

Information collection requirement	17 CFR Part or section where identified and described	Current OMB control No.	Expiration date
Form 5-R	§ 279.5	3235-0240	Jan. 31, 1989.
Form 6-R	§ 279.8	3235-0240	Jan. 31, 1989.
Form 7-R	§ 279.7	3235-0240	Jan. 31, 1989.
Add:			
Form N-7	§ 239.18A	3235-0338	June 30, 1988.
Form S-4	§ 239.25	3235-0324	Jul. 31, 1987.
Form N-14	§ 239.23	3235-0336	May 31, 1988.
Form F-4	§ 239.34	3235-0325	Jul. 31, 1987.
Form ET	§ 239.82	3235-0329	Oct. 31, 1986.
Form ID	§ 239.63	3235-0328	Oct. 31, 1986.
Form SE	§ 239.84	3235-0327	Oct. 31, 1986.
Form TA-2	§ 240.102	3235-0337	June 30, 1988.
Form N-SAR	§ 240.330	3235-0330	Mar. 31, 1989.
Form SE	§ 240.444	3235-0327	Oct. 31, 1986.
Form ET	§ 240.445	3235-0329	Oct. 31, 1986.
Form ID	§ 240.448	3235-0328	Oct. 31, 1986.
Form SE	§ 250.603	3235-0327	Oct. 31, 1986.
Form ET	§ 250.601	3235-0329	Oct. 31, 1986.
Form ID	§ 250.602	3235-0328	Oct. 31, 1986.
Form SE	§ 269.7	3235-0327	Oct. 31, 1986.
Form ET	§ 269.5	3235-0329	Oct. 31, 1986.
Form ID	§ 269.8	3235-0328	Oct. 31, 1986.
Rule 2a19-1	§ 270.2a19-1	3235-0332	Dec. 31, 1988.
Rule 26a-3	§ 270.26a-3	3235-0333	Dec. 31, 1987.
Form N-3	§ 274.11b	3235-0316	Apr. 30, 1987.
Form N-4	§ 274.11c	3235-0318	Apr. 30, 1987.
Form N-SAR	§ 274.101	3235-0330	Mar. 31, 1988.
Form SE	§ 274.403	3235-0327	Oct. 31, 1986.
Form ET	§ 274.401	3235-0329	Oct. 31, 1986.
Form ID	§ 274.402	3235-0328	Oct. 31, 1986.
Form N-7	§ 274.12A	3235-0338	June 30, 1988.
Delete:			
Form C-3	§ 239.5	3235-0112	Nov. 30, 1984.
Form S-12	§ 239.19	3235-0112	Nov. 30, 1984.
Form S-14	§ 239.23	3235-0052	Oct. 31, 1984.
Rule 17a-12	§ 240.17a-12	3235-0182	Dec. 31, 1984.
Rule 17a-16	§ 240.17a-16	3235-0038	Sept. 30, 1984.
Rule 17a-17	§ 240.17a-17	3235-0039	Sept. 30, 1984.
Rule 17a-20	§ 240.17a-20	3235-0207	Dec. 31, 1984.
Rule 24b-2	§ 240.24b-2	3235-0127	Nov. 30, 1984.
Form 2-MD	§ 249.402	3235-0215	Dec. 31, 1984.
Form X-17a-12(1)	§ 249.819	3235-0182	Dec. 31, 1984.
Form X-17a-12(2)	§ 249.820	3235-0183	Dec. 31, 1984.
Form X-17a-16(1)	§ 249.831	3235-0038	Sept. 30, 1984.
Form X-17a-16(2)	§ 249.832	3235-0040	Sept. 30, 1984.
Form X-17a-17	§ 249.833	3235-0039	Sept. 30, 1984.
Rule 48(b)	§ 250.48(b)	3235-0156	Dec. 31, 1984.
Form N-1R	§ 274.101	3235-0227	Oct. 31, 1985.
Form N-3DA-2	§ 274.201	3235-0051	Oct. 31, 1984.
Form N-3DA-3	§ 274.103	3235-0051	Oct. 31, 1984.
Form N-SA	§ 274.105	3235-0210	Dec. 31, 1984.
Form N-1Q	§ 274.106	3235-0248	Oct. 31, 1985.

Dated: March 17, 1986.

John Wheeler,
Secretary.

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17 CFR Part 270

[Release No. IC-14983; File No. S7-30-85]

Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Adoption of final rule and rule amendments.

SUMMARY: The Commission is adopting amendments to an existing rule that permits money market funds to use the amortized cost method of valuing their portfolio securities or the penny-rounding method of computing their price per share. The amendments will allow funds relying on the rule to

acquire put options and to treat variable rate or floating rate debt securities with periodic demand features, a type of put option, as short-term debt securities under certain conditions. The amendments also clarify the responsibilities that the existing rule assigns to money market fund directors and allow money market funds to rely on a high quality rating assigned by a nationally recognized statistical rating organization that does not control and is not controlled by or under common control with the issuer of or any insurer, guarantor or provider of credit support for the rated securities.

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

new rule that allows registered investment companies to assign a fair value of zero to standby commitments.

EFFECTIVE DATE: April 21, 1986.

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

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

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

Last July, the Commission proposed amendments to rules 2a-7 and 12d3-1 and adoption of new rule 2a41-1¹ to give money market funds more flexibility to acquire certain types of put options known as demand features and standby commitments. The fifteen commentators on the proposal generally supported the initiative taken by the Commission, but believed that certain aspects of the proposal should be modified or eliminated. Those comments are reflected in the final version of the rule and rule amendments as discussed below.

Subject to specified conditions, rule 2a-7 allows certain open-end investment companies known as money market funds to use either the amortized cost method of valuing their portfolio securities² or the penny-rounding method of pricing their securities.³ The rule requires money market funds using the above methods to limit their investments to instruments that are of high quality and that have a remaining maturity of one year or less. Funds relying on the rule must also maintain

an average dollar-weighted portfolio maturity of no more than 120 days.⁴

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

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

As in the proposal, the amendments permit funds relying on rule 2a-7 to use certain demand features to shorten the maturity of variable and floating rate instruments.⁶ In the final version of the rule, such demand features must entitle the fund to receive the principal amount of the underlying security or securities and must be exercisable either (i) at any time on no more than thirty days' notice;

or (ii) at specified intervals not exceeding one year and upon no more than thirty days' notice. Since the proposal would have prescribed a seven day minimum notice period, a note has been added to the final rule to remind money market fund directors of their responsibility to ensure that the fund has sufficient liquidity.

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

Finally, rule 2a-7 is amended to allow money market funds to rely on a high quality rating if the rating is assigned by a nationally recognized statistical rating organization ("NRSRO") that does not control and is not controlled by or under common control with the issuer of, or any insurer, guarantor or provider of credit support for the securities. The final rule refers only to that aspect of the Act's definition of "affiliated person" that includes any person directly or indirectly controlling, controlled by or under common control with another person and not, as proposed, to all aspects of that definition.⁸

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

¹ See Investment Company Act Release No. 14607 (July 1, 1985) [50 FR 27982] ("proposing release").

² A money market fund using the amortized cost method of valuation values the debt securities in its portfolio and other assets at acquisition cost. The interest earned on each portfolio debt security (plus any discount received or less any premium paid upon purchase) is then accrued ratably over the remaining maturity of the security. By declaring these accruals to its shareholders as a daily dividend, the money market fund is able to set a fixed price per share, which is usually \$1.00.

The final version of the rule retains the description of the amortized cost method that appears in the existing rule. Although the proposal would have clarified that language, the Commission has decided to retain the original language because the commentators expressed so much concern that the proposed change might have some hidden meaning.

³ A money market fund using the penny-rounding pricing method values portfolio securities for which market quotations are readily available at current market value, and other securities and assets at fair value as determined in good faith by the board of directors. The current net asset value per share is then rounded to the nearest one percent, allowing the fund to maintain a fixed price per share (usually \$1.00). Penny-rounding funds may also use the amortized cost valuation method to value portfolio securities having a remaining maturity of sixty days or less. See Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555] adopting the existing rule ("adopting release") at footnote 44, citing Investment Company Act Release No. 9786 (May 31, 1977), 42 FR 28999.

The final version of the rule retains the description of penny-rounding that appears in the existing rule. As in the case of the description of the amortized cost method that appears in the existing rule, the Commission had proposed to describe the penny-rounding method more precisely. The original rule language is retained to assuage commentator concern as to any hidden meaning behind the proposed language change.

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

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

⁶ As proposed, the definitions of variable and floating rate in instruments have been clarified.

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

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

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

to standby commitments under certain conditions.

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

Discussion

A. Amendments to Rule 2a-7

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

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

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

must always be paid at the time of exercise, a result that was not intended.

As in the proposal, a fund relying on the rule may use demand features to shorten the maturity of only variable or floating rate instruments.¹⁰ One commentator suggested that the final rule permit funds to use demand features to shorten the maturity of fixed rate instruments. However, the Commission still believes that an instrument should have an adjustable interest rate, as well as a demand feature, to be treated as a short-term debt security. For example, if a fund using amortized cost decides that exercise of a demand feature is not in the best interests of the fund or if the demand feature cannot be exercised, then the Commission believes that a mechanism must exist that can be reasonably expected to return the value of the instrument to par, *i.e.*, a variable interest rate, or that can reasonably be expected to keep the value of the instrument at par, *i.e.*, a floating interest rate. Otherwise, the market-based value of the instrument could deviate significantly from its amortized cost value after the exercise date.

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

2. *Limitation on puts from a single institution.* The diversification requirements contained in the final amendments to rule 2a-7 track those in section 5(b)(1) of the Act and provide that immediately after the acquisition of any put, a money market fund which uses the amortized cost valuation method may not, with respect to 75 percent of the total amortized cost value of its assets, have more than five percent of its assets invested in securities subject to puts from the same institution. Similarly, in the case of a

money market fund which uses the penny-rounding pricing method, the fund may not, with respect to 75 percent of the total market-based value of its assets, have more than five percent of its assets invested in securities subject to puts from the same institution. In each case, however, the amended rule also tracks rule 5b-2 under the Act and provides that a fund may invest up to ten percent of its assets in unconditional puts and other securities issued by the same institution. An unconditional put is considered to be a put that is exercisable even in the event of a default in the payment of principal or interest on the underlying securities. A put is considered to be from the institution to whom the fund will look for payment of the exercise price.¹²

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

The proposed amendments would have limited funds relying on the rule to investing no more than five percent of their total assets in securities subject to any type of put from the same institution. A number of commentators felt that these proposed limitations were unnecessarily restrictive. Several questioned the need for any separate limitation in rule 2a-7, given the existing diversification requirements imposed by section 5¹⁴ and by subchapter M of the Internal Revenue Code of 1954 ("IRC").¹⁵ Another commentator maintained that the acquisition of puts should not be subject to any diversification requirements, given the relatively small number of financial institutions engaged in issuing puts.

On the other hand, several commentators did not oppose the

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

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

¹⁴ See section 5(b)(1) and rule 5b-2 thereunder.

¹⁵ See 26 U.S.C. 851 *et seq.*

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

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

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

inclusion of a separate limitation in rule 2a-7. One commentator expressly supported the proposed five percent limitation on the grounds that it would prevent money market funds from being subjected to "unnecessary and unintended market risks." Other commentators argued that the proposed five percent limitation should be modified so that it would track the Act's diversification requirements, *i.e.*, the limitation should apply only to 75 percent of the fund's portfolio and the fund should be able to invest up to ten percent of its portfolio in unconditional puts from the same institution. Still other commentators expressed the opinion that funds should be able to invest up to ten percent of their assets in any kind of puts issued by the same institution.

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

The Commission has decided to include a separate diversification requirement in the final version of the rule in order to ensure that a fund's liquidity will not be impaired by relying too heavily upon the same institution or upon only a handful of institutions to support whatever puts are in the fund's

portfolio. However, as described above, the proposed five percent limitation has been clarified and modified to track the Act's diversification requirements.

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

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

The final amendments provide that both the short-term and long-term aspects of a demand instrument must be rated high quality or found by the board to be of high quality¹⁸ unless the

demand feature is unconditional. In that event, the fund may focus only on the short-term quality of the instrument. A demand feature is considered to be unconditional if exercisable even in the event of a default in the payment of principal or interest on the underlying securities.

The proposed amendments would have provided that a fund may use a demand feature to shorten the maturity of a demand instrument only if the demand instrument has a short-term and a long-term high quality rating or is found to be of comparable quality. Several commentators urged the Commission to focus only on the quality of the demand feature, not on the quality of the securities underlying the demand feature. Two commentators believed, however, that this should be the case only if the demand feature is unconditional. In addition, several commentators noted that the quality of the securities underlying a demand feature should still be taken into account when a fund makes its investment decision.¹⁹ Finally, some commentators maintained that a separate quality requirement for demand instruments is unnecessary, given the high quality requirements presently contained in rule 2a-7.

In view of the nature of demand instruments, the Commission continues to believe that rule 2a-7 should separately address the quality requirements that should be applicable to those instruments. Since a demand instrument must be of high quality for a fund relying on the rule to acquire it, as well as to shorten its maturity, this separate requirement has been added to the rule's existing quality requirements, not to the rule's maturity requirements as originally proposed. While the final version of the rule still generally requires a fund to focus on both the long-term and short-term aspects of a demand instrument, an exception is made in the case of demand instruments with unconditional demand features. Where credit support will be provided even in the event of default on the underlying securities, the Commission agrees that a fund should be able to focus only on the quality of the short-

¹⁶ 751 F.2d 1131 (10th Cir. 1984), cert. granted 308 S.Ct. 245 (1985) (No. 84-1972). That case held that a standby letter of credit is a "deposit" for purposes of Federal Deposit Insurance Corporation ("FDIC") insurance. Since federal tax law denies tax-exempt status to municipal debt securities that are guaranteed in whole or in part by the United States Government, the holding in *Philadelphia Gear* could mean the loss of the tax-exempt status of any municipal bond that is supported by a letter of credit issued by an FDIC-insured bank. Such a holding could significantly limit the number of institutions that could continue to provide credit support for tax-exempt issues.

¹⁷ See *supra* note 8.

¹⁸ See proposing release, *supra* note 1, at note 38 for a discussion of the credit factors that the board should examine in making a comparable quality determination. A demand instrument may be considered an unrated security in the event that a rating agency has not taken into account the existence of an external agreement to provide credit support, such as insurance or a letter of credit. Also, where only the long-term or short-term quality has been rated, the board may make a comparable quality determination with regard to the unrated credit aspect.

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

term aspect of the demand instrument—the demand feature. If the quality of any demand instrument falls below the high quality level required by the rule, a fund must dispose of the instrument within a reasonable period of time by exercising the demand feature or by selling the demand instrument on the secondary market, whichever is in the best interests of the fund and its shareholders.

Finally, the quality requirements of the amended rule provide that a standby commitment will be considered to be of high quality if the directors have determined that the issuer of the commitment presents a minimal risk of default. This representation has been routinely made by applicants who have received exemptive relief to acquire standby commitments²⁰ and is added to the rule at the request of one commentator who pointed out that without clarification, it would be difficult for the directors to know how to ascertain whether a standby commitment is of high quality.

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

Open-end investment companies are required to limit their acquisition of illiquid securities to ensure that all redemption requests will be satisfied within the seven day period prescribed by section 22(e) of the Act [15 U.S.C. 80a-22(e)]. In 1989, the Commission took the position that in no event should the percentage of illiquid securities held by an open-end investment company exceed 10% of the market-based value of the company's net assets.²¹ The term "illiquid security" generally includes any security which cannot be disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within seven days.

In the release adopting rule 2a-7, the Commission elaborated upon the responsibilities of money market fund board of directors with regard to the acquisition and valuation of illiquid

securities, noting that because of the nature of money market funds, the difficulties that could arise in conjunction with the purchase of illiquid securities might be even greater than for other types of open-end management investment companies. In particular, the Commission pointed out that money market funds often have a greater and perhaps less predictable volume of redemptions than other open-end investment companies. Further, the portfolio management of a money market fund might be impaired if a fund were forced to meet redemption requests by selling marketable securities that it would otherwise wish to retain in order to avoid attempting to dispose of illiquid portfolio instruments. Finally, the valuation of illiquid securities may potentially overstate or understate the fund's net asset value to the detriment of shareholders. In light of these potential problems, the board of directors of a money market fund relying on the rule must take steps to limit the acquisition of illiquid portfolio instruments to a level lower than the ten percent limit set for other types of open-end investment companies.²²

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

In addition to addressing the proposed notice requirement for periodic demand instruments, several commentators questioned whether the amended rule

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

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

B. Amendment to Rule 12d3-1

As amended, rule 12d3-1 provides exemptive relief to allow registered investment companies to acquire puts, as defined in amended rule 2a-7, from persons engaged in securities related activities. This is in contrast to the proposal that provided exemptive relief only to money market funds that have complied with all of the provisions of rule 2a-7. At the request of two commentators, the proposal has been redrafted so that the final amendment applies to all types of investment companies and conditions exemptive relief upon a company's compliance with the same diversification requirements that are found in amended rule 2a-7. Since these diversification

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

²¹ See Investment Company Act Release No. 5847 (October 21, 1989) [35 FR 19899].

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

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

requirements track those of section 5(b)(1) of the Act and rule 5b-2 thereunder, a diversified fund would not have to take any additional steps to diversify the puts that it has acquired from persons engaged in securities related activities. However, the fund would still have to comply with section 5 with respect to the securities underlying those puts.

C. Rule 2a41-1

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

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Rule and Rule Amendments

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

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

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

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

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

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

(a) * * *

(2) * * *

(iv) The money market fund will limit its portfolio investments, including puts and repurchase agreements, to those United States dollar-denominated

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

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

(3) * * *

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

of credit support for the instrument which the money market fund is considering acquiring, or (B) or, in the case of an instrument that is not rated, of comparable quality as determined by the board of directors. In this regard, a demand instrument must have received both a short-term and a long-term high quality rating or have been determined to be of comparable quality by the board of directors, *except* that a demand instrument that has an unconditional demand feature may be acquired solely in reliance upon a short-term high quality rating or upon a finding of comparable short-term quality by the board of directors. The directors may base a determination that a standby commitment is of comparable quality upon a finding that the issuer of the commitment presents a minimal risk of default.

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

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

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

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

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

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

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

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

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

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

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

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

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

year and upon no more than 30 days' notice.

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

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

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

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

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

Note.—The board of directors of a money market fund relying on this rule is reminded that the Commission has said that "because of the nature of money market funds, the difficulties that could arise in conjunction with the purchase of illiquid instruments by such funds might be even greater than for other types of openend management investment companies. . . . By purchasing or otherwise acquiring illiquid instruments, a money market fund exposes itself to a risk that it will be unable to satisfy redemption requests promptly. . . . In addition, . . . management of the investment company's portfolio could also be affected by the purchase of illiquid instruments. . . . Finally, the purchase of illiquid instruments can seriously complicate the valuation of a money market fund's shares and can result in the dilution of shareholders' interests." See Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 at 32561-32562 July 18, 1983]. See also Investment Company Act Release No. 5847 (October 21, 1989) [35 FR 19989].

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

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

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

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

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

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

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

(d) * * *

(8) * * *

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

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

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

Dated: March 12, 1986.

By the Commission.

Shirley E. Hollis,

Assistant Secretary.

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