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**MONEY MARKET FUNDS
SELECTED ISSUES**

- **The “Approximates Par” Requirement**
- **Mandatory Tenders**
- **Adviser Bailouts**

David A. Sturms
Vedder, Price, Kaufman & Kammholz
Chicago, Illinois
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I. THE “APPROXIMATES PAR” REQUIREMENT

In order to be eligible for purchase by a money market fund, an instrument has to meet various requirements under Rule 2a-7 including, among other things, certain maturity and quality tests. The “approximates par” requirement comes into play when applying the maturity test set forth in paragraph (c)(2)(i), which prohibits a money market fund from acquiring any instrument with a remaining maturity of greater than 397 days.² Ordinarily, money market funds must measure the maturity of a debt instrument by reference to the specified date on which the issuer of the instrument has an unconditional obligation to repay the principal amount owed (typically, the final maturity date). Paragraph (d), however, provides a number of exceptions to this general rule.

- Paragraph (d)(1) provides that “an instrument that is issued or guaranteed by the United States Government or any agency thereof which has a variable rate of interest adjusted no less frequently than every 762 days shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.”
- Paragraph (d)(2) provides that “a Variable Rate Instrument, the principal amount of which is scheduled on the face of the instrument to be paid in 397 calendar days or less shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.”

¹ As of the date of submission of this outline, the SEC has not yet adopted the proposed amendments to Rule 2a-7 set forth in SEC Release IC-19959 (Dec. 17, 1993). The author understands that adoption of the proposed amendments is expected in IQ96, and that those amendments, and the accompanying release, may affect these outline materials.

² This restriction is intended to limit the fund’s exposure to both interest rate volatility and credit risks. See SEC Release IC-18005 (Feb. 2, 1991).

- Paragraph (d)(3) provides that “a Variable Rate Instrument that is subject to a Demand Feature³ 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.”
- Paragraph (d)(4) provides that “a Floating Rate Instrument that is subject to a Demand Feature shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand.”
- Paragraph (a)(21) defines “a Variable Rate Instrument” as “a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and which, upon such adjustment, can reasonably be expected to have a market value that approximates its par value.”
- Paragraph (a)(17) defines “a Floating Rate Instrument” as “a security the terms of which provide for the adjustment of its interest rate whenever a specified interest rate (such as a bank’s designated prime lending rate) changes and which, at any time, can reasonably be expected to have a market value that approximates its par value.”

Often it is not easy to tell whether a particular security is a Variable Rate Instrument or a Floating Rate Instrument without examining the terms of security. The “street,” for example, will often refer to a security that resets off a floating rate index (e.g., “Prime”) as a “floater.” In fact, it is common to “structure” this type of security as a Variable Rate Instrument by providing for an interest rate reset on “set dates” (e.g., on the first business day of each month, the interest rate is reset to equal Prime plus a spread). While “Prime Floaters” may be a simplistic example, other securities may not be so easy. Take, for example, a long-term U.S. Government Agency security that provides for the interest rate to be adjusted weekly “on the calendar day following each auction of three-month Treasury bills.” This is not an uncommon structure in many U.S. Government Agency securities. Although this security generally has the characteristics of a Variable Rate Investment, what happens if no auction is held in a particular week? Then, under the terms of the security, the interest rate in effect at the time of the last auction remains in effect until such time, if any, when another auction is held. Technically, the interest rate on this security is not adjusted on “set dates,” meaning that the security is not a Variable Rate Instrument. Many overlook this technical glitch assuming that such a security will, over its life, functionally meet the “set date” requirement since it is generally believed that weekly U.S. Treasury bill auctions will continue to be held. In these times of U.S. Government “gridlock,”

³ Paragraph (a)(4) provides that a “Demand Feature” is: “a put that entitles the holder to receive the principal amount of the underlying security or securities and that may be exercised either: (1) at any time on not more than 30 days’ notice; or (2) at specified intervals not exceeding 397 calendar days and upon no more than 30 days’ notice.”

Paragraph (a)(12) provides that 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 securities or security.”

however, it is not inconceivable that the Treasury could halt its regular auctions, which might shed further light upon the “eligibility” of this type of security under Rule 2a-7.

A. Does the “approximates par” requirement apply to U.S. Government Securities?

It may be argued that since paragraph (d)(1) does not use the term “Variable Rate Instrument” (it uses the phrase “an instrument ... which has a variable rate of interest”), the approximates par requirement is not necessary for a U.S. Government security. Such an argument, while technically correct, is counter to various SEC and SEC staff pronouncements. The SEC release initially adopting Rule 2a-7⁴ (the “1983 Release”) explicitly provided that, in order to rely upon the maturity-shortening provisions of the Rule for U.S. Government securities, a determination must be made that “it is reasonable to expect that when the rate is readjusted it will cause the instrument to have a current market value which approximates its par value.” This interpretation was reaffirmed by the SEC staff in Morgan Keegan & Company, Inc. (pub. avail. July 22, 1992) in which the staff noted that reliance upon paragraph (d)(1) presupposes that the instrument is a “variable rate instrument” and, therefore, has the approximates par value requirement. Finally, in the SEC release proposing the latest round of amendments to Rule 2a-7⁵ (the “1993 Release”), the SEC sought to clarify that the maturity of a U.S. Government security may only be determined by reference to the interest readjustment date if, upon readjustment, the security can reasonably be expected to have a market value that approximates par value.

B. What does “approximates par” mean?

The critical question in applying the paragraph (d) exceptions is, what does “approximates par” mean? While Rule 2a-7 does not provide guidance regarding what “approximates par” means, the SEC and its staff have commented upon, on an after-the-fact basis, some of the structures that it considers inappropriate (because they may not approximate par).

In a letter to the Investment Company Institute (Dec. 6, 1991), the staff of the SEC stated its belief that “inverse floaters” were not an appropriate investment for money market funds. Inverse floaters have interest rates that move in the opposite direction of market rates and, therefore, increase rather than reduce the price volatility of the instrument. In another letter to the Investment Company Institute (June 16, 1993), the staff of the SEC stated its belief that adjustable rate instruments subject to interest rate caps were also generally inappropriate for money market funds unless the cap were imposed by applicable usury laws and exceeded 20%.

In the 1993 Release, the SEC identified five types of adjustable rate instruments that it believed may be inappropriate for a money market fund: (1) “inverse floaters”; (2) “capped floaters”; (3) “CMT floaters”; (4) leveraged floaters; and (5) instruments linked to an interest rate that significantly lags prevailing short-term rates, such as “COFI floaters.” As the 1993 Release noted: “These securities share the common characteristic that, at the time of issuance, changes in interest rates or other conditions that can reasonably be foreseen to occur during their term will result in their market value not returning to par at the time of an interest rate adjustment.”

⁴ SEC Release IC-13380 (July 11, 1983).

⁵ SEC Release IC-19959 (Dec. 17, 1993).

The 1993 Release was followed by a letter from Barry P. Barbash (the Director of the Division of Investment Management of the SEC) to the Investment Company Institute (June 30, 1994) (the “Barbash Letter”). The Barbash Letter restated and amplified the 1993 Release and similarly categorized five types of adjustable rate instruments that the staff of the SEC viewed as inappropriate for a money market fund:

- (1) securities whose interest rate reset provisions are based on a formula that magnifies changes in interest rates, such as “inverse floaters” and “leveraged floaters”;
- (2) securities whose interest rate reset provisions are tied to long-term interest rates so that a change in the slope of the yield curve could result in the value of the instrument falling below par, such as “CMT floaters”;
- (3) securities on which interest is not paid above a certain level, such as “capped floaters,” or that cease to pay any interest when a certain level is reached, such as “range floaters”;
- (4) securities whose interest rate reset provisions are tied to more than one index so that a change in the relationship between these indexes may result in the value of the instrument falling below par, such as “dual index floaters”; and
- (5) securities whose interest rate reset provisions are tied to an index that materially lags short-term interest rates, such as “COFI floaters.”

The Barbash Letter, as with the 1993 Release, did not propose express limitations upon money market funds holding adjustable rate securities. Rather, the Barbash Letter sought to provide further guidance concerning money market fund management of interest rate risk and to “clarify that, to measure the maturity of a variable rate security by reference to its next interest rate reset date, the board of directors or trustees of a fund, or its delegate (typically the adviser), must have a reasonable expectation that the security will maintain a value of par upon adjustment of the security’s interest rate *at any time until final maturity or until principal can be recovered through demand.*”⁶

The Barbash Letter further noted that “in analyzing whether a particular adjustable rate security is appropriate for a money market fund, an adviser must determine not only that holding the security is not specifically prohibited by the rule, but also that the security meets the general rule applicable to *all* investments by a money market fund: that investment in the security is consistent with maintaining a stable net asset value. In short, that a particular security is not expressly prohibited by rule 2a-7 does not mean that the security is necessarily an appropriate investment for a money market fund.”

Assuming a security is not one of the enumerated types deemed inappropriate by any of the SEC or staff pronouncements described above, how can an investment adviser determine whether the security is eligible under Rule 2a-7? At the time of purchase, an investment adviser

⁶ Emphasis added. The phrase “maintains a value of par” is inconsistent with the current and proposed rule which uses the term “approximates” par. The italicized words were italicized in the Barbash Letter.

should make the determination that, based upon changes in interest rates or other conditions that could reasonably be foreseen over the life of the security, at each interest reset date the security would reasonably be expected to have a market value that approximates par. Rule 2a-7 does not require the Board or the adviser “to be an insurer of [a security ... but rather] requires that the [security] be evaluated as to whether an expectation of reaching the result set forth in the rule is reasonable.”⁷ In adopting the maturity shortening provisions for U.S. Government variable rate instruments, the SEC said that it did so based upon its understanding that the volatility of a U.S. Government variable rate instrument would not be greater than the volatility of a fixed interest rate instrument having a maturity equal to the readjustment period of such variable rate instrument. The SEC’s position was based entirely upon experience with Small Business Administration guaranteed debentures (“SBA notes”), which at the time were the only government instruments in existence with variable interest rates. The SEC noted that, in reviewing a U.S. Government variable rate instrument other than a SBA note, a determination should be made that the expected volatility of such instrument would not be expected to differ “materially” from the volatility of fixed rate notes of the same quality.⁸ It is ironic that the type of security (i.e., SBA notes) around which the SEC designed this provision of the Rule is generally not held by money market funds because its volatility is often considered to be inappropriate; on the other hand, this provision of the Rule is often relied upon for other types of U.S. Government Agency securities.

Whether a security, at the time of purchase, can reasonably be expected to approximate par at each reset is a factual question. The answer depends upon the definition of approximates par and upon: (1) the relationship between the interest rate paid and the reset period; (2) the historical justification for the spread or formula between the reset period and interest rate; and (3) the anticipated market environment between the purchase date and the next put date or final maturity. These relationships may best be illustrated by a series of examples that demonstrate increasing levels of potential variance away from par:

- A long-term variable rate U.S. Government Agency Security that resets every three months off a three-month fixed U.S. Government Agency Security of the same quality should reasonably emulate that three-month fixed U.S. Government Agency Security and, therefore, reasonably could be expected to approximate par. (This is the example cited by the SEC in the 1983 Release.)
- A long-term variable rate U.S. Government Agency Security that resets every three months off a three-month Treasury bill rate could also reasonably be expected to approximate par, depending upon the “spread risk.” Spread risk is the risk that the spread, which compensates a holder for assuming credit and yield curve risk, will widen or narrow.⁹ For example, a three-month U.S. Government

⁷ See footnote 21 of 1983 Release.

⁸ See Footnote 16 of 1983 Release.

⁹ Spread risk can be broken down into two components: Credit risk and yield curve risk.

(1)Credit Risk. Securities issued by many U.S. Government Agencies have slightly lower credit quality than a direct obligation of the U.S. Treasury. As a result, the interest rate paid on the securities must be higher than that paid on a Treasury bill rate of the same maturity in order to compensate a holder for the differing credit quality. This difference makes up part of the spread.

Agency Security may trade, at one time, at 25 basis points higher yield than a three-month Treasury bill. As yield levels change, this spread may widen or narrow in response to supply/demand or other factors. Take, for example, a U.S. Government Agency Security that was issued at par with a coupon of 4.75%, while the Treasury bill was yielding 4.50%. Assume there is an upward rate movement that pushes the Treasury bill yield to 5.50% and the Treasury/U.S. Government Agency spread widens to 50 basis points. The U.S. Government Agency Security market value will drop so as to yield 6.00%. This drop in value will be attributable in part to the general movement in interest rates, but also to the widening of the spread.

- A long-term variable rate U.S. Government Agency Security that resets weekly off a three-month Treasury bill rate may also reasonably be expected to approximate par, again depending upon the spread risk, which in this case has two components: (1) the Treasury/U.S. Government Agency spread relationship and (2) the seven-day/ three-month spread relationship.

There is no clear guidance regarding the extent to which the price of a Variable Rate Instrument can deviate from its par value, but still be determined to “approximate” par. As noted above, the SEC has not articulated a definition of the approximates par requirement, despite numerous requests from the industry to do so. In the 1983 Release, the SEC deliberately chose not to define the amount of deviation that could exist on a security by security basis, but rather chose to limit the overall portfolio deviation to no more than 1/2 of 1%. While a conservative interpretation of the approximates par requirement would suggest a 1/2 of 1% standard, a more liberal interpretation seems appropriate under the Rule. **The fact that the Rule permits a 1/2 of 1% variance between the amortized cost value and the market value of a money market fund’s portfolio as a whole suggests that, with respect to any individual security, it would be appropriate to allow a percentage tolerance that is greater than 1/2 of 1%. (This is analogous to the imposition of higher limits upon the maturity of individual securities than upon the average portfolio maturity of a money market fund).**

Further guidance may be found by looking at other areas of the 1940 Act that apply “approximate” or materiality standards. Guide 4 to Form N-1A, for example, defines an illiquid security as one that “may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment” (emphasis added). While again the SEC has not provided a definition of “approximately,” it does allow a mutual fund to value an investment within a range of bid and asked prices¹⁰ and recognizes that an investment may be sold at the bid, the ask or in between. Given the potentially wide range of bid/ask spreads for various types of investments, the phrase

(2)Yield Curve Risk. Under normal market conditions, the maturity/yield curve dictates that long-term instruments yield a greater return than shorter-term instruments of comparable credit quality. For this reason, the market often treats various types of Variable Rate Instruments as having a maturity in excess of their Rule 2a-7 maturity. In other words, the spread on two variable rate instruments of comparable quality, with the same interest reset and other provisions, will generally be higher on the instrument with the longer final maturity. The yield curve risk is also driven by a reset provision that does not match the index rate (i.e.; a seven-day reset off a three-month index rate).

¹⁰ See Guide 28 to Form N-1A.

“approximately” in this context must inherently provide for greater leeway than 1/2 of 1%.¹¹ While it is impossible to articulate an absolute standard for the approximates par requirement, a number of money market funds apply a deviation tolerance of 1%. This is not a magic number. Perhaps more important than the particular deviation at any point in time is the overall pattern of deviation that a particular instrument may exhibit. For example, it may be more important to focus upon whether an instrument is designed to react to interest rate changes such that the market values will, in the main, fall within a relatively tight cluster around par value, rather than whether there are occasional outlying market values. Further, there is no reason to artificially limit Variable Rate Instruments which, in contrast to fixed rate alternatives, have inherently more price stability despite their spread risk.

C. What happens when a security does not approximate par?

Assuming a security is initially eligible for purchase, what happens if after purchase, it no longer approximates par? Although there is no bright line test as to what level of deviation would cause a security to no longer approximate par, paraphrasing a former Supreme Court Justice, we generally know it when we see it. In such a case, even though the security may no longer be eligible for purchase, holding the security does not automatically cause a violation of Rule 2a-7. Paragraph (c)(2)(i) provides that a money market fund may not purchase any instrument with a remaining maturity of greater than 397 days. Paragraph (c)(5)(ii) provides that, in the event a portfolio security ceases to be an “eligible security,” absent a board finding that disposal is not in the best interests of the fund, the fund must dispose of such security as soon as practicable.¹² In determining whether it would be in the best interests of a money market fund to dispose of a security, the board would need to take into account the other requirements of Rule 2a-7, which, for example, limit the overall maturity of the portfolio. Paragraph (c)(2)(iii) provides that, in order to rely upon Rule 2a-7, a money market fund must not “maintain a dollar-weighted average portfolio maturity that exceeds 90 days.” If a security ceased to approximate par, although the Rule does not provide explicit instructions, presumably it should be treated as having a maturity equal to its final maturity, which would extend the dollar-weighted average maturity. While footnote 28 to the 1993 Release suggests that if a money market fund’s weighted-average maturity exceeds 90 days it would violate (c)(2)(iii), the 1983 Release provided limited relief from the weighted-average maturity requirement (which, at that time, was 120 days) to allow for remedial action as soon as reasonably practicable. Specifically, the 1983 Release stated that:

In no event shall the fund maintain a dollar-weight average portfolio maturity that exceeds 120 days. Should the disposition of a portfolio instrument or some market action cause the dollar-weighted average portfolio maturity to exceed 120 days, the board of directors is obligated to cause the fund to invest its available cash in such a manner as to reduce its dollar-weighted average maturity to 120 days or less as soon as reasonably practicable. (Emphasis added).

¹¹ See also Securities and Exchange Commission v. Steadman, (D.C.C. June 26, 1992) which held, contrary to the SEC’s assertion, that a penny per share is not *per se* material. Rather, materiality is dependent upon the total facts and circumstances. While not necessarily embracing it, the court recognized that the 5% materiality standard suggested by Steadman was not out of a range of reason.

¹² While the definition of an “eligible security” under paragraph (a)(5) focuses on the quality requirements of the Rule, it also incorporates the 397 day maturity limit requirement.

D. Conclusion.

As the market continues to develop more innovative structures for money market securities designed to boost yield, advisers are advised to review Section III of this outline entitled: “*Adviser Bailouts,*” and to remember: “*Caveat Consiliarius!*”¹³

II. MANDATORY TENDERS

Many securities, particularly municipal bonds, allow the issuer to change the terms of the security (i.e., the interest rate, rate period, etc.) during the life of the security without having to re-issue the security. Commonly, such a change in terms by the issuer is linked with a right by the holder to sell or “put” the securities back to the issuer or a third party. In other instances, the securities are subject to a mandatory tender, and, only after such tender, may the issuer change the terms of the securities. On the tender date, the issuer has the legal obligation to make payment. Often, these types of securities are supported by bank arrangements, whereby the bank will, pursuant to a line of credit, make advances to the issuer to pay the purchase price of tendered securities. Rule 2a-7 is very unclear, on its face, as to how to treat such mandatory tenders. A reasonable and often-used approach is to treat a mandatory tender as a maturity.

A. Maturity, Quality and Diversification Tests

As noted above under Section I of this outline, in order to be eligible for purchase by a money market fund, a security has to meet various requirements under Rule 2a-7. In addition to the maturity test described above, a security must be rated by two Nationally Recognized Statistical Rating Organizations (NRSROs) in one of the two highest rating categories for short-term debt obligations.¹⁴ In addition, money market funds are subject to diversification tests. These tests are described further below.

Rule 2a-7 requires a money market fund to limit its portfolio investments to those that are “eligible securities.”¹⁵ As noted above, in order to meet the maturity test, many funds purchase securities with maturity-shortening devices, such as “puts” or “demand features.” If the put or demand feature is “conditional,” then both the short-term ratings and the long-term ratings must be within the two highest rating categories by the requisite number of NRSROs in order for it to be an eligible security.¹⁶

In order to further limit a money market fund’s investment risk, Rule 2a-7 requires funds to meet certain diversification tests. Generally, a *taxable* money market fund may not invest more than 5% of its total assets in securities of any one issuer (except U.S. Government securities).¹⁷ Although this requirement does not currently apply to *tax-exempt* funds, the SEC

¹³ “Adviser Beware!”

¹⁴ There are other provisions for securities that have been rated by only one NRSRO and for unrated securities. In addition, a security must also have been determined to present minimal credit risks.

¹⁵ Rule 2a-7(c)(3). Eligible securities are broken down into “first tier” and “second tier” securities based upon, among other things, a requisite number of ratings from the various NRSROs.

¹⁶ Rule 2a-7(c)(3)(ii).

¹⁷ Rule 2a-7(c)(4)(i)(A).

has proposed extending it to such funds.¹⁸ Diversified tax-exempt funds are subject, however, to the general diversification limits of Section 5(b)(1) of the 1940 Act, which provides that a fund may not invest, with respect to 75% of its total assets, more than 5% in securities of any one issuer. (This creates a “25% basket” for tax-exempt funds for over 5% positions.)

Rule 2a-7(c)(4)(ii) also limits the amount that both *taxable* and *tax-exempt* funds may invest in “puts.” In particular, the Rule provides that immediately after the acquisition of a put, a fund may have no more than 5% of its assets invested in puts and other securities issued by any one institution. (Tax-exempt funds, however, currently have a 25% “put” basket.) An unconditional put (or a guarantee) will not be deemed to be issued by the institution, provided that the value of all securities (including puts and guarantees) held by the fund does not exceed 10% of the fund’s total assets.¹⁹

B. Application of Rule 2a-7 to Mandatory Tenders

A security with a final maturity greater than 397 days, but subject to a mandatory tender in less than 397 days, does not fit neatly into the provisions of Rule 2a-7.

- The mandatory tender date is not “the date noted on the face of the instrument.”
 - The date noted on the face of the instrument is the final maturity (e.g., October 1, 2015).
- A mandatory tender date is not “the date on which the redemption [of a called instrument] must be made.”
 - A mandatory tender is not a “call.” A call is an *optional* right of an issuer, not a mandatory obligation of the issuer, to redeem a security. A mandatory tender also does not normally result in the “redemption” of a security.
- A mandatory tender is not a “put.” A put is an *optional* right, not a mandatory obligation of a holder to sell a security.

A worst case interpretation is that a security with a final maturity greater than 397 days, but subject to a mandatory tender that is less than 397 days, is simply ineligible since it cannot satisfy the maturity test of the Rule. Such an interpretation, however, is inconsistent with the spirit of the Rule and inconsistent with common industry practice.

(i) Mandatory Tender is Equal to a Maturity

Putting aside the literal language of the Rule, from a practical standpoint, a mandatory tender is the same as a maturity or a called security. On the tender date, the issuer has the legal

¹⁸ SEC Release No. IC-19959 (Dec. 17, 1993).

¹⁹ Rule 2a-7(c)(4)(iii)(C).

obligation to make payment.²⁰ Similarly, on the maturity date (or on the redemption date in the case of a called security), the issuer has the legal obligation to make payment. It would seem reasonable, then, to look at the substance of the economic terms of the instrument to determine its maturity and to treat securities with mandatory tenders in the same manner in which they generally trade in the market (i.e., as if they had a maturity on the tender date).²¹ This is consistent with an approach taken by the SEC staff in Merrill, Lynch, Pierce, Fenner & Smith, Inc. (pub. avail. April 6, 1987). In Merrill Lynch, the staff found that certain “extendable” notes with the following characteristics would satisfy the maturity requirements of Rule 2a-7:

- The note will mature on a specified date (e.g., issued January 1, 1996; maturity on December 31, 1996), unless the note is extended.
- On each interest payment date (e.g., quarterly), the maturity of the notes would extend by a specified period (e.g., three months), unless the holder gave notice of its election not to extend the maturity. (Unless the holder gives an election, the notes will never mature).

In Merrill Lynch, the staff stated that it would not recommend enforcement action if a money market fund “were to measure the remaining maturity of the [extendable notes] by reference to the date specified on the face of the instrument, as automatically extended . . .” [Emphasis added]. In reaching its position, the staff considered that the date to which the maturity was automatically extended could be determined from the provisions of the notes. The staff stated that “the introductory language [contained in paragraph (d)]²² was intended to allow money market funds to measure the maturity of a debt instrument by reference to a specified date on which the issuer of the instrument has an unconditional obligation to repay the principal amount owed.”

If the SEC staff, in Merrill Lynch, was comfortable looking to the terms of an instrument to *extend* the maturity of an instrument, logic would dictate that the staff should similarly feel comfortable looking to the terms of an instrument to *shorten* the maturity of an instrument.

This interpretation of the maturity provisions of Rule 2a-7 is buttressed by the proposed amendments that are outstanding.²³ Under the proposed amendments, the maturity provisions would be revised as follows (additions underlined; deletions):

“For the purpose 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

²⁰ The mandatory tender provisions and the obligation of an issuer to purchase on the mandatory tender date may vary from security to security. Accordingly, for any given security these provisions should be reviewed carefully to determine the nature of the issuer’s obligation(s).

²¹ The “market treatment test” is often a helpful tool in analyzing instruments that present unique structural issues.

²² At the time of the Merrill Lynch no-action letter, the language in question was contained in paragraph (b).

²³ SEC Release IC-19959 (Dec. 17, 1993).

redemption, the date on which the redemption payment must be made . . .”

Under the proposed amendments, the date of a mandatory tender, which provides for the unconditional payment of the principal amount, would serve to set the maturity of an instrument. Although not so stated in the proposing release, one could reason that this change is merely meant to be a clarification of the maturity definition.

(ii) A Mandatory Tender is Not a Put

While treating a mandatory tender as a put would help the argument that the security met the maturity test under the Rule, such an interpretation could be a double-edged sword in that a money market fund would then have to examine and satisfy the quality and diversification tests under the Rule as they apply to puts.²⁴

For example, a mandatory tender could be viewed as an issuer put.²⁵ Although the effect of a mandatory tender is similar to that of an issuer put, a mandatory tender is more like a maturity than a put. With a mandatory tender, just like with a maturity, the security has a predetermined date upon which payment must be made. A put, on the other hand, requires the holder to act. When a bank line of credit is available (as it often is) to support mandatory tender structures, the analysis becomes more complicated; since Rule 2a-7 blurs the distinctions between puts and demand features on the one hand, and guarantees and insurance on the other. The complication stems from the definition of an “unconditional put,” which equates a “guarantee, letter of credit or similar credit enhancement” with a “put” and a “demand feature.” A bank line of credit could be viewed, in light of this phrase, as a “letter of credit or similar credit enhancement,” and, therefore, a “put.” While it is true that a bank line of credit is an important part of the overall credit analysis of an issuer, it is not a “true put” (i.e., the bank does not give the holder a right to sell the securities to the bank). It is also not a “guarantee.” Rather, it is simply a means of financing that an issuer can use to manage cash flow. A bank line of credit supporting a mandatory tender is no different from, for example, General Motors Acceptance Corporation obtaining a line of credit from a bank to finance its operations and/or commercial paper program.²⁶

C. Conclusion.

²⁴ The SEC has received comments on their current proposal to amend Rule 2a-7 (SEC Release IC-19959 (Dec. 17, 1993)), asking that the Rule expressly provide that a mandatory tender is not considered to be a put.

²⁵ Currently, and as proposed to be amended, the Rule does not distinguish between issuer and third-party puts. A number of commenters, however, have suggested that the SEC should limit the definition of a “put” to undertakings by a third-party to purchase the security.

²⁶ If, however, the credit of a third party is *substituted* for that of an issuer and is the basis upon which a credit determination is made, that party is a guarantor of a security and is subject to Section 5 of the 1940 Act and Rule 5b-1 thereunder with respect to diversification. Moreover, to the extent that a provider of credit enhancement may be the party to which a fund would look for payment on a “true put,” paragraph (c)(4)(iii)(A) would require that this party be counted for put diversification.

Industry practice suggests that many believe that it is reasonable to treat a mandatory tender feature as a “maturity” rather than as a “put” under Rule 2a-7. We can hope that the next round of amendments to the Rule will confirm this analysis.

III. ADVISER BAILOUTS

Perhaps even more unnerving to advisers than struggling with the meaning of the “approximates par” requirement and the appropriate treatment of mandatory tenders, has been the rash of adviser bailouts of money market funds that have occurred over the last few years. The overwhelming majority of these bailouts has been motivated not by curing a wrong (such as an investment restriction violation), but, rather, have been motivated by the adviser’s own interest in not having one of its advised funds “break the buck.” These bailouts have been made in differing fashions, including (i) infusing cash into the fund to reimburse it for losses; (2) purchasing securities from the fund at an above-market price; (3) issuing puts; and (4) securing a third-party credit enhancement.

Historically, cash infusions were not the preferred method of adviser bailouts. Rather, the adviser and the fund preferred that the adviser buy the trouble security. Cash infusions were viewed by the fund as a realized loss with a corresponding contribution to capital; from the adviser’s standpoint, there was greater concern that cash infusions were not a deductible business expense. These distinctions have, for the most part, been rendered moot. A letter to Chief Financial Officers from Lawrence A. Friend (November 1, 1994) advised that, regardless of the nature (cash infusion or purchase), such affiliated transactions should be reflected on the fund’s books as a realized loss and as a corresponding contribution to capital. Tax advisers have, likewise, become more comfortable with the ability of an adviser to deduct cash infusions to funds.²⁷

A. Affiliated Purchases.

As noted above, when money market funds, in the past, held a defaulted security, fund advisers or related persons often repurchased the security from the fund at the security’s amortized cost value to prevent the fund from breaking the buck.²⁸ These transactions came within Section 17(a)(2) of the 1940 Act, which prohibits an affiliated person of a fund from knowingly purchasing a security from the fund in the absence of an SEC exemption.²⁹ Nevertheless, since the transactions were generally reasonable, fair and in the best interests of fund shareholders, the SEC staff orally advised parties to these transactions that it would not recommend enforcement action to the SEC if these transactions were consummated. Based upon this past practice, in the 1993 Release, the SEC proposed a new Rule 17a-9 to exempt these types of transactions from Section 17(a). The proposed exemption would apply when: (1) the security is no longer an eligible security; (2) the purchase price is paid in cash; and (3) the purchase price is equal to the greater of the amortized cost of the security or its market price.

²⁷ See Katherine H. Fritts and David J. Mangefrida, “Deductibility of Investment Advisers’ ‘Bail-Out’ Payments,” The Investment Lawyer, Vol. 2, No. 6, July 1995.

²⁸ In 1989 and 1990, several money market funds held defaulted commercial paper issued by Mortgage and Realty Trust, or Integrated Resources, Inc. In these instances, the SEC gave no-action relief allowing the fund’s investment advisers to purchase the defaulted commercial paper from the funds.

²⁹ Those transactions also raise issues under Section 17(d) [which prohibits joint transactions] and, to the extent there is the issuance of a security (e.g., a put), under 12(d)(3) [which prohibits the purchase of a security issued by a person engaged in a securities-related business; Rule 12d3-1 is not available because the security would be issued by an affiliate].

In 1994, a dramatic rise in short-term interest rates caused many adjustable rate securities to deviate from their par value. Unlike the “default” situation identified in the 1993 Release, these securities (which were usually issued by U.S. Government Agencies) were not in default; but rather, were causing the funds’ market price net asset value to deviate from \$1.00 by more than 1/2 of 1% (i.e., .9950). To stop the fund from breaking a buck, advisers sought to purchase these troubled securities from the funds.³⁰ The SEC staff granted a number of advisers oral no-action relief to purchase these troubled securities, generally following the requirements in proposed Rule 17a-9 (i.e., purchase in cash at the greater of amortized cost or market).³¹

B. Adviser Puts and Letters of Credit.

The next major shift in the fashioning of adviser bailouts was brought to the forefront by the December 6, 1994 bankruptcy filing by Orange County, California. A number of money market funds held sizeable positions of Orange County securities which, after the bankruptcy filing, caused their market-based net asset value to deviate by more than 1/2 of 1%. Rather than make a cash infusion or purchase the Orange County securities from the funds, a number of advisers sought no-action relief from the SEC staff to provide a put to the funds, the terms of which allowed a fund to put the securities to the adviser at a specified future date at the amortized cost value of the securities (i.e., par plus accrued interest). In general, the SEC staff granted oral relief to advisers whose short-term credit quality was First Tier, but only allowed the put date to extend for 90 days (which was prior to the date that the securities matured). The SEC staff viewed an adviser put as a “temporary” situation. After 90 days, the SEC staff expected that the fund would put the securities to the adviser or that some alternative credit enhancement (from a non-affiliate) would replace the adviser put.³² Subsequently, a number of advisers arranged for non-affiliated banks to provide letters of credit through the maturity date of the Orange County securities (most of which were scheduled to mature in mid-to-late 1995) covering all or a significant percentage of the principal and interest on the Orange County Securities.

Thereafter, Orange County sought to extend to 1996 the maturity of its debt maturing in 1995. On July 7, 1995, the owners of the Orange County securities (including various money market funds) agreed to extend the maturity on certain Orange County securities until June 30, 1996 in order to allow Orange County more time to develop a financial recovery plan. In order to induce funds that had adviser puts or bank letters of credit to extend the maturity on the Orange County securities, some advisers or their affiliates “guaranteed” that the extended securities would pay a market rate (i.e., LIBOR) plus a kicker. In order to “roll-over” a troubled security, the advisers were back at the doorstep of the SEC staff again asking for no-action relief.

³⁰ Some transactions were motivated by other factors. For example, S&P required a money fund that it rated to maintain a market based net asset value above \$0.9975 in order to maintain its AAA rating.

³¹ See Fund Action, September 12, 1994. Some advisers requested and were accorded confidential treatment of their no-action request for up to 120 days pursuant to 17 CFR 200.81.

³² Any decision not to put the securities to the adviser on the put date required the approval of the non-interested members of the Board.

More than before, this time the staff took a more active part in setting the terms of the transactions and, ultimately, gave written no-action relief.³³

C. Conclusion.

The number, variety and continuing development of methods to provide support to defaulted and troubled securities suggests that a rule, such as proposed Rule 17a-9, is woefully inadequate. Rather, the SEC and its staff may better serve the money market industry by being part of the process; a process that has been demonstrated to work and to be flexible.

³³ See Kemper Corporation (pub. avail. June 23, 1995); Twentieth Century Companies, Inc. (pub. avail. June 30, 1995); Lehman Brothers Holdings, Inc. (pub. avail. July 7, 1995); Twentieth Century Companies, Inc. (pub. avail. July 7, 1995); and Wells Fargo Bank, N.A. (pub. avail. July 7, 1995).