ACTION MEMORANDUM

JUL 18 1980

TO: The Commission

FROM: The Division of Investment Management

SUBJECT: Implications Of Rescission Of Credit Control Regulations With Respect To Money Market Funds.

RECOMMENDATION: That the Commission issue the attached general statement of policy expressing its views relating to various disclosure obligations under the Securities Act of 1933 and various regulatory concerns under the Investment Company Act of 1940 arising from the elimination of the credit control regulations applicable to certain registered investment companies including money market funds.

ACTION REQUESTED By: Seriatim Consideration.

OTHER DIVISIONS OR OFFICES CONSULTED: None.

RESPONSIBLE STAFF MEMBERS: Kenneth S. Gerstein X23023
Jeffrey B. Bailey X23033

SUNSHINE ACT STATUS: Closed Seriatim Consideration.

NOVEL, UNIQUE OR COMPLEX ISSUES: Whether it is appropriate for the Commission to issue a general statement of policy which would permit money market funds to take certain extraordinary actions to assist such funds in adapting their operations as a result of the rescission of credit control regulations.

SUMMARY

On July 3, 1980, the Board of Governors of the Federal Reserve System ("Board") announced the phase-out of its credit control regulations applicable to registered investment companies, thereby eliminating the current requirement to make special deposits with respect to weekly reporting periods beginning on July 28, 1980, and thereafter. As a result of such action, the Division believes that it will be necessary for boards of directors of money market funds to consider various important issues arising under the federal securities laws. This will be particularly true with respect to so-called "clone" funds which were created to help minimize inequities to shareholders of money market funds existing at the time of the imposition of the credit control regulations ("existing funds").

Accordingly, for the reasons more fully discussed below, the Division recommends that the Commission issue the attached general statement of policy concerning the implications of rescission of credit control regulations in order (1) to provide guidance to boards of directors of money market funds and (2) to assist money market funds in taking certain extraordinary steps to achieve orderly and equitable transitions in their operations. 1/

BACKGROUND

The credit control regulations were promulgated by the Board on March 14, 1980, and subsequently amended on March 28, and May 22, 1980, pursuant to the Board's authority under the Credit Control Act of 1969, as implemented by Executive Order of the President. The regulations required each investment company subject thereto to maintain a non-interest bearing special deposit, with the Federal Reserve Bank in the district where such company had its principal place of business, equal to a specified percentage of the amount by which the average daily amount of its "covered credit" during specified weekly periods exceeded a specified "base" amount.

In response to the imposition of credit control regulations, the Commission issued a general statement of policy concerning some of the implications of such regulations under the federal securities laws to provide guidance to boards of directors of registered investment companies concerning various disclosure obligations under the Securities Act of 1933 ("1933 Act") and various regulatory matters under the Investment Company Act of 1940 ("1940 Act"). Consistent with the views expressed in that general statement of policy, many money market funds and their investment advisers implemented a variety of actions, including the formation of "clone" funds, to accomodate the impact of the Board's regulations while minimizing inequities to existing shareholders and investors. In order to enhance the ability of investment companies to take a variety of responsive actions, the Commission adopted Rule 6c-4(T) under the 1940 Act [17 CFR 270.6c-4(T)], providing money market funds subject to the Board's regulations, and companies and persons dealing with such funds, with temporary exemptions on an emergency basis from various provisions of the 1940 Act and the rules adopted thereunder.

As noted above, on July 3, 1980, the Board announced its decision to rescind the credit control regulations applicable to money market funds.

NATURE OF THE PROBLEM

As a result of the Board's action, it will be necessary for money market funds to make certain disclosures to shareholders and investors respecting various matters, including: (1) the effect upon the funds' yields, and (2) the effect of modifications of any policies, such as restrictions on sales of shares, which may have been implemented as a result of the adoption of credit

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1/ The Division further recommends that the Commission should announce that it intends to adopt a temporary exemptive rule prior to July 28, 1980, which would permit certain affiliated transactions, as discussed *infra*. Should the Commission adopt this recommendation, we will promptly draft a rule for its consideration.

controls. In addition, however, the Board's rescission of credit control regulations may precipitate large scale redemptions of shares of "clone" funds as shareholders of such funds redeem their shares and seek to purchase shares of an existing fund. These redemptions, coupled with an anticipated reduction of sales of shares of "clone" funds, would have serious implications respecting the future viability of such funds. 2/

To avoid certain inequities to shareholders, it appears that boards of directors of "clone" funds will have to consider the appropriateness of: (1) terminating the business activities of the funds; (2) modifying their investment objectives to provide a continued business purpose; (3) effecting mergers, consolidations or reorganizations with existing funds; and (4) creating reserve accounts or other protective devices to assure that, if significant net redemptions occur, remaining shareholders of "clone" funds will not bear a disproportionate share of the expenses associated with liquidations of the funds. The two most significant concerns immediately confronting boards of directors of "clone" funds appear to be: (1) the expected movement of investors to existing funds, and (2) the accompanying high level of redemptions that may be experienced by "clones." Thus, some boards of directors may wish to implement a variety of measures to effectuate the prompt and orderly movement of investors from "clone" funds to existing funds.

OUR RECOMMENDED APPROACH

In order to assist boards of directors of money market funds in their consideration of the matters discussed above, we believe that the Commission should issue the attached general statement of policy outlining the obligations of boards of directors under the federal securities laws. In addition, we believe that it would be appropriate for the Commission to take certain positions therein interpreting various provisions of the 1940 Act, the 1933 Act and of the Commission's rules, to enable certain extraordinary measures by money market funds to deal with the potential exodus from the "clones." Our discussions with representatives of the industry at a public meeting conducted by the Division on July 11, 1980, has made it apparent that, absent the flexibility to take such extraordinary measures, "clone" funds may be

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2/ While we are, of course, unable to predict the magnitude of redemptions, there are two reasons which lead us to believe that redemptions may be rather significant: (1) the yields of "clones" will, in most cases, be less than the yields of existing funds, and (2) existing funds will reopen their doors to new sales on July 28, 1980, although the special deposits of "clones" will not be refunded until August 11, 1980, under the phase-out announced by the Board.

unable to handle in an efficient and orderly manner the potential problems which they are likely to face. 3/ Although under ordinary circumstances we would be extremely reluctant to recommend permitting many of the actions we are now suggesting that the Commission permit, we believe such actions would be appropriate in view of the unprecedented and potentially disruptive situation arising as a consequence of the Board's action.

Accordingly, the Division recommends that, among other things, the general statement of policy:

(1) permit the use of "automatic" offers of exchange (absent rejection by a shareholder) which would be utilized to exchange shares of "clone" funds for shares of existing funds; 4/

(2) permit, under certain circumstances, the forced redemption of the interests of those "clone" fund shareholders who reject offers of exchange; and

(3) announce that a temporary rule under the 1940 Act will be adopted next week to permit assets of "clone" funds to be sold to existing funds as a method of generating the cash necessary to meet redemptions while avoiding the transactions costs which would ordinarily be associated with such sales in the secondary market.

It appears to us that, by permitting these types of transactions as a method of enabling money market funds to fulfill their obligations to meet redemptions under Section 22(e) of the 1940 Act, "clone" funds will in many cases be able to avoid the time consumming and costly requirements under state law of seeking shareholder approval of reorganizations or liquidations. In this regard, the attached general statement of policy indicates that, where a fund must take the actions enumerated above to effect redemptions in compliance with federal law, such federally imposed obligations may take precedence over any state law requirements, which should be read liberally. 5/

3/ No doubt, the implementation of such measures would at most, temporarily toll the death knell for a "clone" fund. Thus, we would not suggest that the Commission specifically recommend that particular course of action. However, representatives of the industry present at the public meeting unanimously agreed that, because the end of credit controls will inevitably cause the deterioration of "clone" funds, it would be best if the Commission provided directors with a means to accomplish promptly that result. They believe that there is virtually no reason why any shareholder of a "clone" would not want to become, instead, a shareholder of an existing fund.

4/ With respect to offers of exchange, the Commission should not require funds to provide shareholders with prospectuses of the existing funds where the use of "stickers" to the prospectuses of the "clones" can be used to provide all necessary information.

5/ See Section 50 of the 1940 Act.

Finally, it should be noted that the staff of the Board has advised the Division and representatives of the industry, that they would be prepared to recommend the refund of special deposits of "clone" funds on July 28, 1980, rather than on August 11, 1980, if it appears that such action is necessary to enable "clone" funds to meet redemptions. Such action by the Board would, in our view, go a long way in enabling the operations of "clone" funds to be suspended on July 28, 1980, avoiding certain of the problems which would otherwise exist if such funds had to wait two weeks for the return of their special deposits.

CONCLUSION

In view of the foregoing, the Division recommends that the Commission issue the attached general statement of policy.

ATTACHMENT

8574

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 231 and 271

[Release Nos. 33-6224 , and IC-11263]

Effect of the Termination of Credit Controls on the Operations of Certain Registered Investment Companies Including Money Market Funds

AGENCY: Securities and Exchange Commission.

ACTION: General Statement of Policy.

SUMMARY: The Securities and Exchange Commission announces a general statement of policy concerning implications under the federal securities laws of the rescission of credit control regulations applicable to certain registered investment companies, including "money market" funds. The credit control regulations were promulgated by the Board of Governors of the Federal Reserve System ("Board") on March 14, 1980, and subsequently amended on March 28, 1980, and May 22, 1980, pursuant to the Board's authority under the Credit Control Act of 1969, as implemented by Executive Order of the President. On July 3, 1980, the Board announced that its credit control regulations would be eliminated with respect to the weekly reporting periods beginning on July 28, 1980. This general statement of policy expresses the Commission's views concerning various disclosure obligations under the Securities Act of 1933 and various regulatory considerations under the Investment Company Act of 1940, which should promptly be considered by boards of directors of registered investment companies which have been subject to the Board's regulations.

EFFECTIVE DATE: July 21, 1980.

FOR FURTHER INFORMATION CONTACT: Kenneth S. Gerstein, Special Counsel (202-272-3023), Gene A. Gohlke, Examination Program Coordinator (202-272-2024) or Jeffrey B. Bailey, Esq. (202-272-3033), Division of Investment Management, Securities and Exchange Commission, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: On July 3, 1980, the Board of Governors of the Federal Reserve System ("Board") announced its decision to rescind its credit control regulations [12 CFR §229.11-.15] applicable to certain registered investment companies, including "money market" funds and short-term unit investment trusts. The Board's regulations, which were adopted on March 14, 1980, and thereafter amended on March 28, 1980, and May 22, 1980, required each investment company subject thereto to maintain a noninterest bearing special deposit with the Federal Reserve Bank in the district where such investment company had its principal place of business equal to a specified percentage of the amount by which the average of the daily amounts of its "covered credit" during specified weekly periods exceeded a specified "base" amount, subject to certain adjustments. 1/

1/ 45 FR 17927 (March 19, 1980), 45 FR 22883 (April 4, 1980), and 45 FR 37413 (June 3, 1980). The last amendment to the Board's regulations reduced from 15 percent to 7.5 percent the proportion of each investment company's covered credit, in excess of its base, required to be deposited under the regulations.

The Board's action provides that the week ending July 27, 1980, shall be the last reporting period for which special deposits will be required. Such special deposits are required to be made on August 4, 1980, and will be refunded on August 11, 1980. 45 FR 46064 (July 9, 1980).

In response to adoption of the Board's regulations, the Commission issued a general statement of policy concerning some of the implications of such regulations under the federal securities laws in order to provide the boards of directors of registered investment companies with guidance respecting various disclosure obligations under the Securities Act of 1933 ("1933 Act") [15 U.S.C. 77a et seq.] and various regulatory matters under the Investment Company Act of 1940 ("1940 Act") [15 U.S.C. 80a-1 et seq.]. 2/ Consistent with the views expressed in that general statement of policy, and in recognition of their responsibilities, many money market funds and their investment advisers implemented a variety of actions designed to modify the operations of such investment companies to accommodate the impact of the Board's regulations while minimizing inequities to existing shareholders and investors.

In particular, a number of so-called "clone" funds ("new funds") were organized by investment advisers to duplicate already existing money market funds ("existing funds"). The purpose of each new fund was to absorb new sales of shares which, if sold by the existing fund, could have increased the amount of its special deposit and, thus, adversely affected dividends payable to shareholders of the existing fund. 3/ In order to enhance the ability of investment companies to

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2/ Investment Company Act Release No. 11088 (March 14, 1980) [45 FR 17954, March 20, 1980].

3/ Because the credit control regulations imposed a special deposit, generally, only on assets in excess of the outstanding "covered credit" on March 14, 1980 ("base"), existing funds would have to make special deposits only if their assets (covered credit) increased above their base amounts.

take a variety of responsive actions, the Commission adopted Rule 6c-4(T) [17 CFR §270.6c-4(T)], which provides money market funds subject to the Board's regulations, and companies and persons dealing with such funds, with temporary exemptions on an emergency basis from various provisions of the 1940 Act and the rules adopted thereunder. 4/

The Commission believes that rescission of the Board's regulations will have various implications with respect to the operations of certain money market funds. 5/ Accordingly, this general statement of policy is intended to provide guidance to the directors of registered investment companies which have been subject to the Board's regulations respecting compliance and disclosure responsibilities of such investment companies under the federal securities laws arising from termination of credit control regulations. In addition, it will outline one possible method that boards of directors may wish to utilize to transfer efficiently the interests of investors in new funds to existing funds, and one possible method that may be available for new funds to achieve the high degree of liquidity necessary to meet redemptions. It is not, however,

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4/ Investment Company Act Release No. 11137 (April 22, 1980) [45 FR 28307, April 29, 1980].

5/ The rescission of the credit control regulations will also have an impact on short-term unit investment trusts. However, the implications of the Board's action with respect to short-term unit investment trusts should simply be that special deposits of existing trusts will be refunded to the trustees of the trusts and then distributed to unitholders. Thus, this general statement of policy relates principally to open-end, management investment companies investing in short-term debt obligations, commonly termed "money market" funds.

intended to address all of the issues which may arise from the Board's action, which issues may nevertheless be appropriate for directors to consider.

DISCLOSING THE ELIMINATION OF SPECIAL DEPOSITS

The primary implication of the Board's rescission of its credit control regulations will be that money market funds no longer will be required to maintain special deposits and that special deposits now being held by Federal Reserve Banks will be refunded. When investment companies are able to invest the assets previously constituting special deposits, investors in these funds, generally, should receive somewhat increased yields. Thus, to the extent that the prospectuses of money market funds currently disclose the existence and consequences of the special deposit requirement, money market funds should amend their prospectuses as soon as practicable to reflect the investment and other implications of the elimination of the need to make special deposits. In this regard, the Commission will not object to the use of a Rule 424(c) [17 CFR §230.424(c)] "sticker" by an investment company to amend its prospectus. In addition, the Commission will not object to continued use of the current prospectus to sell securities during the time reasonably necessary to amend the prospectus to make appropriate disclosures. 6/

6/ Because shareholders of money market funds affected by the credit control regulations in many cases may have elected to have dividends reinvested, the Commission expects that any disclosures made by investment companies will be furnished promptly to existing shareholders, as well as to all future investors.

In certain cases, prompt disclosure of other matters also will be necessary and appropriate. For example, an existing fund which adopted certain restrictive policies respecting the sale of its shares to minimize the impact of the special deposit requirement on existing shareholders should disclose any revision of such policies. 7/ Similarly, where any other modifications of a money market fund's policies, objectives or services are made as a result of the elimination of credit control regulations, the fund should promptly make appropriate disclosure of such modifications. The matters discussed hereinafter also may necessitate certain additional disclosures to investors.

IMPLICATIONS FOR "NEW" MONEY MARKET FUNDS

As noted above, certain new funds were organized after the adoption of the credit control regulations by the investment advisers to existing funds for the purpose of minimizing the impact that additional sales of shares would otherwise have had on the existing funds. In most cases, these new funds are rather similar, if not identical, to the existing funds which they duplicate. However, the yields currently being earned by existing funds in most cases exceed those being earned by new funds by amounts which exceed differences

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7/ As discussed at p. 19, *infra*, the Commission believes that certain matters should be considered by the boards of directors of money market funds before eliminating or modifying restrictive sales policies.

attributable solely to the larger special deposits maintained by the new funds. 8/

Under these circumstances, many shareholders of new funds may decide to redeem their shares and to seek to purchase either (1) shares of the existing fund in the same "complex" of investment companies (if available) or (2) shares of another money market fund (whose shares may previously have been unavailable because of sales restrictions adopted after the institution of the special deposit requirement). In some cases, the level of such redemptions, coupled with reduced sales of new shares of such funds, may have serious implications respecting the future viability of new funds. As a result, directors of a new fund may have to consider seriously whether: (1) to terminate the business activities of and to liquidate the new fund; (2) to modify the fundamental investment objectives of the new fund to provide a continued business purpose; or (3) to enter into a merger, consolidation or reorganization with another money market fund. In some instances, shareholder approval may be necessary, and certain of these alternatives could cause the new fund to incur significant expenses.

Thus, the Commission believes that boards of directors of new funds should consider the effect of rescission of the credit control regulations on the continued viability of new funds as soon as reasonably

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8/ These differences may, in part, be due to: (1) the higher expense ratios of new funds, and (2) the fact that existing funds still hold in their portfolios some higher yielding debt obligations which were acquired prior to the recent decline in short-term interest rates.

practicable. Further, after that matter has been considered, it would be appropriate for new funds then to disclose their boards' conclusions as to any future courses of action they are likely to recommend that the new funds pursue. Most importantly, if the board of directors of a new fund determines that it is likely to seek shareholder approval of a fundamental change in the nature of a new fund's business or of a plan of liquidation or reorganization, or if the board determines to use an offer of exchange to transfer shareholders' interests to the existing fund, the board should carefully consider the appropriateness of creating a reserve account or some other protective device to assure that shareholders of the new fund who have benefited from the use of that investment vehicle each bear their fair share of any anticipated expenses, including unamortized organization expenses. Of particular concern to the Commission is the possibility that, if a new fund were to suffer significant net redemptions, the remaining shareholders of the new fund would bear a disproportionate portion of the expenses associated with liquidating, reorganizing or restructuring the fund. 9/ In the Commission's view, failure of an investment company to take these anticipated expenses promptly into account may, under certain circumstances, raise questions as to whether a new fund's shares are

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9/ Of course, if the investment adviser or underwriter of the new fund agreed to bear all of such expenses, the creation of a reserve account or some other protective device may not be necessary. The Commission would not view such agreement in these unusual circumstances to be a joint enterprise within the meaning of Section 17(d) of the Act [15 U.S.C. 80a-17(d)] and Rule 17d-1 thereunder [17 CFR §270.17d-1]. See Rule 17d-1(d)(8).

being priced properly 10/ and, depending upon all of the facts and circumstances, may raise questions concerning a breach of fiduciary duty on the part of those persons responsible for such decisions. 11/

The Commission cannot predict the magnitude of net redemptions of shares that may be experienced by new funds. However, it is possible that such funds may be faced with sufficient redemptions to require the sale of portfolio securities prior to maturity. In view of this possibility, the board of directors of a new fund should consider the appropriateness of maintaining an unusually high degree of liquidity so that an unusually high volume of shareholder orders to redeem shares can be satisfied promptly, 12/ with minimum disruption of the fund's activities and operations.

10/ Rule 22c-1 under the 1940 Act [17 CFR §270.22c-1] requires that redeemable securities of investment companies be sold and redeemed at the current net asset value per share next computed after receipt of an order to buy or to redeem such securities. Rule 2a-4 under the 1940 Act [17 CFR §270.2a-4], among other things, requires that expenses be included in calculating an investment company's current net asset value per share.

11/ Section 36(a) of the 1940 Act [15 U.S.C. 80a-35(a)], in pertinent part, authorizes the Commission to seek injunctive or other relief where any officer, director, investment adviser, or principal underwriter of a registered investment company has engaged, or is about to engage, in any act or practice constituting a breach of fiduciary duty involving personal misconduct.

12/ Although Section 22(e) of the Act [15 U.S.C. 80a-22(e)] permits redemption requests to be satisfied within seven days of receipt, some money market funds have undertaken to process shareholder purchase and redemption requests more expeditiously. Unless those undertakings are qualified, or have been modified with ample notice to all shareholders, it is expected that such funds will adhere to the more restrictive time periods which they have disclosed in their prospectuses.

POSSIBLE ARRANGEMENTS FOR ORDERLY TRANSITIONS

As noted above, two significant concerns immediately confronting boards of directors of new funds appear to be: (1) the expected movement of investors from new funds to existing funds, and (2) the accompanying high level of redemptions that may be experienced by new funds. The Commission recognizes that a variety of methods might be utilized to deal with these concerns promptly and efficiently to provide investors in new funds with a means to exchange their shares promptly for shares of existing funds, and to enhance the liquidity of new funds. In this regard, outlined below are certain methods which might be utilized to effect exchanges of shares of new funds for shares of existing funds, and to meet redemptions, in instances where the board of directors has determined that it is in the best interests of shareholders of the new fund to suspend its operations.

1. Offers of Exchange.

In providing for an orderly transition, boards of directors of existing funds, and the principal underwriters and investment advisers of such funds, may wish to make offers of exchange to shareholders of new funds. Such offers of exchange, when based upon the relative net asset values per share of the money market funds involved, are permitted

under Section 11(a) of the 1940 Act [15 U.S.C. 80a-11(a)] without orders of the Commission. 13/ Such offers would normally have to be accompanied by a statutory prospectus to comply with the prospectus delivery requirements of Section 5 of the 1933 Act [15 U.S.C. 77(e)]. In these unusual circumstances where the existing fund and the new fund are for all practical purposes almost identical in structural make-up and operation, including having the same investment adviser and directors, to satisfy the requirement that a statutory prospectus be provided the Commission will not object to the use of a Rule 424(c) prospectus which consists of a document that: (1) incorporates by reference the prospectus of the new fund already delivered, and (2) includes such additional information as is necessary to constitute

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13/ Anticipated liquidation expenses and unamortized organization expenses of a new fund must be fully and accurately reflected in the net asset value per share of that fund, regardless of the method utilized to value such fund's assets or to price such fund's shares. See p. 8, supra, concerning the establishment of liquidation reserves. The Commission believes that, if these expenses are not reflected in this manner, Section 11(a) of the 1940 Act would require the investment company making such an offer to obtain an order of the Commission prior to the making of an offer of exchange. On the other hand, to the extent that the investment adviser or principal underwriter of a new fund agreed to bear such expenses it would not be necessary to reflect such expenses in the new fund's net asset value per share. As noted above at n. 9, the Commission will not view such an agreement in these unusual circumstances as a joint enterprise within the meaning of Section 17(d) of the Act and Rule 17d-1 thereunder.

the complete prospectus of the existing fund. 14/ Investment companies may rely on this Commission position only where the objectives, services and features of the new fund and existing fund are essentially the same. Of course, the Commission would not object if a statutory prospectus of the existing fund is sent with the offer of exchange.

Offers of exchange may be useful in achieving a prompt and orderly movement of shareholders from new funds to existing funds. 15/ Thus, directors of new funds and existing funds may wish to consider various methods, consistent with applicable state law, to effectuate exchanges of shares. Such offers of exchange are not subject to the Commission's rules under the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq.*] respecting tender offers, which do not apply to equity securities of registered open-end investment companies. 16/ However, because an offer of exchange is an offer of a security as

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14/ The financial information contained in the currently effective prospectus of the existing fund, or any more recent financial information contained in a periodic report to shareholders, may be utilized in the Rule 424(c) prospectus. In addition, shareholders should be advised to request a prospectus of the existing fund if they have not retained their copies of the new fund's prospectus.

15/ This assumes, of course, that the existing fund has the authority under state law through its corporate charter or articles of incorporation to own, purchase or hold the shares of another registered investment company.

16/ *See* Sections 14(d)(1) and 12(g)(2)(B) of the Securities Exchange Act of 1934 [15 U.S.C. 78n(d)(1) and 78*l*(g)(2)(B)].

to which the prospectus delivery requirements of Section 5 of the 1933 Act apply, shareholders to whom offers of exchange are made should be furnished, in the manner described above, with all material information relevant to their investment decisions, and be given appropriate time and means to communicate their decisions respecting such offers. Under such circumstances, the Commission will not object to offers of exchange being made effective pursuant to methods chosen by directors, provided that in each instance the boards of directors of the new fund and the existing fund determine that such procedures are fair and in the best interests of the shareholders of their respective funds. 17/

17/ If shares of the new fund are acquired by the existing fund pursuant to offers of exchange, the Commission will not view such acquisitions as violating the provisions of Section 12(d)(1) of the 1940 Act [15 U.S.C. 80a-12(d)(1)], provided that the shares so acquired are promptly redeemed. In this regard, the Commission intends to institute rulemaking proceedings to propose a temporary rule which may become effective on an emergency basis before July 28, 1980, immediately upon approval by the Commission, to exempt existing funds, whose fundamental policies may not permit the purchase of shares of other investment companies, from the provisions of Section 13(a) of the 1940 Act [15 U.S.C. 80a-13(a)] to the extent necessary to permit such purchases. In addition, the temporary rule would provide an exemption from the provisions of Section 12(d)(1) of the 1940 Act to permit the existing fund to hold shares of the new fund for not more than 120 days where no investment advisory fee, or fee for administrative services, is charged by the existing fund on account of the shares so held.

The Commission will not view the offer of exchange, or the liquidation of assets which will follow of necessity, as having the effect of changing the nature of the business of the new fund so as to cease being an investment company without shareholder approval as required by Section 13(a)(4) of the 1940 Act [15 U.S.C. 80a-13(a)(4)].

Many money market funds are utilizing amortized cost valuation or "penny rounding" pricing pursuant to orders of the Commission for purposes of pricing their shares for sales and redemptions. 18/ Such prices constitute "net asset value" for purposes of Section 11(a) of the 1940 Act. 19/ This practice is not inherently objectionable because the most basic assumption underlying the amortized cost and "penny rounding" pricing methods is that all securities purchased will be held to maturity by the investment company as a "going concern."

Nevertheless, under certain circumstances the use of exchange ratios reflecting relative net asset values based upon amortized cost prices or "penny rounded" prices of shares of the new fund and the existing fund could result in serious inequities due to the magnitude of the exchanges, and consequential redemptions, which may occur. For example, where at the time of exchange the unrounded market based

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18/ See, e.g., Investment Company Act Release Nos. 10451 and 10824 (dated October 26, 1978, and August 8, 1979, respectively).

19/ See Section 11(a)(B) of the 1940 Act.

net asset value per share of a new fund (less any reserve for liquidation and organization expenses) is less than the price per share of the new fund, the new fund would not in fact have sufficient assets to redeem all of its remaining shares at their amortized cost or "penny rounded" price. Such a result would be inequitable to remaining shareholders of the new fund. Similarly, a windfall gain could result to shareholders of the new fund remaining after the offer of exchange if the new fund's unrounded market based net asset value per share (less liquidation and organization expenses) at the time of exchange exceeds its amortized cost or "penny rounded" price per share. 20/ Accordingly, in the Commission's view, if offers of exchange are effected at relative net asset values per share calculated through the use of any method other than by reference to market factors (without rounding), boards of directors should, consistent with their fiduciary duties, give close and careful consideration to adopting the use of a market based net asset value per share before exchanges of shares are

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20/ Assuming directors have considered all other relevant factors, this latter result could be avoided through the declaration of a dividend prior to the exchange in an amount equal to the excess of market based net asset value per share (less amounts reserved) over the amortized cost price per share.

effected in order to insure that such exchanges are equitable to all shareholders of the funds involved. 21/

Finally, in considering the timing and appropriateness of offers of exchange, boards of directors of new funds should be cognizant of the fact that special deposits will not be refunded until August 11, 1980. Significant redemptions of new fund shares prior to that date, absent appropriate emergency arrangements, will have the effect of increasing the portion of a new fund's assets subject to the special deposit, and could impair the ability of a fund to continue to redeem its remaining shares. 22/

21/ In fact, boards of directors of funds operating pursuant to Commission orders permitting amortized cost valuation are required, pursuant to the conditions of such orders, to adjust exchange ratios to reduce to the extent reasonably practicable any unfair result or material dilution.

22/ To alleviate some of the problems that could arise if shareholders remain in new funds, directors may be asked to consider whether shareholders who remain in the new fund should be redeemed on an involuntary basis. In that regard, directors should consider carefully the factors addressed in Rule 13e-3 under the Securities Exchange Act of 1934 [17 CFR §240.13e-3]. The staff of the Commission has stated that it would not recommend action by the Commission if shares held by shareholders who have not accepted offers of exchange are involuntarily redeemed, provided the board of directors of the new fund concludes that such mandatory action is in the best interests of these shareholders. The offers of exchange in such cases should disclose fully the consequences of rejecting the exchange offer. Although, under most circumstances, effectuation of involuntary redemptions could be viewed as a violation of shareholders' fundamental rights to redeem shares, as assured by Section 22(e) of the 1940 Act, in this situation the need to assure the orderly suspension of the operations of new funds, in a manner that is not inequitable, could justify the use of this highly unusual measure.

This discussion is not intended to suggest that directors do not have the responsibility to consider and to determine whether other actions may not be equally appropriate.

2. Sales of Securities Between Funds.

Section 17(a) of the 1940 Act [15 U.S.C. 80a-17(a)], in pertinent part, generally prohibits an affiliated person of a registered investment company from purchasing securities from, or selling securities to, such registered investment company. Registered investment companies that are part of the same "complex" of investment companies are normally affiliated persons of each other. 23/ In such cases, securities held in the portfolio of the new fund could not be sold or otherwise transferred to the existing fund absent an exemption from the provisions of Section 17(a) of the 1940 Act. However, the most efficient and economical method of generating the necessary cash to meet the redemptions anticipated in new funds may be for the new fund to sell some or all of its assets to the existing fund.

23/ Section 2(a)(3)(C) of the 1940 Act [15 U.S.C. 80a-2(a)(3)(C)]. For purposes of Section 17(a) of the Act, each series of shares of a registered open-end investment company meeting the provisions of Section 18(f)(2) of the 1940 Act [15 U.S.C. 80a-18(f)(2)] should be deemed to be separate companies which are affiliated persons of each other. See Section 2(a)(8) of the 1940 Act [15 U.S.C. 80a-2(a)(8)].

The Commission intends to institute rulemaking proceedings permitting such transactions to be effected; it expects, before July 28, 1980, to propose a temporary rule which may become effective on an emergency basis, immediately upon approval by the Commission. It is expected that this rulemaking will require that the boards of directors of the companies involved find the transaction to be in the best interests of the respective affiliated companies, and find that the interests of the shareholders of the respective companies will not be diluted as a result of the transaction. The rule will require that all portfolio instruments of the new fund being sold to the existing fund be sold at market value (i.e., marked to market), regardless of whether the new fund previously has valued such instruments at amortized cost, but will permit the sale of individual instruments at their amortized cost values provided that in the aggregate the mark to market value of all such individual instruments being sold does not differ materially from the amortized cost value of such instruments. Solely for this purpose, the rule will deem a deviation of mark to market value from amortized cost value of less than 1/2 of 1 percent not to be material. 24/

24/ The rule will permit the sale of portfolio instruments of the new fund to the existing fund in several separate transactions. However, in such cases and in cases where all of the assets of the new fund are not sold, boards of directors of new funds will be required to consider certain factors in selecting those assets to be sold in order to protect the interests of shareholders remaining in the new funds.

The adoption of such a rule should enable new funds to generate sufficient cash, and existing funds to purchase assets, promptly and without some of the transactions costs normally associated with sales and purchases of portfolio securities.

OTHER MATTERS

Before revising any current policies presently restricting the sale of shares of an existing fund, the board of directors of the fund should give careful consideration to the potential impact of such policy revision upon existing shareholders of the fund. For example, if an existing fund previously has limited sales of its shares to existing accounts, the board of directors should consider whether elimination of that sales restriction at this time would result in substantial new sales of fund shares, requiring the fund to purchase debt securities bearing lower yields and thereby reducing significantly the dividends payable on existing shares of the fund. 25/ Although under ordinary circumstances the Commission would not expect money market funds to alter their sales policies merely because of declining interest rates, the extraordinary level of sales of shares of existing funds that may occur warrants directoral consideration of this issue.

25/ Of course, this possibility should also be considered before making any offer of exchange pursuant to Section 11(a) of the 1940 Act to shareholders of another money market fund.

In addition, where a new fund currently is relying upon temporary Rule 6c-4(T) and the board of directors of that new fund is considering whether to modify its investment objectives, its features or its services, the directors should recognize that such modifications may deprive the new fund of its ability to continue to rely upon the temporary rule. 26/ Such modifications could also eliminate the availability of the rule for use by other persons and companies associated or dealing with the new fund and now relying on the rule. 27/ On the other hand, the rescission of the Board's regulations will not be considered by the Commission as making a company or person ineligible to rely on Rule 6c-4(T) solely because of the rescission of the Board's regulations. Thus, paragraphs (a)(3)(ii) and (iii) of the rule, which, among other things, require that a fund relying upon the rule be a "covered creditor" under the Board's regulations, should be read for this purpose as though the Board's regulations remained in effect.

26/ Among other things, paragraph (a)(3) of Rule 6c-4(T) requires that the new fund provide essentially the same features and services as an "existing company," and have comparable policies and objectives, in order to qualify for the exemptions provided by the rule.

27/ Paragraph (c) of Rule 6c-4(T) extends certain exemptions to persons and companies associated with or transacting business with a new fund to enable certain relationships and transactions with respect to an existing fund to continue with the new fund. However, that exemptive relief is conditioned upon the new fund meeting the requirements set forth in paragraph (a)(3) of the rule.

The Commission expects to consider the continued appropriateness of Rule 6c-4(T) in the near future, as investment companies react to rescission of the credit control regulations. As stated in the release adopting the temporary rule on an emergency basis, after appropriate notice, the Commission may determine it to be appropriate to rescind the rule in whole or in part.

Finally, the Commission expects to consider in the near future whether Rule 24e-2 under the 1940 Act [17 CFR §270.24e-2] should be amended to mitigate duplication of registration fees.

CONCLUSION

The Commission has instructed its Division of Investment Management to monitor closely the manner in which money market funds address the matters discussed herein, and to advise the Commission with respect to its findings as developments may require.

Accordingly, 17 CFR Parts 231 and 271 are hereby amended to incorporate therein this general statement of policy.

By the Commission.

George A. Fitzsimmons
Secretary.

July 21, 1980.