SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239 and 274

[Release No. 33-6927; IC-18612]

Revisions of Guidelines to Form N-1A

AGENCY: Securities and Exchange Commission.

ACTION: Revisions to Guidelines.

SUMMARY: The Commission is publishing revisions to the Guidelines to Form N-1A to permit open-end management investment companies to increase from 10% to 15% the amount of illiquid assets they may hold. Revising the Guidelines will permit investment companies more flexibility to make investments in the illiquid securities of small businesses. This could provide small businesses with better access to the capital markets in a manner consistent with the public interest and the protection of investment company shareholders.

EFFECTIVE DATE: March 20, 1992.

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SUPPLEMENTARY INFORMATION: The Commission is publishing revisions of the Guidelines to Form N-1A (17 CFR 239.15A, 274.11A), the registration form used by open-end management investment companies ("mutual funds") to register under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) ("1940 Act") and to register their securities under the Securities Act of 1933 (15 U.S.C. 77a-1 *et seq.*). The revised Guidelines will permit a mutual fund to invest up to 15% of its net assets in illiquid securities. Currently, the Guidelines recommend a 10% limit on mutual fund investments in illiquid assets. In addition, the revisions make other minor changes to the Guidelines and place the discussion of liquidity requirements in one place. The Guidelines, which consist of a compilation and adaptation of applicable Commission releases and staff positions, are prepared by the Division of Investment Management for use in the preparation and filing of registration statements on Form N-1A.

I. Background

The Guidelines are being revised in connection with the Commission's efforts to remove unnecessary barriers to capital formation and to facilitate access to the capital markets by small businesses.[1] Historically, small local enterprises have satisfied a large portion of their capital needs by using the financial resources of local banks and similar institutions. In recent years, concern has been expressed about the ability of U.S. small businesses to obtain financing from traditional sources.[2] The health and existence of small business is critical to local economies and to the national economy.

Mutual funds represent a significant potential source of capital for small business.[3] Currently there are 1,787 funds which have aggregate total assets of $474.2 billion that could be a source of capital for small businesses.[4] Allowing mutual funds to invest an additional 5% of their net assets in illiquid securities, including illiquid securities of U.S. small businesses, could make a significant amount of capital available to small business without significantly increasing the risk to any fund.

However, the securities of small businesses are generally illiquid and mutual funds are constrained in the amount of illiquid assets they may hold. Under the 1940 Act, mutual funds must stand ready to redeem shares daily and pay redeeming shareholders within seven days of receiving a redemption request.[5] In addition, a mutual fund must compute its net asset value each business day and give purchase and redemption orders the price next computed after receipt of an order.[6] Moreover, most mutual funds allow shareholders easily to exchange their fund shares for shares of another mutual fund managed by the same investment adviser, in transactions which generally can include only nominal costs. Shareholders thus easily may move their money among equity, income, and money market funds as they choose, increasing the need for liquidity of mutual fund assets.

To compute an accurate net asset value per share, a mutual fund must be able to value each portfolio security accurately. Mutual funds must use market price to value securities for which market quotations are readily available; the board of directors must make a good faith determination of the fair value of securities for which market prices are not readily available.[7] If the net asset value of a mutual fund is not accurate, purchasing or redeeming shareholders may pay or receive too little or too much for their shares, and the interests of remaining shareholders may be overvalued or diluted.

To meet these requirements, a mutual fund must maintain a high degree of portfolio liquidity. In 1969, the Commission stated that a prudent limit on mutual fund holdings of illiquid securities would be 10 percent.[8] This conservative standard was designed to ensure that mutual funds will be ready at all times to meet even remote contingencies. The 10% standard has been reflected in the Guidelines to Form N-1A, the mutual fund registration form. The Commission has determined it is consistent with investor protection to increase the limit in the Guidelines to 15%. The Commission believes that a 15% standard should satisfactorily assure that mutual funds will be able to make timely payment for redeemed shares. Experience has shown that mutual funds generally have not had difficulty in meeting redemption requests from available cash reserves, even during times of abnormally high selling activities in the securities markets.[9] Even if a fund were forced to sell securities to meet redemption requests, substantially all of its remaining assets would be required to be liquid securities which it could sell

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[1] See Securities Act Rel. No. 6924 (Mar. 11, 1992) ("Small Business Initiatives" proposing, among other things, amendments to regulation A and Rule 504) and Securities Act Rel. No. 6926 (Mar. 12, 1992) (proposing amendments to regulation E).

[2] See The Small Business Credit Crunch, Hearings Before the House of Representatives Comm. on Small Business, 101st Cong., 2nd Sess. (1990).

[3] See section 1(a)(4) of the 1940 Act (15 U.S.C. 80a-1(a)(4)) (mutual funds are "media for investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of savings into the capital markets").

[4] This estimate was derived by subtracting from the total assets of mutual funds the assets of funds that ordinarily would not invest in the securities of small businesses—money market funds, funds investing primarily in securities of the U.S. government and its agencies and instrumentalities, and funds investing primarily in securities of state and local governments. See Investment Company Institute Trends in Mutual Fund Activity (Nov. 1991), table 6A.

[5] Section 22(e) of the 1940 Act (15 U.S.C. 80a-22(e)) prohibits a mutual fund from suspending the right of redemption or postponing the date of payment or satisfaction upon redemption for more than seven days after the tender of such security to the mutual fund.

[6] Rule 22c-1(a) (17 CFR 270.22c-1(a)).

[7] Rule 2a-4 (17 CFR 270.2a-4).

[8] Investment Company Act Rel. No. 5847 (Oct. 21, 1969).

[9] During the 1987 market break, approximately 2% of all equity mutual fund shares were redeemed on October 16 and 19, 1987, and most funds were able to meet these redemptions from available cash reserves. See Securities and Exchange Commission, Division of Market Regulation, The October 1987 Market Break 2-17 to -18 (1988).

consistent with appropriate portfolio management.

II. Revision of Liquidity Test in Guidelines to Form N-1A

As revised, Guide 4 will permit a mutual fund to invest up to 15% of its assets in illiquid assets. An illiquid asset is defined as an asset which 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 on its books.[10]

While the changes to the Guidelines will permit mutual funds to increase their holdings of illiquid assets, it will not require them to do so.[11] Nor will it relieve a fund from the requirements concerning valuation and the general responsibility to maintain a level of portfolio liquidity that is appropriate under the circumstances. If no market quotations for an illiquid security are available, the board of directors of the fund will be required to determine the fair value of the security. In addition, the Commission expects funds to monitor portfolio liquidity on an ongoing basis to determine whether, in light of current circumstances, an adequate level of liquidity is being maintained. For example, an equity fund that begins to experience a net outflow of assets because investors increasingly shift their money from equity to income funds should consider reducing its holdings of illiquid securities in an orderly fashion in order to maintain adequate liquidity. Finally, the Commission intends to review the operation of the Guideline revision through its investment company inspection program to determine whether the revision is achieving its intended purposes in a manner consistent with investor protection.

[10] Investment Company Act Rel. No. 14983 (Mar. 12, 1986) (51 FR 9773 (Mar. 21, 1986) (adopting amendments to rule 2a-7 under the 1940 Act) (17 CFR 270.2a-7).

[11] Funds that have fundamental investment policies restricting their ability to invest in illiquid securities would be required by section 13(a) of the 1940 Act (15 U.S.C. 80a-13(a)) to obtain shareholder approval to change those policies. In addition, funds that choose to make additional investments in illiquid assets, as permitted by the Guideline revision, should consider whether to amend or "sticker" their disclosure documents to reflect these changes.

III. Text of Revisions to the Guidelines

List of Subjects in 17 CFR Parts 239 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is amended as follows:

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

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

1. The authority citation for part 239 continues to read as follows:

Authority: 15 U.S.C. 77a, *et seq.*, unless otherwise noted.

2. The authority citation for part 274 continues to read as follows:

Authority: The Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.*, unless otherwise noted;

Note: The Guides to Forms N-1A are not codified in the Code of Federal Regulations.

3. Amending Guide 4 to Form N-1A (239.15A and 274.11A) by adding at the end a paragraph to read as follows:

Guide 4. Types of Securities

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If an open-end company holds a material percentage of its assets in securities or other assets for which there is no established market, there may be a question concerning the ability of the fund to make payment within seven days of the date its shares are tendered for redemption. The usual limit on aggregate holdings by an open-end investment company of illiquid assets is 15 percent of its net assets. An illiquid asset is any asset which 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. *See* Investment Company Act Release No. 14983 (Mar. 12, 1986).

4. Amending Guide 12 to Form N-1A (239.15A and 274.11A) by removing the last sentence and adding a new last sentence to read as follows:

Guide 12. Purchase and Sale of Real Estate

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For the limits on the aggregate holdings by open-end companies of illiquid assets, see Guide 4.

5. Amending Guide 13 to Form N-1A (239.15A and 274.11A) by removing the fourth and fifth sentences and adding a new last sentence to read as follows:

Guide 13. The Making of Loans to Other Persons

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For the limits on the aggregate holdings by open-end companies of illiquid assets, see Guide 4.

Dated: March 12, 1992.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 92-6177 Filed 3-19-92; 8:45 am]

BILLING CODE 8010-01-M