UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

SION OF
IT MANAGEMENT

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Act ICA-40

Section

Rule 2a-7

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Ms. Amy B.R. Lancellotta
Associate Counsel
Investment Company Institute
1600 M Street
Washington, D.C. 20036

re: Applicability of Rule 2a-7 to Certain Capped Floating and Variable Rate Instruments

Dear Ms. Lancellotta:

This letter is in response to your request that the Division of Investment Management clarify its position with respect to the ability of money market funds to acquire certain capped floating and variable rate government securities in compliance with Rule 2a-7 under the Investment Company Act of 1940.

Paragraph (c)(2)(i) of Rule 2a-7, with limited exceptions, prohibits money market funds from holding portfolio securities having maturities greater than 397 days. Paragraph (d)(1) permits funds to measure the maturity of a security issued or guaranteed by the United States government (or agency thereof) paying a variable rate of interest by reference to the period remaining until the next interest rate adjustment. Paragraphs (d)(3) and (4) provide similar relief for variable rate and floating rate instruments subject to demand features, but require their maturity dates to be measured by reference to the later of their interest rate readjustment dates or final maturity. In addition, the terms of these instruments must provide for the readjustment of interest rates so that, upon readjustment, it can reasonably be expected that the security will have a market value of par. <u>See</u> paragraphs (a)(7) (defining "floating rate instrument") and (a)(21) (defining "variable rate instrument"). Although paragraph (d)(1) does not explicitly provide that the instruments covered by that paragraph must have a market value that approximates their par value upon their interest rate readjustment, such a requirement is implicit in the rule. Morgan, Keegan & Co., Inc. (pub. avail. July 24, 1992), n.7.

As the Division has stated, interest rate caps on floating or variable rate instruments are inconsistent with the requirement that they can reasonably be expected to return to par upon readjustment. <u>Id.</u> Once the cap is reached (and, more likely, once short-term interest rates approach the cap) it can reasonably be expected that the instruments will trade below par.

Nonetheless, in the current interest rate environment the Division does not object if money market funds purchase variable or floating rate instruments issued by the United States government or agencies thereof the interest rates of which are capped at a rate in excess of 20% to comply with certain state usury laws. This exception does not relieve money market funds from the overall duty of care to manage the fund in such a manner as to stabilize the fund's net asset value. This obligation will require money market funds to pay close attention to the market value of capped instruments to assure that their market value does not deviate significantly from their amortized cost and affect the ability of the fund to maintain its stable share price.

This position does not limit the ability of money market funds to invest in capped floating and variable rate instruments with final maturities of less than 397 days, because investment in such instruments does not require reliance on paragraph (d) to shorten their maturities. For purpose of determining the average weighted maturity, the remaining maturity of these securities must be determined by reference to their final maturity rather than their interest rate readjustment date. However, consistent with the position taken above, funds may determine the maturity of variable or floating rate instruments issued by the United States government or agencies thereof the interest rates of which are capped at a rate in excess of 20% to comply with certain state usury laws based on their interest rate readjustment date.

Finally, this position does not affect the ability of money market funds to invest in capped floating or variable rate demand notes or other instruments the maturity of which is determined by reference to a demand feature under paragraph (d)(3) or (4) of Rule 2a-7. See John Nuveen & Co. (Sept. 4, 1990). If short-term interest rates rise so that the market value of the instrument is below par as a result of the cap, a money market fund may exercise the demand feature and may receive the amortized value of the instrument.

Sincerely,

Robert E. Plaze
Assistant Director