(b)(2)]. Rule 3a–7 excludes structured financings, such as ABSs, from the definition of ''investment company.''

[45] Paragraph (a)(3) of rule 2a–7, as amended. Paragraph (a)(3) defines ''special purpose entity'' as a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities that entitle holders to receive payments from the cash flows of the ''qualifying assets.'' Paragraph (a)(3) defines ''qualifying assets'' as either fixed or revolving financial assets that by their terms convert into cash within a finite time period.

[46] Paragraph (a)(10)(ii)(B) of rule 2a–7, as amended.

[47] Paragraph (c)(4)(ii)(D) of rule 2a–7, as amended.

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

[49] A synthetic security is created typically by placing a long-term fixed rate municipal bond into a trust that issues short-term variable or floating rate securities subject to a conditional demand feature. This process effectively converts long-term fixed rate bonds into short-term variable or floating rate demand instruments that meet the rule's maturity requirements. Synthetic securities were developed to address a shortage in the supply of short-term tax exempt securities eligible for money market fund investment. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] at nn.100–05 and accompanying text (''Release 19959'') (discussing the development and characteristics of synthetic securities).

1996 Amendments required that all ABSs purchased by money market funds receive a rating from an NRSRO.[50] In light of the role that NRSROs have played in the development of structured finance, the Commission believed that this ABS rating requirement was appropriate and would not be burdensome.

The Commission proposed to further amend the rule to exclude from this rating requirement ABSs substantially all of the qualifying assets of which consist of municipal securities.[51] The Commission was persuaded by the assertions of industry participants that, as applied to these ABSs, the rating requirement was burdensome and unnecessary.[52] Commenters generally supported the amendment, which the Commission is adopting as proposed.[53]

b. Diversification Standards. i. Look-Through to Secondary ABSs. Rule 2a–7 treats the special purpose entity as the issuer of the ABS and requires the rule's issuer diversification standards to be met with respect to the special purpose entity. The rule contains an exception to this treatment, which requires a fund to ''look-through'' the special purpose entity to any issuer of qualifying assets whose obligations constitute ten percent or more of the principal amount of the qualifying assets of the special purpose entity (''ten percent obligor''). For diversification purposes, a fund must treat these ten percent obligors as if they issued a proportionate amount of the special purpose entity.[54] The ''look-through'' to ten percent obligors is designed to ensure that a fund does not invest indirectly more than five percent of its assets in a particular issuer.

Some or all of the qualifying assets of certain ABSs (''primary ABSs'') also consist of other ABSs (''secondary ABSs''). The Commission proposed amendments to clarify that a ten percent obligor of a primary ABS that is also the issuer of secondary ABSs would be deemed to have issued a portion of the assets of the primary ABS that such secondary ABSs represent. For purposes of identifying ten percent obligors, the proposed amendments provided that a fund should ''continue down the chain'' of ten percent obligors until a special purpose entity with no ten percent obligors is reached.[55] Commenters supported this general approach, which the Commission is adopting, but raised several concerns that have led the Commission to further revise and clarify the rule.

One commenter observed that the benefits and materiality of the required ''look-through'' to secondary ABSs diminish rapidly. This commenter asserted that the risks posed by remote special purpose entities are likely to be outweighed by the costs incurred by funds to create compliance systems that identify, and treat as proportionate issuers, ten percent obligors beyond those comprising the qualifying assets of secondary ABSs. The Commission agrees and has amended the ABS ''look-through'' provision so that, instead of ''continuing down the chain'' indefinitely, funds are required to identify and treat as proportionate issuers of a primary ABS only ten percent obligors of the primary ABS and ten percent obligors of any secondary ABSs.[56]

Another commenter urged that a particular type of ABS issuer, a ''restricted special purpose entity,'' be excluded from treatment as a ten percent obligor under the rule, and thus not be counted for diversification purposes. A ''restricted special purpose entity'' is one that does not issue its ABSs to anyone other than another specific ABS issuer. For example, a company that provides financing for automobile purchasers may establish a restricted special purpose entity to securitize its automobile loans. The restricted special purpose entity will only sell ABSs to another special purpose entity that issues ABSs to money market funds or other investors. No diversification risk would appear to be posed to funds in this instance because funds cannot directly or indirectly invest in the restricted special purpose entity (*i.e.,* a secondary ABS) other than through the purchase of ABSs from a particular primary ABS issuer.[57] The Commission has decided to further amend the rule to exclude restricted special purpose entities from treatment as ten percent obligors.[58]

ii. Demand Features and Guarantees Securing Obligations of Ten Percent Obligors. The Commission is adopting a proposed amendment to clarify that in the case of any ten percent obligors deemed to be issuers for purposes of the rule's diversification standards, any demand features or guarantees supporting the obligations of the ten percent obligors are treated as being held by the fund and are subject to the rule's demand feature and guarantee diversification standards.[59]

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[50] The 1996 Amendments excluded unrated ABSs from the definition of an ''eligible security.''

[51] Proposing Release, *supra* note, at nn.41–43 and accompanying text.

[52] Industry participants noted that when ABSs consist of a large pool of financial assets, such as credit card receivables, they may not be susceptible to conventional means of credit risk analysis because credit quality is based on an actuarial analysis of a pool of financial assets, rather than a single issuer. The credit analysis for synthetic structures and municipal pools whose qualifying assets consist of one or a few municipal issuers, however, is typically no different than that required for a security directly issued by a municipality. Since many synthetic securities are not rated, applying the ABS rating requirement to them would have restricted the available supply of ABSs suitable for money market fund investment. ABSs involving large pools of financial assets, on the other hand, are typically rated.

[53] Paragraph (a)(10)(ii)(B) of rule 2a–7, as amended. An ABS subject to a guarantee is not itself required to be rated. Under rule 2a–7, as amended, an ABS subject to a guarantee that has received a short-term rating is considered a ''rated security.'' Paragraph (a)(19) of rule 2a–7, as amended. Moreover, an ABS subject to a guarantee may be determined to be an eligible security based solely on whether the guarantee is an eligible security. Paragraph (c)(3)(iii) of rule 2a–7, as amended.

[54] Paragraph (c)(4)(ii)(D)(*1*)(*i*) of rule 2a–7, as amended.

[55] Proposing Release, *supra* note, at nn. 48–50 and accompanying text. The approach set forth in the Proposing Release was illustrated in materials prepared by the staff of the Division of Investment Management and made available at the 1996 ICI Conference on Money Market Fund Regulation. See Materials for 1996 ICI Conference on Money Market Fund Regulation: Asset Backed Securities and Synthetic Securities—Application of Paragraph (c)(4)(vi)(A)(*4*) of Rule 2a–7 (May 9, 1996).

[56] Paragraphs (c)(4)(ii)(D)(*1*)(*i*) and (*ii*) of rule 2a–7, as amended. Under this provision, funds must ''look through'' to any ten percent obligor of a primary ABS, and to any ten percent obligor of a secondary ABS, and treat each such obligor as an issuer of a portion of the primary ABS. Funds need not, however, ''look-through'' to the qualifying assets of any ten percent obligor of a ''tertiary ABS'' (*i.e.,* a ten percent obligor of a secondary ABS that is itself a special purpose entity issuing ABSs) for purposes of compliance with the rule's diversification standards. Although the rule does not specifically prohibit a multi-layered ABS designed to avoid the ''look-through'' to secondary ABSs, the Commission would collapse the multiple layers of such an ABS and view remote ten percent obligors as proportionate issuers for purposes of determining compliance with the rule's issuer diversification standards. The Appendix to this Release illustrates the operation of the ''look-through'' to secondary ABSs under the amended rule.

[57] This commenter further noted that compliance costs of tracking ten percent obligors may cause funds to avoid any ABS whose issuer discloses the existence of ten percent obligors. Since a large number of ABSs may be structured such that all or a significant portion of ten percent obligors are restricted special purpose entities, allowing funds to disregard these ten percent obligors would further increase the supply of desirable ABSs for money market fund investment, avert the imposition of unnecessary constraints on the asset backed commercial paper market, and expose funds to little, if any, additional risks.

[58] Paragraph (c)(4)(ii)(D)(*2*) of rule 2a–7, as amended. The amended rule provides that a restricted special purpose entity may issue its securities to other persons that control, are controlled by or are under common control with, the restricted special purpose entity if such persons are not ABS issuers.

[59] Paragraph (c)(4)(ii)(D)(*3*) of rule 2a–7, as amended. If the fund is not relying on a demand feature or guarantee of a ten percent obligor for purposes of credit quality or maturity, or for liquidity, the fund may disregard the demand feature or guarantee for all purposes. See paragraph (c)(5) of rule 2a–7, as amended.

iii. Special Purpose Entity Cap. In the Proposing Release, the Commission explained that it was possible under the rule for a large portion of a fund to be exposed to a single ABS, as a result of a fund investing in a special purpose entity with one or more ten percent obligors.[60] The Commission noted that this could expose the fund to an undue amount of structural risk (*e.g.*, the risk that the special purpose entity might be affected by the bankruptcy of its sponsor), and requested comment whether the rule should restrict fund investment in the obligations of a single special purpose entity.

Although the three industry participants that responded to the request for comment urged adoption of such a cap, the Commission has decided not to amend the rule in this manner. The Commission is concerned that such a cap would add complexity to the rule without meaningfully limiting structural risks. While a cap would limit a fund's investment in a particular special purpose entity, it would not prevent a fund from investing large amounts of its assets in multiple identically-structured special purpose entities established by the same sponsor. A structural flaw in an ABS that exposes investors in one special purpose entity to the bankruptcy of the sponsor would likely affect all of the special purpose entities similarly structured. Therefore, the Commission is not persuaded that a cap would effectively contain a fund's exposure to structural risk, and in any event, rule 2a–7 looks to the ratings of the NRSROs to provide an independent review of ABS structures.[61] Fund advisers, however, should consider the fund's exposure to structural risk when evaluating whether an investment in a particular ABS is consistent with the fund's objective of maintaining a stable net asset value.

iv. Sponsor-Provided Demand Features and Guarantees. Rule 2a–7 provides that a fund may not invest, with respect to seventy-five percent of its total assets, more than ten percent of its total assets in securities issued by or subject to puts from the same institution (or under the amended rule's terminology, ''guarantee'' or ''demand feature'').[62] A fund is not subject to the ten percent limitation with respect to the remaining twenty-five percent of its total assets (''twenty-five percent basket'') if the securities held in the basket are first tier securities and the puts are issued by non-controlled persons.[63] As a result, a fund holding an ABS subject to a put from its sponsor is not able to include this investment in its twenty-five percent basket if the sponsor is in a control relationship with the special purpose entity.[64]

The twenty-five percent basket is restricted to securities subject to puts from non-controlled persons in order to minimize a fund's exposure to the credit risk of a single economic enterprise and limit the aggregate exposure to the risks of related, active businesses.[65] Permitting a fund to invest more than ten percent of its total assets in an ABS subject to a demand feature or guarantee issued by a sponsor, however, would not have this effect, because the special purpose entity, unlike an active enterprise, is a limited purpose vehicle created solely for the purpose of issuing fixed income securities based on the cash flow of the qualifying assets. Therefore, the Commission proposed to amend rule 2a–7 to allow funds to treat a demand feature or guarantee from an ABS sponsor as a demand feature or guarantee from a non-controlled person. Commenters supported the proposed amendment, which the Commission is adopting as proposed.[66]

v. First Loss Guarantees. Some ABSs are supported by a guarantee that covers all losses up to an amount of expected losses likely to be experienced by the ABS. Because a fund's exposure to such a ''first loss guarantee'' is similar to its exposure to a guarantee of the entire security,[67] the 1996 Amendments required a fund to treat a first loss guarantor as a guarantor of the entire ABS. Commenters urged that first loss guarantees be treated similar to other fractional guarantees under the rule and raised numerous questions about the application of the provision to certain ABS structures.

The Commission continues to believe that investment in an ABS subject to a first loss guarantee can potentially result in a fund being overexposed to the credit risk of the first loss guarantor. The number and nature of questions raised by the 1996 Amendments, however, have convinced the Commission that these risks are better managed by the fund's investment adviser. The Commission, therefore, is revising the rule to permit funds to treat a first loss guarantee as any other fractional guarantee when calculating compliance with the rule's guarantee and demand feature diversification standards.[68] Advisers should, however, carefully consider potential exposure to the credit risks of a first loss guarantor when evaluating whether investment in an ABS is consistent with the fund's objective of maintaining a stable net asset value.

c. Periodic Determinations Regarding Ten Percent Obligors. The 1996 Amendments required a fund to adopt written procedures requiring periodic determinations of the number of ten percent obligors deemed to be issuers of all or a portion of an ABS. The Commission is amending this requirement so that periodic determinations are not required with

[60] Proposing Release, *supra* note 6, at n.52 and accompanying text.

[61] NRSROs, prior to assigning a rating, not only analyze the quality of the assets underlying an ABS, but also conduct an independent analysis of the structural integrity of the ABS. *See* Release 19959, supra note 49, at nn.108–12 and accompanying text.

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

[63] *Id.* The amended rule refers to such instruments as guarantees or demand features from ''non-controlled persons.'' See paragraphs (a)(9) and (a)(16) of rule 2a–7, as amended. The Appendix to this Release illustrates the operation of the twenty-five percent basket under the amended rule when securities are subject to guarantees or demand features from multiple providers.

[64] This may occur, for example, if an ABS sponsor owns a residual equity interest in the special purpose entity. In this case, the ABS sponsor might ''control'' the special purpose entity within the meaning of section 2(a)(9) of the 1940 Act [15 U.S.C. 80a–2(a)(9)]. See Proposing Release, *supra note* 6, at n.54 and accompanying text. An ABS sponsor may not, however, be deemed to ''control'' the special purpose entity under other federal securities laws or for other purposes.

[65] Release 21837, *supra* note 2, at n.73 and accompanying text.

[66] Paragraphs (a)(9) (''demand feature issued by a non-controlled person'') and (a)(16) (''guarantee issued by a non-controlled person'') of rule 2a–7, as amended. Although a guarantee provided by a person in a control relationship with the issuer of the underlying security is excluded from the Rating Requirement for guarantees, the exclusion does not apply to a sponsor-provided guarantee of an ABS under the amended rule. Thus, sponsor-provided guarantees of ABSs must be rated. Paragraph (a)(10)(iii)(A) of rule 2a–7, as amended; see also *supra* Section I.B.1.c. of this Release.

[67] The failure of a first loss guarantor covering the first ten percent of all losses likely to be incurred by an ABS is likely to have a more significant effect on the value of the ABS than the failure of a fractional guarantor supporting only a portion of any losses incurred.

[68] Paragraph (c)(4)(iv)(A) of rule 2a–7, as amended. ABSs also may be subject to ''second loss guarantees'' that guarantee a specific amount of losses in excess of losses covered by a first loss guarantee. Funds should treat second loss guarantees of ABSs in the same manner as any other fractional guarantees or demand features under the amended rule. Sponsors of ABSs may provide additional credit risk protection by structuring an offering such that the value of qualifying assets in the pool exceeds the amount of the ABS offering. For example, a $1 billion ABSs offering might be collateralized by an asset pool of $1.1 billion. The $100 million of ''overcollateralization'' may be applied to cover any first losses incurred before drawing upon third party guarantees or other credit enhancements. Although overcollateralization would be relevant in determining whether the ABS presents minimal credit risks, this type of seller-provided credit enhancement does not fall within the rule's definition of a guarantee or demand feature and may be disregarded for purposes of the rule's diversification standards. *See* paragraphs (a)(8) (definition of ''demand feature'') and (a)(15) (definition of ''guarantee'') of rule 2a–7, as amended.

respect to any ABS that a fund's board of directors initially has determined will never have, or is unlikely to have, any ten percent obligors.[69] This determination may be based upon a structural analysis of the ABS or upon representations in the offering materials or governing documents of an ABS that it will never have ten percent obligors. Funds also must maintain a record of this determination.[70]

d. Swap Arrangements. The Proposing Release noted that certain ABSs may consist of qualifying assets whose cash flow has been ''swapped'' to a financial institution (the ''swap counterparty'') that ultimately acts as the primary source of payment to funds holding the ABSs (*i.e.*, a ''total return swap''). The Commission requested comment whether the swap counterparty in this instance should be treated as the issuer of the ABSs for diversification purposes and on the appropriate treatment of swaps and similar arrangements under the rule.

Commenters suggested various approaches to the treatment of swaps under the rule.[71] All acknowledged, however, the difficulty of addressing swaps and similar arrangements by rule due to the constantly evolving nature of swap transactions and the wide variations in the types of swaps used to structure ABSs offerings. The Commission has determined not to amend the rule at this time to specifically address the treatment of swaps or similar arrangements. Swaps and similar arrangements that fall within the rule's definition of a guarantee or demand feature, however, should be treated as such for purposes of guarantee and demand feature diversification.[72] A fund's adviser, however, should seek to ensure that investments by the fund in securities subject to swap arrangements are consistent with rule 2a–7's overriding policy of limiting funds to investments that are consistent with maintaining a stable net asset value and do not expose the fund excessively to credit risks posed by swap counterparties.

4. Other Amendments to Rule 2a–7

a. Investments in Other Money Market Funds. The 1996 Amendments permitted a fund (''acquiring fund'') to treat an investment in another money market fund (''acquired fund'') as a first tier security, but limited investment in any single money market fund to no more than five percent of fund assets. The 1996 Amendments created an exception, however, for a fund investing substantially all of its assets in shares of another money market fund in reliance on section 12(d)(1)(E) of the 1940 Act (*e.g.*, a master-feeder arrangement).[73] The 1996 Amendments deemed this type of a fund to be in compliance with rule 2a–7's diversification standards if the acquiring fund's board of directors reasonably believed that the acquired fund is in compliance with rule 2a–7.

Several commenters pointed out that, as a result of Commission exemptive orders[74] and amendments to the 1940 Act's limitations on ''funds of funds'' arrangements,[75] some money market funds may now invest more than five percent but less than substantially all of their assets in shares of another money market fund. The Commission is amending the rule to expand the exception to cover all investments by a fund in the shares of another money market fund in excess of the otherwise applicable issuer diversification standards.[76]

Under the amended rule, shares of money market funds are considered to be first tier securities,[77] and are thus subject to the rule's issuer diversification standards with respect to first tier securities.[78] A fund may, however, within the limitations of section 12(d)(1) of the 1940 Act, invest in shares of another money market fund in excess of the rule's issuer diversification standards, but only if the acquiring fund's board of directors reasonably believes that the acquired fund is in compliance with rule 2a–7.[79]

b. Definition of Eligible Security—Certain Unrated Securities. Under the 1996 Amendments, an unrated security that was a long-term security when issued, but had a remaining maturity of less than 397 calendar days when purchased by the fund, was an eligible security based on whether the security is comparable in quality to a rated security (*i.e.*, one with a short-term rating), unless the unrated security had received a long-term rating from any NRSRO that was not within the three highest categories of long-term ratings. The Commission is adopting a proposed amendment to the rule permitting a fund to treat such a security as an eligible security if that security has a long-term rating from the ''requisite NRSROs''[80] within the three highest rating categories.[81]

c. Additional Amendments. The Commission proposed additional amendments designed to further clarify and make technical corrections to the rule. Commenters supported the amendments, and the Commission is adopting them as follows:

(i) Acquisition of Portfolio Securities. The Commission is adding the new defined term ''acquisition'' to make the rule more uniform in its application to

[69] Paragraph (c)(9)(iv) of rule 2a–7, as amended. The board of directors may delegate this determination, and most other determinations required by the rule, to the fund's adviser or to the officers of the fund. The board, however, may not delegate certain specific determinations required under rule 2a–7. See paragraph (e) of rule 2a–7, as amended.

[70] Paragraph (c)(10)(v) of rule 2a–7, as amended.

[71] Six commenters addressed this issue and generally suggested that a swap counterparty acting as the primary source of payment to a fund be treated as an issuer and subject to the issuer diversification standards. Most of these commenters suggested that counterparties in swaps that support or guarantee the obligations of an ABS issuer or other party to pay (but are not the sole source of payment on the ABS) be treated as guarantees subject to the guarantee and demand feature diversification standards.

[72] See paragraphs (a)(8), (a)(15), (c)(4)(iii) and (c)(4)(iv) of rule 2a–7, as amended.

[73] 15 USC 80a–12(d)(1)(E).

[74] See, *e.g.*, Daily Money Fund, *et al.*, Investment Company Act Release Nos. 22285 (Oct. 16, 1996) (Order) and 22236 (Sept. 20, 1996) (Notice).

[75] In 1996, the 1940 Act's restrictions on fund investments in other funds were relaxed by, among other things, adding new section 12(d)(1)(G) [15 USC 80a–12(d)(1)(G)] that excepts ''affiliated'' funds of funds from the restrictions of section 12(d)(1)(A) under certain conditions. See The National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290, 110 Stat. 3416 (1996).

[76] Paragraph (c)(4)(ii)(E) of rule 2a–7, as amended.

[77] Paragraph (a)(12) of rule 2a–7, as amended.

[78] See paragraph (c)(4)(i) of rule 2a–7, as amended.

[79] Paragraph (c)(4)(ii)(E) of rule 2a–7, as amended. A taxable or national fund could take advantage of the three day safe harbor of paragraph (c)(4)(i)(A) and a single state fund could use its ''twenty-five percent basket'' under paragraph (c)(4)(i)(B) to invest up to twenty-five percent of fund assets in the securities of a single money market fund without the board making a ''reasonable belief'' finding, even though, in both cases, the investment would be in excess of five percent of fund assets. Under the rule, an acquiring fund that holds securities of a particular issuer (''Issuer A''), and invests in shares of an acquired fund that also holds securities of Issuer A, would not aggregate those positions to determine its compliance with the rule's diversification standards with respect to Issuer A.

[80] Paragraph (a)(21) of rule 2a–7, as amended (definition of ''requisite NRSROs'').

[81] Paragraph (a)(10)(ii)(A) of rule 2a–7, as amended. For example, an unrated ''stub'' security may have long-term ratings from three NRSROs. One of these NRSROs may give the security a long-term rating in the NRSRO's fourth highest category, which would have precluded the fund from purchasing the security before the adoption of these amendments. Under the revised rule, however, the fund may look to the other ratings and treat the security as an eligible security if the two other NRSROs have given the security long-term ratings within one of their three highest long-term rating categories. If any NRSRO has given the security (or the issuer of the security with respect to a class of debt obligations that is comparable in priority and security) a short-term rating, however, the short-term rating would override the long-term ratings and reference to long-term ratings would be unnecessary to determine whether the security was an eligible security. Long-term ratings may be relevant, however, to an evaluation of whether the issuer presents minimal credit risks under paragraph (c)(3)(i) of rule 2a–7, as amended.

fund investments and to clarify that the failure of a fund to exercise a demand feature does not have similar consequences under the rule as a decision to ''rollover'' commercial paper.[82]

(ii) Single State Funds. The Commission is amending the definition of a ''single state fund'' to include a fund seeking to ''maximize'' the amount of income exempt from income taxes of a particular state.[83]

(iii) Standby Commitments. As proposed, the Commission has deleted the term ''standby commitment'' and all references to that term from the rule.[84]

(iv) Downgrades, Defaults, and Other Events. The Commission is amending the rule to require a fund's board of directors to reassess whether an unrated or second tier security continues to present minimal credit risks only when the fund's adviser (or other person delegated portfolio management responsibilities) becomes aware that the security has been downgraded by any NRSRO below that NRSRO's two highest short-term rating categories.[85]

(v) Recordkeeping Requirements. The Commission is adding rule text inadvertently omitted from the 1996 Amendments that requires the board of directors to document minimal credit risk determinations of portfolio securities.[86]

(vi) Holding Out. Using new rulemaking authority, the Commission is restating the rule's prohibition on a fund's use of names suggesting that it is a money market fund, unless it complies with rule 2a–7.[87]

[82] Paragraph (a)(1) of rule 2a–7, as amended.

[83] Paragraph (a)(23) of rule 2a–7, as amended. The effect of the amendment would be to permit this type of a fund to take advantage of the twenty-five percent basket in determining compliance with the rule's diversification standards, even if it did not primarily distribute income exempt from state income taxes. See paragraph (c)(4)(i)(B) of rule 2a–7, as amended; see also Proposing Release, *supra* note 6, at nn.66–68 and accompanying text.

[84] See Proposing Release, *supra* note 6, at nn.69–71 and accompanying text. Under the amended rule, a standby commitment that meets the definition of a demand feature must be treated as such. See paragraph (a)(8) of rule 2a–7, as amended (definition of ''demand feature''). A standby commitment that is not a demand feature is not subject to the rule's credit quality or diversification standards.

[85] Paragraph (c)(6)(i)(A)(*2*) of rule 2a–7, as amended; see Proposing Release, *supra* note 6, at n.72 and accompanying text.

[86] Paragraph (c)(10)(iii) of rule 2a–7, as amended; see Proposing Release, *supra* note 6, at nn.74–75 and accompanying text.

[87] Paragraph (b) of rule 2a–7, as amended. The National Securities Markets Improvement Act of 1996 [Pub. L. 104–290, 110 Stat. 3416 (1996)] amended Section 35(d) of the 1940 Act [15 USC 80a–34(d)] to make it unlawful to adopt as a fund name or title, or as a title of fund securities, words that the Commission finds are materially deceptive or misleading, and to authorize the Commission to define names and titles deemed to be ''materially deceptive and misleading.''

II. Amendments to the Advertising Rules Applicable to Money Market Funds

The Commission is adopting amendments to the Commission's money market fund advertising rules and forms to clarify the formula used by money market funds to calculate yield and to reduce the potential for investors being misled or confused by the presentation of a money market fund's short-term total return.

A. Calculation of Yield

The Commission proposed to amend its money market fund yield formula to clarify that only investment income may be included in the yield of a money market fund. Three commenters supported the amendment; one opposed it and urged the Commission to specifically permit inclusion of non-investment income. The Commission is concerned that inclusion of non-investment income will distort yield and diminish the utility of money market fund yield to investors. The Commission, therefore, has decided to adopt the proposed amendment to the money market fund yield formula.[88]

B. Use of Total Return

The Proposing Release noted that some money market fund advertisements have used short-term total return instead of yield and expressed concern that many investors may not understand the difference.[89] The Commission proposed to amend its rules to require that total return quotations in advertisements and sales literature cover a period of at least one year, and that such quotations be accompanied by a quotation of current yield, computed in accordance with Commission rules and set forth with equal prominence.

All commenters that addressed this proposal objected to the proposed requirement that total return quotations cover at least one year. They argued that the proposal would preclude total return quotations during a fund's first year and in other circumstances in which the purpose of the advertisement was other than to circumvent the Commission's yield formula. The Commission has decided not to require all money market fund total return quotations to cover a period of one year. Instead, the Commission is revising its rules to require that (i) quotations of total return be accompanied by quotations of current yield and that both quotations be placed next to each other and shown in the same size print,[90] and (ii) if there is a material difference between the quoted total return and the quoted yield, a statement that the yield quotation more closely reflects the current earnings of the fund than the total return quotation.[91]

[88] *See* Item 22 of Form N–1A [17 CFR 239.15A and 274.11A], Item 25 of Form N–3 [17 CFR 239.17a and 274.11b], and Item 21 of Form N–4 [17 CFR 239.17b and 274.11c], as amended.

[89] Proposing Release, *supra* note 6, at n.81 and accompanying text. As a result, investors may assume incorrectly that a fund quoting the higher total return figure is a better performing fund than other money market funds quoting yield. For example, during a period of declining interest rates, the fund's total return will be higher than its current yield because it will include periods of time during which the fund held higher yielding securities. In addition, investors may incorrectly assume that the higher ''total return'' is the yield they can expect to receive upon an investment in the fund.

[90] Quotations of total return and current yield in an advertisement delivered electronically must be presented together and in a manner that presents each quotation with identical prominence in light of the particular electronic medium used to transmit the advertisement.

[91] *See* paragraph (d)(2) of rule 482 under the 1933 Act, as amended [17 CFR 230.482(d)(2)]; paragraph (b)(1)(ii)(C) of rule 34b–1 under the 1940 Act, as amended [17 CFR 270.34b–1(b)(1)(ii)(C)].

III. Effective Date/Compliance Date

A. Effective Date

The rule amendments adopted in this Release will become effective February 10, 1998. The Office of Management and Budget has determined that the technical amendments to rule 2a–7 are ''major rules'' and the amendments to the Commission's money market fund advertising rules and forms are ''minor rules'' under Chapter 8 of the Administrative Procedure Act,[92] which was added by the Small Business Regulatory Enforcement Fairness Act of 1996 (''SBREFA'').[93] SBREFA requires all final agency rules to be submitted to Congress for review and requires generally that the effective date of a major rule be delayed for sixty days pending Congressional review. A major rule may become effective at the end of the sixty-day review period, unless Congress passes a joint resolution disapproving the rule.[94]

B. Compliance Dates

The Proposing Release requested comment whether the Commission should provide for a six-month

[92] 5 USC 801.

[93] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996). Under SBREFA, a rule is ''major'' if it is likely to result in (i) an annual effect on the economy of $100 million or more, (ii) a major increase in costs or prices for consumers or individual industries, or (iii) significant adverse effects on competition, investment, or innovation. 5 USC 804(2).

[94] 5 USC 801(a)(3).

transition period for compliance.[95] Commenters supported a six-month period to give fund boards of directors sufficient time to review and approve fund procedures. Several commenters also suggested that the ''grandfathering'' of certain securities provided for by the release adopting the 1996 Amendments be extended,[96] whereas one commenter opposed such extension. The Commission has decided to delay the date for compliance with the amended rule for six months and to extend the ''grandfathering'' of fund investments in certain securities, as described below.

1. General Compliance Date

All money market funds must be in compliance with rule 2a–7, as amended, (and with conforming amendments reflecting the revisions to rule 2a–7) by July 1, 1998, except with respect to ''grandfathered securities'' as provided below.[97] Funds must comply with the amendments to the advertising rules and forms applicable to money market funds by February 10, 1998.

2. ''Grandfathered'' Securities

To minimize disruption to funds and markets as a result of the adoption of these amendments, the Commission is ''grandfathering'' certain securities first issued on or before February 10, 1998 that do not meet the following requirements of the amended rule:

(i) The Rating Requirement for guarantees;[98]

(ii) The Notification Requirement, which provides that, in order for a security subject to a guarantee or demand feature to be an eligible security, the fund must receive notice from the demand feature or guarantee provider (or another institution) if there is a substitution of the provider of the demand feature or guarantee;[99]

(iii) The requirements for ABSs regarding maturity determinations and ratings;[100]

(iv) The requirement that a demand feature and a guarantee include the ability to recover principal and any accrued interest;[101] and

(v) The requirement that a security subject to a conditional demand feature is an eligible security only if the fund's board of directors makes certain determinations regarding the conditional demand feature's exercisability.[102]

A fund may continue to hold these ''grandfathered'' securities or acquire these securities provided that they satisfy the other provisions of the rule, as amended, and are issued on or before February 10, 1998.

IV. Cost/Benefit Analysis and Effects on Competition, Efficiency and Capital Formation

A. Technical Amendments to Rule 2a–7

The technical amendments to rule 2a–7 make refinements and corrections to the 1996 Amendments. They are intended to permit money market funds the maximum amount of flexibility in selecting their investments consistent with the objective of maintaining a stable net asset value. This additional flexibility will promote market efficiency by allowing funds to invest in a wider variety of instruments that present risks consistent with that objective. For example, the technical amendments expand the investment opportunities of funds, without increasing risks, by allowing funds to substitute the credit quality of guarantee providers for the issuers of securities subject to guarantees (instead of only those subject to unconditional demand features) for purposes of compliance with the rule's credit quality standards. By resolving interpretive issues, the technical amendments also address competitive inequities that might arise among funds if, for example, funds draw different conclusions as to the permissibility of a particular investment that may increase fund yield.

As discussed above,[103] the 1996 Amendments tighten the risk-limiting conditions of rule 2a–7 applicable to tax exempt money market funds and clarify the rule's treatment of certain instruments, such as ABSs. The technical amendments potentially will benefit investors to the extent that rule 2a–7, as finally amended, operates to decrease the likelihood that a fund will not maintain a stable net asset value and provides investors greater opportunities to obtain higher yields without exposure to risks inconsistent with their investment expectations.

The costs of the technical amendments to funds and fund advisers (and ultimately fund shareholders) are likely to be minimal, since the amendments do not impose additional procedural requirements or reporting burdens on funds. The Commission believes that the direct or indirect benefits derived from the technical amendments cannot be quantified because it is impossible to predict with certainty how funds will structure their portfolio holdings in response to these amendments.[104] In addition, any costs or benefits are likely to affect not only funds, but also a wide variety of market participants.[105]

In the Proposing Release, the Commission requested specific comment on the costs and benefits associated with the proposals. No commenters provided specific estimates of any costs or benefits. One noted generally the increase in time and costs incurred to document compliance with rule 2a–7 since 1991, and suggested that procedural requirements focus less on periodic reviews of existing information and more on actions required by a board or fund managers in response to new information.[106] In response to these

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[95] *See* Proposing Release, *supra* note 6, at nn.84–85 and accompanying text.

[96] The 1996 Amendments ''grandfathered'' fund investments in certain securities issued on or before June 3, 1996.

[97] Rule 2a–7 requires a fund to meet the rule's diversification standards with respect to a particular issuer on the date the fund acquires a security of that issuer. Paragraphs (c)(4)(i) and (ii) (with respect to issuer diversification) and (c)(4)(iii) and (iv) (with respect to diversification of demand features and guarantees) of rule 2a–7, as amended. A tax exempt fund holding a greater percentage of its total assets in the securities of an issuer than the applicable diversification standard permits as of July 1, 1998 may not purchase additional securities or ''roll over'' current holdings until the purchase or roll over of such securities will not cause the fund to exceed the applicable diversification standards immediately after the purchase or roll over. Funds are not required to exercise puts or otherwise dispose of portfolio holdings to meet the new diversification standards.

[98] Paragraph (a)(10)(iii)(A) of rule 2a–7, as amended.

[99] Paragraph (a)(10)(iii)(B) of rule 2a–7, as amended.

[100] Paragraphs (a)(8)(ii) (definition of demand feature for ABSs) and (a)(10)(ii)(B) (rating requirement for ABSs) of rule 2a–7, as amended. Funds are required, however, to apply the issuer diversification standards for ABSs in accordance with Section I.B.3.b. of this Release, *supra. See* paragraph (c)(4)(ii)(D) of rule 2a–7, as amended.

[101] Paragraphs (a)(8) and (a)(15) of rule 2a–7, as amended.

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

[103] *See supra* Section I.A. of this Release.

[104] For example, many money market funds currently do not invest in ABSs, or invest only in those ABSs that do not raise the diversification issues addressed in this Release. The Commission expects that more funds will invest in ABSs, although there is no empirical basis for predicting the size of that expected effect.

[105] Many of the complex money market fund instruments affected by the technical amendments are specifically designed to comply with rule 2a–7. The primary effect of the amendments will be to change how those instruments are structured, rather than to prohibit funds from investing in currently-available money market instruments. Thus, to the extent the amendments impose costs or provide benefits, these costs and benefits may be shared by funds, investors, issuers, and the investment banks or other entities that structure money market instruments.

[106] The technical amendments do not require additional periodic reviews. The rule's procedural requirements, including periodic reviews of certain determinations, were adopted before the proposal of the technical amendments. The costs and benefits of these procedures were analyzed previously in

concerns, the technical amendments create exceptions to the rule's periodic review requirements when those requirements are not necessary to prevent the fund from inadvertently holding ineligible securities.[107]

Section 2(c) of the 1940 Act provides that whenever the Commission is engaged in rulemaking and is required to consider whether an action is necessary or appropriate in the public interest, the Commission also must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[108] For the reasons stated in the cost/benefit analysis above, the Commission has concluded that the technical amendments will promote efficiency, competition and capital formation.

B. Amendments to Advertising Rules Applicable to Money Market Funds

The amendments to the Commission's advertising rules and forms applicable to money market funds are designed to clarify the formula used by money market funds to calculate yield and reduce the potential for investors being misled or confused by the presentation of a money market fund's short-term total return. They benefit funds and fund investors by clarifying the yield formula and codifying accepted practices under the current rules. The amendments are intended to preserve the consistency of advertised yield and to maintain the ability of investors to compare yields quoted by various funds.

The Commission anticipates that the costs of these amendments to funds and investors are likely to be minimal. No commenters responded to the Commission's request for specific estimates of costs or benefits associated with the proposed rule amendments. One commenter stated that the proposal to clarify that only investment income may be included in a fund's yield would benefit neither funds nor investors, because it would discourage funds from identifying sources of safe, non-investment income, encourage funds to increase yield through riskier investments, and deprive investors of information regarding consistent sources of non-investment income.[109] The Commission believes, however, that the rule will benefit investors by ensuring that a money market fund's yield is consistently advertised and represents only income that reflects the performance of the fund's investment portfolio.[110]

V. Paperwork Reduction Act

As set forth in the Proposing Release, certain provisions of the amendments adopted in this Release contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[111] The collection of information requirements contained in these amendments were submitted to the Office of Management and Budget (''OMB'') for review in accordance with section 3507(d) of the PRA. The title for the collection of information is ''Rules Regulating Money Market Funds.'' The collection of information requirements are in accordance with section 3507 of the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the agency displays a valid OMB control number. OMB approved the PRA submission with respect to these amendments and assigned OMB control numbers with respect to the rules amended by this Release.[112]

Responses to the collection of information requirements for the rules and forms amended by this Release are mandatory. The collection of information requirements under rule 2a–7 are designed to enable the Commission staff to ascertain a money market funds' compliance with the rule and ensure that funds have in place procedures for collecting information necessary to make the required determinations regarding portfolio securities. Most responses required by rule 2a–7 and requested by or submitted to the Commission will be kept confidential to the extent permitted by relevant statutory and regulatory provisions.[113] The collection of information required by rule 34b–1, rule 482, Form N–1A, Form N–3 and Form N–4, and which is disclosed in fund prospectuses, registration statements and advertisements, is public and is not kept confidential by the Commission.

The Supporting Statement to this Paperwork Reduction Act submission notes that, because the technical amendments to rule 2a–7 clarify existing reporting and recordkeeping obligations, it is estimated that they will have no effect on the annual reporting burden of money market funds. The amendments to the advertising rules and forms applicable to money market funds are estimated to impose no substantive additional paperwork burdens on funds. The Commission is aware of only one money market fund that has sought to include income other than investment income in its yield calculation, and very few money market funds that quote any type of total return in their advertisements. If total return is quoted, however, an insignificant additional burden is required only if the quoted yield differs materially from quoted total return, which the Commission believes occurs infrequently.

VI. Summary of Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis (''IRFA'') regarding the proposed amendments, which was prepared in accordance with 5 U.S.C 603, was published in the Proposing Release. No comments were received on the IRFA. The Commission has prepared a Final Regulatory Flexibility Analysis (''FRFA'') in accordance with 5 U.S.C 604 regarding the adoption of technical amendments to rule 2a–7 and the adoption of amendments to the Commission's advertising rules applicable to money market funds.

The FRFA discusses the need for, and objectives of, the rule amendments. The FRFA explains that the technical amendments to rule 2a–7 address many of the questions and issues raised by industry participants after the adoption of the 1996 Amendments. The objective of the technical amendments is to refine

connection with the adoption of rule 2a–7 in 1983, and in connection with amendments to rule 2a–7 in 1986, 1991 and 1996.

[107] For example, the amended rule does not require periodic determinations of the number of ten percent obligors of an ABS that the board determines will never have, or is unlikely to have, ten percent obligors. *See* paragraphs (c)(9)(iv) and (c)(10)(v) of rule 2a–7, as amended.

[108] 15 USC 80a–2(c).

[109] According to this commenter, the inability to advertise non-investment income also would have an adverse effect on competition in the industry.

[110] The Commission believes that it is not relevant to consider the costs to funds identified by the commenter in connection with these amendments. The amendments are intended to clarify the existing money market fund yield formula, and as noted in the Proposing Release, the existing yield formula does not permit the inclusion of non-investment income in yield. *See* Proposing Release, *supra* note 6, at n.83 and accompanying text. In addition, the Commission believes that any such costs are in fact quite limited, since it is aware of only one fund that has sought to include non-investment income in its calculation of yield.

[111] 44 U.S.C 3501—3520.

[112] OMB control numbers are as follows: rule 2a–7 (3235–0268, expires Mar. 31, 2000); rule 34b–1 (3235–0346, expires Mar. 31, 2000); rule 482 (3235–0074, expires Mar, 31, 2000); Form N–1A (3235–0307, expires May 31, 2000); Form N–3 (3235–0316, expires Mar. 31, 2000); and Form N–4 (3235–0318, expires Apr. 30, 2000).

[113] If the board of directors takes action with respect to defaulted securities, events of insolvency or deviations in share price, however, funds must file an exhibit to Form N-SAR describing the action. This collection of information under rule 2a–7 is public and is not kept confidential by the Commission. See paragraph (c)(10)(vii) of rule 2a–7, as amended.

and correct the 1996 Amendments, and thereby permit money market funds the maximum amount of flexibility in selecting their investments consistent with the objective of maintaining a stable net asset value. The FRFA explains that the amendments to the advertising rules applicable to money market funds clarify that only investment income may be included in the yield of a money market fund and reduce the potential for investors being misled or confused by the presentation of a money market fund's short-term total return.

The FRFA estimates that out of the approximately 650 investment companies registered with the Commission that have one or more portfolios that are money market funds, a total of 130 would be considered small entities. The FRFA indicates that the technical amendments to rule 2a–7 and the amendments to the advertising rules and forms applicable to money market funds would effect small entities in the same manner as other funds subject to these rules.

The FRFA explains that neither the technical amendments to rule 2a–7 nor the amendments to the advertising rules applicable to money market funds impose any substantive additional reporting, recordkeeping or other compliance burdens. Finally, the FRFA states that in adopting the amendments the Commission considered (a) the establishment of differing compliance requirements that take into account the resources available to small entities; (b) simplification of the requirements for small entities; (c) the use of performance rather than design standards; and (d) an exemption from the rules for small entities. The FRFA states that the Commission concluded that different requirements for small entities with respect to either the technical amendments to rule 2a–7 or the amendments to the advertising rules applicable to money market funds are unnecessary and would be inconsistent with investor protection, and that the adopted amendments are not design standards.

Cost/benefit information reflected in the ''Cost/Benefit Analysis'' section of this Release also is reflected in the FRFA. A copy of the FRFA may be obtained by contacting David P. Mathews, Senior Counsel, Mail Stop 10–2, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

VII. Statutory Authority

The Commission is amending rule 2a–7 and the advertising rules and forms applicable to money market funds under the exemptive and rulemaking authority set forth in sections 6(c) [15 USC 80a–6(c)], 8(b) [15 USC 80a–8(b)], 22(c) [15 USC 80a–22(c)], 34(b) [15 USC 80a–33(b)], 35(d) [15 USC 80a–34(d)] and 38(a) [15 USC 80a–37(a)] of the Investment Company Act of 1940. The authority citations for the amendments to the rules and forms precede the text of the amendments.

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 230.482 is amended by revising paragraph (d) to read as follows:

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

* * * * *

(d) In the case of a money market fund:

(1) Any quotation of the money market fund's yield in an advertisement shall be based on the methods of computation prescribed in Form N–1A (§§ 239.15A and 274.11A of this chapter), Form N–3 (§§ 239.17a and 274.11b of this chapter), or Form N–4 (§§ 239.17b and 274.11c of this chapter) and may include:

(i) A quotation of current yield that identifies the length of and the date of the last day in the base period used in computing that quotation; or

(ii) A quotation of effective yield if it appears in the same advertisement as a quotation of current yield and each quotation relates to an identical base period and is presented with equal prominence.

(2) Accompany any quotation of the money market fund's total return in an advertisement with a quotation of the money market fund's current yield under paragraph (d)(1)(i) of this section. Place the quotations of total return and current yield next to each other, in the same size print, and if there is a material difference between the quoted total return and the quoted current yield, include a statement that the yield quotation more closely reflects the current earnings of the money market fund than the total return quotation.

* * * * *

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

3. The general authority citation for Part 270 is revised to read as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(b), 80a–37, 80a–39 unless otherwise noted;

* * * * *

4. Section 270.2a–7 is revised to read as follows:

§ 270.2a–7 Money market funds.

(a) *Definitions.*

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

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

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

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

(5) *Collateralized Fully* in the case of a repurchase agreement means that:

(i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the money market fund reasonably could

expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price (as defined in paragraph (a)(5)(v) of this section) provided in the agreement;

(ii) The money market fund or its custodian either has actual physical possession of the collateral or, in the case of a security registered on a book entry system, the book entry is maintained in the name of the money market fund or its custodian;

(iii) The collateral consists entirely of cash items, Government Securities or other securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the Requisite NRSROs; and

(iv) Upon an Event of Insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller.

(v) *Resale Price* means the Acquisition price paid to the seller of the securities plus the accrued resale premium on such Acquisition price. The accrued resale premium shall be the amount specified in the repurchase agreement or the daily amortization of the difference between the Acquisition price and the resale price specified in the repurchase agreement.

(6) *Conditional Demand Feature* means a Demand Feature that is not an Unconditional Demand Feature. A Conditional Demand Feature is not a Guarantee.

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

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

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

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

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

(8) *Demand Feature* means:

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

(A) At any time on no more than 30 calendar days' notice; or

(B) At specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice; or

(ii) A feature permitting the holder of an Asset Backed Security unconditionally to receive principal and interest within 397 calendar days of making demand.

(9) *Demand Feature Issued By A Non-Controlled Person* means a Demand Feature issued by:

(i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature (*control* means ''control'' as defined in section 2(a)(9) of the Act (15 U.S.C. 80a–2(a)(9)); or

(ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.

(10) *Eligible Security* means:

(i) A Rated Security with a remaining maturity of 397 calendar days or less that has received a rating from the Requisite NRSROs in one of the two highest short-term rating categories (within which there may be sub-categories or gradations indicating relative standing); or

(ii) An Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(10)(i) of this section, as determined by the money market fund's board of directors; *Provided, however,* that:

(A) A security that at the time of issuance had a remaining maturity of more than 397 calendar days but that has a remaining maturity of 397 calendar days or less and that is an Unrated Security is not an Eligible Security if the security has received a long-term rating from any NRSRO that is not within the NRSRO's three highest long-term ratings categories (within which there may be sub-categories or gradations indicating relative standing), unless the security has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories;

(B) An Asset Backed Security (other than an Asset Backed Security substantially all of whose Qualifying Assets consist of obligations of one or more Municipal Issuers, as that term is defined in paragraph (a)(7) of this section) shall not be an Eligible Security unless it has received a rating from an NRSRO.

(iii) In addition, in the case of a security that is subject to a Demand Feature or Guarantee:

(A) The Guarantee has received a rating from an NRSRO or the Guarantee is issued by a guarantor that has received a rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee, *unless*:

(*1*) The Guarantee is issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security subject to the Guarantee (other than a sponsor of a Special Purpose Entity with respect to an Asset Backed Security);

(*2*) The security subject to the Guarantee is a repurchase agreement that is Collateralized Fully; or

(*3*) The Guarantee is itself a Government Security; and

(B) The issuer of the Demand Feature or Guarantee, or another institution, has undertaken promptly to notify the holder of the security in the event the Demand Feature or Guarantee is substituted with another Demand Feature or Guarantee (if such substitution is permissible under the terms of the Demand Feature or Guarantee).

(11) *Event of Insolvency* means, with respect to a person:

(i) An admission of insolvency, the application by the person for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; or

(ii) The institution of similar proceedings by another person which proceedings are not contested by the person; or

(iii) The institution of similar proceedings by a government agency responsible for regulating the activities of the person, whether or not contested by the person.

(12) *First Tier Security* means any Eligible Security that:

(i) Is a Rated Security that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); or

(ii) Is an Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(12)(i) of this section, as determined by the fund's board of directors; or

(iii) Is a security issued by a registered investment company that is a money market fund; or

(iv) Is a Government Security.

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

(14) *Government Security* means any ''Government security'' as defined in section 2(a)(16) of the Act (15 U.S.C. 80a–2(a)(16)).

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

(16) *Guarantee Issued By A Non-Controlled Person* means a Guarantee issued by:

(i) A person that, directly or indirectly, does *not* control, and is not controlled by or under common control with the issuer of the security subject to the Guarantee (*control* means ''control'' as defined in section 2(a)(9) of the Act (15 U.S.C. 80a–2(a)(9)); or

(ii) A sponsor of a Special Purpose Entity with respect to an Asset Backed Security.

(17) *NRSRO* means any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi)(E), (F) and (H) of § 240.15c3–1 of this Chapter, that is not an ''affiliated person,'' as defined in section 2(a)(3)(C) of the Act (15 U.S.C. 80a–2(a)(3)(C)), of the issuer of, or any insurer or provider of credit support for, the security.

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

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

(i) The security has received a short-term rating from an NRSRO, or has been issued by an issuer that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security; or

(ii) The security is subject to a Guarantee that has received a short-term rating from an NRSRO, or a Guarantee issued by a guarantor that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the Guarantee; but

(iii) A security is not a Rated Security if it is subject to an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement as provided in paragraph (a)(19)(i) of this section, or the credit support agreement with respect to the security has received a short-term rating as provided in paragraph (a)(19)(ii) of this section.

(20) *Refunded Security* means a debt security the principal and interest payments of which are to be paid by Government Securities (''deposited securities'') that have been irrevocably placed in an escrow account pursuant to agreement between the issuer of the debt security and an escrow agent that is not an ''affiliated person,'' as defined in section 2(a)(3)(C) of the Act (15 U.S.C. 80a–2(a)(3)(C)), of the issuer of the debt security, and, in accordance with such escrow agreement, are pledged only to the payment of the debt security and, to the extent that excess proceeds are available after all payments of principal, interest, and applicable premiums on the Refunded Securities, the expenses of the escrow agent and, thereafter, to the issuer or another party; *provided* that:

(i) The deposited securities shall not be redeemable prior to their final maturity;

(ii) The escrow agreement shall prohibit the substitution of the deposited securities unless the substituted securities are Government Securities; and

(iii) At the time the deposited securities are placed in the escrow account, or at the time a substitution of the deposited securities is made, an independent certified public accountant shall have certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities; *Provided, however,* an independent public accountant need not have provided the certification described in this paragraph (a)(20)(iii) if the security, as a Refunded Security, has received a rating from an NRSRO in the highest category for debt obligations (within which there may be sub-categories or gradations including relative standing).

(21) *Requisite NRSROs* means:

(i) Any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or

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

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

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

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

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

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

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

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

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

(b) *Holding Out and Use of Names and Titles.* (1) It shall be an untrue statement of material fact within the meaning of section 34(b) of the Act (15 U.S.C. 80a–33(b)) for a registered investment company, in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Act, including any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by section 24(b) of the Act (15 U.S.C. 80a–24(b)), to hold itself out to investors as a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of this section.

(2) It shall constitute the use of a materially deceptive or misleading name or title within the meaning of section 35(d) of the Act (15 U.S.C. 80a–34(d)) for a registered investment company to adopt the term ''money market'' as part of its name or title or the name or title of any redeemable securities of which it is the issuer, or to adopt a name that suggests that it is a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this section.

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

(c) *Share Price Calculations.* The current price per share, for purposes of distribution, redemption and repurchase, of any redeemable security issued by any registered investment company (''money market fund'' or ''fund''), notwithstanding the requirements of section 2(a)(41) of the Act (15 U.S.C. 80a–2(a)(41)) and of §§ 270.2a–4 and 270.22c–1 thereunder, may be computed by use of the Amortized Cost Method or the Penny-Rounding Method; *Provided, however,* that:

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

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

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

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

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

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

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

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

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

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

(iv) *Securities Subject to Conditional Demand Features.* A security that is subject to a Conditional Demand Feature (''Underlying Security'') may be determined to be an Eligible Security or a First Tier Security only if:

(A) The Conditional Demand Feature is an Eligible Security or First Tier Security, as the case may be;

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

(*1*) The conditions limiting exercise either can be monitored readily by the fund, or relate to the taxability, under federal, state or local law, of the interest payments on the security; or

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

(C) The Underlying Security or any Guarantee of such security (or the debt securities of the issuer of the Underlying Security or Guarantee that are comparable in priority and security with the Underlying Security or Guarantee) has received either a short-term rating or a long-term rating, as the case may be, from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories (within which there may be sub-categories or gradations indicating relative standing) or, if unrated, is determined to be of comparable quality by the money market fund's board of directors to a security that has received a rating from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories, as the case may be.

(4) *Portfolio Diversification*—(i) *Issuer Diversification.* The money market fund shall be diversified with respect to issuers of securities Acquired by the fund as provided in paragraphs (c)(4)(i) and (c)(4)(ii) of this section, other than

with respect to Government Securities and securities subject to a Guarantee Issued By A Non-Controlled Person.

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

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

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

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

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

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

(B) *Refunded Securities.* The Acquisition of a Refunded Security shall be deemed to be an Acquisition of the escrowed Government Securities.

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

(D) *Asset Backed Securities*—(*1*) *General.* An Asset Backed Security Acquired by a fund (''Primary ABS'') shall be deemed to be issued by the Special Purpose Entity that issued the Asset Backed Security, *Provided, however*:

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

(*ii*) *Holdings of Secondary ABS.* If a Ten Percent Obligor of a Primary ABS is itself a Special Purpose Entity issuing Asset Backed Securities (''Secondary ABS''), any Ten Percent Obligor of such Secondary ABS also shall be deemed to be an issuer of the portion of the Primary ABS that such Ten Percent Obligor represents.

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

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

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

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

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

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

(C) *Demand Features or Guarantees Issued by Non-Controlled Persons.* Immediately after the Acquisition of any security subject to a Demand Feature or Guarantee, a money market fund shall not have invested more than ten percent of its Total Assets in securities issued by, or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee, unless, with respect to any security subject to Demand Features or Guarantees from that institution (other than securities issued by such institution), the Demand Feature or Guarantee is a Demand Feature or Guarantee Issued By A Non-Controlled Person.

(iv) *Demand Feature and Guarantee Diversification Calculations*—(A) *Fractional Demand Features or Guarantees.* In the case of a security subject to a Demand Feature or Guarantee from an institution by which the institution guarantees a specified portion of the value of the security, the institution shall be deemed to guarantee the specified portion thereof.

(B) *Layered Demand Features or Guarantees.* In the case of a security subject to Demand Features or Guarantees from multiple institutions that have not limited the extent of their obligations as described in paragraph (c)(4)(iv)(A) of this section, each

institution shall be deemed to have provided the Demand Feature or Guarantee with respect to the entire principal amount of the security.

(v) *Diversification Safe Harbor.* A money market fund that satisfies the applicable diversification requirements of paragraphs (c)(4) and (c)(5) of this section shall be deemed to have satisfied the diversification requirements of section 5(b)(1) of the Act (15 U.S.C. 80a–5(b)(1)) and the rules adopted thereunder.

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

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

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

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

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

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

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

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

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

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

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

(iii) *Notice to the Commission.* In the event of a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Demand Feature or Guarantee to which it is subject, where immediately before default the securities (or the securities subject to the Demand Feature or Guarantee) accounted for ½ of 1 percent or more of a money market fund's Total Assets, the money market fund shall promptly notify the Commission of such fact and the actions the money market fund intends to take in response to such situation. Notification under this paragraph shall be made telephonically, or by means of a facsimile transmission or electronic mail, followed by letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management.

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

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

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

(7) *Required Procedures: Amortized Cost Method.* In the case of a money market fund using the Amortized Cost Method:

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

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

(A) *Shadow Pricing.* Written procedures shall provide:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(vi) *Evaluations with Respect to Securities Subject to Demand Features or Guarantees.* For a period of not less

than three years from the date when the evaluation was most recently made, a written record shall be preserved and maintained, in an easily accessible place, of the evaluation required by paragraph (c)(9)(ii) (regarding securities subject to one or more Demand Features or Guarantees) of this section.

(vii) *Inspection of Records.* The documents preserved pursuant to this paragraph (c)(10) shall be subject to inspection by the Commission in accordance with section 31(b) of the Act (15 U.S.C. 80a–30(b)) as if such documents were records required to be maintained pursuant to rules adopted under section 31(a) of the Act (15 U.S.C. 80a–30(a)). If any action was taken under paragraphs (c)(6)(ii) (with respect to defaulted securities and events of insolvency) or (c)(7)(ii) (with respect to a deviation from the fund's share price of more than 1/2 of 1 percent) of this section, the money market fund will file an exhibit to the Form N–SAR (17 CFR 274.101) filed for the period in which the action was taken describing with specificity the nature and circumstances of such action. The money market fund will report in an exhibit to such Form any securities it holds on the final day of the reporting period that are not Eligible Securities.

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

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

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

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

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

(5) *Long-Term Floating Rate Securities.* A Floating Rate Security, the principal amount of which is scheduled to be paid in more than 397 calendar days, that is subject to a Demand Feature, shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.

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

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

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

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

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

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

5. Section 270.2a41–1 is amended by revising the introductory text of paragraph (a) to read as follows:

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

(a) A standby commitment means a right to sell a specified underlying security or securities within a specified period of time and at an exercise price equal to the amortized cost of the underlying security or securities plus accrued interest, if any, at the time of exercise, that may be sold, transferred or assigned only with the underlying security or securities. A standby commitment entitles the holder to receive same day settlement, and will be considered to be from the party to whom the investment company will look for payment of the exercise price. A standby commitment may be assigned a fair value of zero, Provided, That:

* * * * *

6. Section 270.12d3–1 is amended by revising paragraph (d)(7)(v) to read as follows:

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

* * * * *

(d) * * *

(7) * * *

(v) Acquisition of Demand Features or Guarantees, as these terms are defined in §§ 270.2a–7(a)(8) and 270.2a–7(a)(15) respectively, provided that, immediately after the acquisition of any Demand Feature or Guarantee, the company will not, with respect to 75 percent of the total value of its assets, have invested more than ten percent of the total value of its assets in securities underlying Demand Features or Guarantees from the same institution. For the purposes of this section, a Demand Feature or Guarantee will be considered to be from the party to whom the company will look for payment of the exercise price.

* * * * *

7. Section 270.17a–9 is amended by revising the cite to ''paragraph (a)(9)'' in the introductory paragraph to read ''paragraph (a)(10)''.

8. Section 270.31a–1 is amended by revising the last sentence of paragraph (b)(1) to read as follows:

§ 270.31a–1 Records to be maintained by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.

* * * * *

(b) * * *

(1) * * * In the case of a money market fund, also identify the provider of any Demand Feature or Guarantee (as defined in § 270.2a–7(a)(8) or § 270.2a–7(a)(15) respectively) and give a brief description of the nature of the Demand Feature or Guarantee (*e.g.*, unconditional demand feature, conditional demand feature, letter of credit, or bond insurance) and, in a subsidiary portfolio investment record, provide the complete legal name and accounting and other information (including sufficient information to calculate coupons, accruals, maturities, puts, and calls) necessary to identify, value, and account for each investment.

* * * * *

9. Section 270.34b–1 is amended by revising paragraph (b) (the Note remains unchanged) to read as follows:

§ 270.34b–1 Sales literature deemed to be misleading.

* * * * *

(b)(1) Except as provided in paragraph (b)(3) of this section:

(i) In any sales literature that contains performance data for an investment company, include the disclosure required by paragraph (a)(6) of § 230.482 of this chapter.

(ii) In any sales literature for a money market fund:

(A) Accompany any quotation of yield or similar quotation purporting to demonstrate the income earned or distributions made by the money market fund with a quotation of current yield specified by paragraph (d)(1)(i) of § 230.482 of this chapter;

(B) Accompany any quotation of tax equivalent yield or other similar quotation purporting to demonstrate the tax equivalent yield earned or distributions made by the money market fund with a quotation of current yield specified in paragraph (d)(1)(i) of § 230.482 of this chapter; and

(C) Accompany any quotation of the money market fund's total return with a quotation of the money market fund's current yield specified in paragraph (d)(1)(i) of § 230.482 of this chapter. Place the quotations of total return and current yield next to each other, in the same size print, and if there is a material difference between the quoted total return and the quoted current yield, include a statement that the yield quotation more closely reflects the current earnings of the money market fund than the total return quotation.

(iii) In any sales literature for an investment company other than a money market fund that contains performance data:

(A) Include the total return information required by paragraph (e)(3) of § 230.482 of this chapter;

(B) Accompany any quotation of yield or similar quotation purporting to demonstrate the income earned or distributions made by the company with a quotation of current yield specified by paragraph (e)(1) of § 230.482 of this chapter; and

(C) Accompany any quotation of tax equivalent yield or other similar quotation purporting to demonstrate the tax equivalent yield earned or distributions made by the company with a quotation of tax equivalent yield specified in paragraph (e)(2) and current yield specified by paragraph (e)(1) of § 230.482 of this chapter.

(2) Any performance data included in sales literature under paragraphs (b)(1)(ii) or (iii) of this section must meet the currentness requirements of paragraph (f) of § 230.482 of this chapter.

(3) The requirements specified in paragraph (b)(1) of this section shall not apply to any quarterly, semi-annual, or annual report to shareholders under Section 30 of the Act (15 U.S.C. 80a–29), containing performance data for a period commencing no earlier than the first day of the period covered by the report; nor shall the requirements of paragraphs (e)(3)(ii) and (f) of § 230.482 of this chapter apply to any such periodic report containing any other performance data.

* * * * *

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

10. The authority citation for part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77sss, 78c, 78*l*, 78m, 78n, 78o(d), 78u–5, 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.

* * * * *

11. 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.

12. Part B, Item 22(a) of Form N–1A (referenced in §§ 239.15A and 274.11A) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase ''and income other than investment income'' after the phrase ''exclusive of capital changes'' in each paragraph.

(b) Adding at the end of Instruction 2 the following: ''Exclude income other than investment income.''

Note: Form N–1A does not and the amendments will not appear in the Code of Federal Regulations.

13. Item 25(a) of Form N–3 (referenced in §§ 239.17a and 274.11b) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase ''and income other than investment income'' after the phrase ''exclusive of capital changes'' in each paragraph.

(b) Adding at the end of Instruction 3 the following: ''Exclude income other than investment income.''

Note: Form N–3 does not and the amendments will not appear in the Code of Federal Regulations.

14. Guide 38 to Form N–3 (Money Market Fund Investments in Other Money Market Funds) (referenced in §§ 239.17a and 274.11b) is amended by revising the last sentence to read as follows:

* * * Paragraph (c)(4)(ii)(E) of rule 2a–7 describes the obligations of a fund that invests its assets in another money market fund.

Note: Guide 38 to Form N–3 does not and the amendments will not appear in the Code of Federal Regulations.

15. Part B, Item 21(a) of Form N–4 (referenced in §§ 239.17b and 274.11c) is amended by:

(a) Adding in paragraphs (i) and (ii) the phrase ''and income other than investment income'' after the phrase ''exclusive of capital changes'' in each paragraph.

(b) Adding at the end of Instruction 3 the following: ''Exclude income other than investment income.''

Note: Form N–4 does not and the amendments will not appear in the Code of Federal Regulations.

By the Commission.

Dated: December 2, 1997.

Margaret H. McFarland,

Deputy Secretary.

Note: The following Appendix will not appear in the Code of Federal Regulations.

BILLING CODE 8010–01–P

APPENDIX

Illustration: Guarantee and Demand Feature Diversification Calculations For Securities Subject to Multiple Demand Features and Guarantees[1]

With respect to securities subject to multiple demand features or guarantees upon which a fund is relying, a fund must first analyze each credit enhancement provider individually to determine whether securities issued by or subject to demand features or guarantees from the same provider exceed ten percent of total assets. If so, then those securities are placed in the twenty-five percent basket. Once placed in the basket, however, the value of each security is counted only once for purposes of calculating the amount of the twenty-five percent basket available for additional investments.

FACTS: A fund invests 9% of its total assets in Security A, which is guaranteed by a letter of credit ("LOC") issued by ABC Bank and subject to a conditional demand feature issued by XYZ Bank. The fund invests 5% of its total assets in Security B, which is guaranteed by a LOC issued by ABC Bank. The fund invests 5% of its total assets in Security C, which is subject to a conditional demand feature issued by XYZ Bank. Assume that the fund holds no other securities subject to guarantees or demand features provided by ABC Bank or XYZ Bank and that no other entity has guaranteed, or issued conditional demand features with respect to, over 10% percent of the fund's assets.

ANALYSIS: For purposes of the demand feature and guarantee diversification standards:

- 14% percent of the fund's total assets (Securities A and B) are subject to guarantees or demand features from ABC Bank. 14% of the fund's total assets (Securities A and C) are subject to guarantees or demand features from XYZ Bank.

- The fund must include Securities A, B and C in its twenty-five percent basket. The amount of investments in the twenty-five percent basket is calculated to be 19% of the fund's total assets (9% + 5% + 5%). This represents the aggregate value of all of the fund's securities subject to guarantees and demand features issued by ABC Bank and XYZ Bank.

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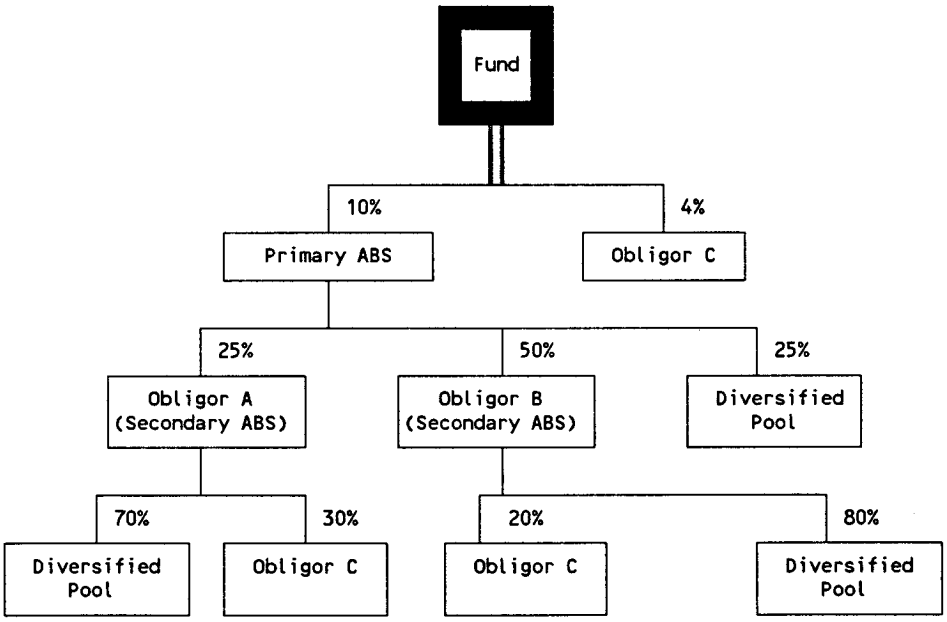
[1] See Section I.B.3.b.iv. of the Release (discussing the twenty five percent basket with respect to the demand feature and guarantee diversification standards).

Illustration: "Look-Through" to Secondary ABSs Under the Rule's ABS Issuer Diversification Standards[2]

Any ten percent obligor of a primary or secondary ABS is deemed to have issued a portion of the assets of the primary ABS that such ten percent obligor represents. To prevent double counting, obligations of each ten percent obligor are netted against the obligations of the special purpose entity ("SPE") for which it is a ten percent obligor. All netted obligations issued by the same direct or indirect ten percent obligor are aggregated when calculating a fund's total investment in any particular security.

FACTS

A fund invests 10% of its assets directly in an ABS ("Primary ABS") issued by an SPE. The fund also invests 4% of its assets directly in securities issued by Obligor C. Obligor C is not an SPE issuing ABSs. 25% of the Primary ABS's qualifying assets is invested in Obligor A and 50% of the Primary ABS's qualifying assets is invested in Obligor B. Obligor A is an SPE with 30% of its qualifying assets invested in securities issued by Obligor C. Obligor B is an SPE with 20% of its qualifying assets invested in securities issued by Obligor C.[3]



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[2] See Section I.B.3.b.i. of the Release.

[3] Reference to "Diversified Pool" in this illustration means that no other obligor's obligations constitute 10% or more of the pool of qualifying assets of the special purpose entity issuing ABSs.

ANALYSIS

For issuer diversification purposes, the fund has invested as follows:

- 1.75% of fund assets in Obligor A ([25% x 10%] - [30% x 25% x 10%]). The portion indirectly invested in Obligor C through Obligor A (.75%) is netted against the portion indirectly invested in Obligor A (2.5%).

- 4% of fund assets in Obligor B ([50% x 10%] - [20% x 50% x 10%]). The portion indirectly invested in Obligor C through Obligor B (1%) is netted against the portion indirectly invested in Obligor B (5%).

- 5.75% of fund assets in Obligor C ([[30% x 25% x 10%] + [20% x 50% x 10%]] + 4%). The portion indirectly invested in Obligor C (1.75%) (i.e., .75% through Obligor A + 1% through Obligor B) is added to the amount directly invested in Obligor C (4%).[4] In this example, the fund's investment in Obligor C would exceed the 5% limit on investments in securities of a single issuer.[5]

- 2.5% of fund assets in the Primary ABS (10% - [1.75% + 4% + 1.75%]). The portion deemed indirectly invested in Obligors A, B and C through the Primary ABS is netted against the amount directly invested in the Primary ABS.

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[4] If Obligors A or B (i.e., secondary ABSs) had, in addition to Obligor C, another ten percent obligor that was an SPE issuing ABSs (i.e., a "tertiary ABS"), the amended rule would not require the fund to "look through" to the qualifying assets of any ten percent obligors of such "tertiary ABS" for purposes of compliance with the issuer diversification standards.

[5] See paragraph (c)(4)(i)(A) of rule 2a-7, as amended.

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