

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 8791]
April 4, 1980

CREDIT RESTRAINT
Amendments to Subpart B

*To All Member Banks, and Others Concerned,
in the Second Federal Reserve District:*

The Board of Governors of the Federal Reserve System has announced a series of amendments to Subpart B of its new regulation on "Credit Restraint." Subpart B of the regulation deals with the expansion of short term credit through money market funds and similar types of creditors (Short Term Financial Intermediaries). In announcing the amendments, the Board indicated that the changes will:

1. Extend the exemption for bank-operated collective investment funds to *bona fide* personal trusts, pension, retirement and other tax-exempt accounts invested in money market funds.
2. Allow the unit investment trusts of a particular sponsor to roll-over without incurring the 15 percent special deposit requirement as long as (a) the units are sold only to the unitholders of record on the date the trust matures, (b) the sales charge is not substantially increased, and (c) a unitholder cannot subscribe to more units than he held in the maturing trust.
3. Exempt the tax exempt assets of money market funds whose investment objective is to invest at least 80 percent of their assets in short-term tax exempt obligations. These funds typically provide a yield substantially below those of other funds and provide a convenient vehicle for investors that otherwise would invest directly in such tax exempt obligations. The remaining nonexempt assets of such funds would be subject to the special deposit requirement to the extent they exceed the fund's base.
4. Provide a minimum base for funds that were engaged in a continuous public offering on March 14.

In addition, the Board changed the reporting and maintenance periods for money market funds to a weekly basis. Special deposits will be required to be maintained beginning April 14. The date on which the base report must be filed has been postponed to April 8.

Enclosed is a copy of the text of the amendments to Subpart B of the "Credit Restraint" regulation. Legal questions regarding the amendments may be directed to Walker F. Todd, Assistant Counsel, Legal Department (Tel. No. 212-791-5041); other types of questions should be directed to the Consumer Credit Reports Unit (Tel. Nos. 212-791-7721 through 7725).

ANTHONY M. SOLOMON,
President.

Board of Governors of the Federal Reserve System

CREDIT RESTRAINT

SUBPART B—SHORT TERM FINANCIAL INTERMEDIARIES

(effective March 28, 1980)

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: On March 14, 1980 the Board adopted this Subpart pursuant to the Credit Control Act (12 U.S.C. § 1901-1909) as implemented by Executive Order 12201 to restrain the expansion of short term credit through money market funds and similar creditors. The Board now amends the Subpart to reflect comments it has received. The effect of the amendments is to:

- exclude from coverage the assets of money market funds representing shares or units held by banks and other fiduciaries investing funds that would be eligible for collective investment by a bank.
- exempt from coverage the tax exempt assets of money market funds that invest at least 80 per cent of their assets in obligations the income from which is exempt from federal income taxation.
- exempt from coverage unit investment trusts whose units are held by unit holders of expiring trusts that were in existence on March 14, 1980, and their successors.
- provide that in calculating its base, a covered creditor in existence on March 14, 1980, can use the amount of its covered credit or \$100 million whichever is greater.
- revise the reporting and deposit maintenance schedule to weekly rather than monthly.
- allow covered funds and similar creditors until April 8, 1980, to file a base report.

EFFECTIVE DATE: March 28, 1980.

FOR FURTHER INFORMATION CONTACT: Gilbert T. Schwartz, Assistant General Counsel (202/452-3625), C. Baird Brown, Attorney (202/452-3265), or Daniel L. Rhoads, Attorney (202/452-3711), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

For this Regulation to be complete, retain:

- 1) Regulation pamphlet entitled "Credit Restraint," adopted effective March 14, 1980.
- 2) Subpart D, effective March 28, 1980.
- 3) This slip sheet.

SUPPLEMENTARY INFORMATION: On March 14, 1980, the Board adopted this Subpart pursuant to the Credit Control Act (12 U.S.C. § 1901-1909) as implemented by Executive Order 12201 to restrain the expansion of short term credit through money market funds and similar creditors (45 F.R. 17930). The Board has received a variety of comments on the Subpart and on the basis of those comments has made several revisions. The various comments are discussed below together with changes made to the Subpart or interpretive positions that the Board has taken in response to those comments.

TRUST ASSETS

The original Subpart exempted moneys contributed to common trust funds of banks provided they were held by the bank incidentally to the management of other trust assets. Also exempt were bank collective investment funds for pension, retirement, profit sharing and other tax exempt trusts. Commenters pointed out that such moneys were also managed for banks, pension plan trustees, and similar fiduciaries by money market funds. In order to place banks, other fiduciaries, and money market funds on an equal footing in managing such moneys, and to permit small banks to avail themselves of the services of money market funds as an alternative to internal operation of a short term investment fund, the Subpart has been revised to reduce the amount of covered credit by the proportion of moneys from these sources. Thus, a money market fund that had 30 per cent of its outstanding shares held by bank trust departments would reduce its covered credit for both its base report and weekly reports by 30 per cent. Additional shares could be sold to bank trust departments or other fiduciaries managing funds eligible for collective investment by banks without incurring a special deposit liability.

Shifting the exclusion from the definition of covered creditor to the definition of covered credit has no effect on the type of activities permitted to bank trust departments or trust companies. All collective investment funds of a bank are covered creditors, but they need not file reports unless they hold covered credit, and their holdings are generally excluded from covered credit. Moneys that are not held incidentally to the management of other trust assets are covered. For example, a revocable, inter vivos trust, with the settler's spouse as beneficiary and with instructions to a bank trustee to invest the corpus in its short term investment fund, gives rise to covered credit. It should be noted, however, that under the revised Subpart a bank trustee would incur a special deposit liability only on increases in such covered credit, not on the entire increase in a short term investment fund that contained money from one or more nonexempt accounts.

Generally, moneys held by a bank or trust company pursuant to a bona fide trust purpose are within the "incidentally" exclusion even though they may temporarily be invested largely in a short term investment fund. However, Individual Retirement Accounts are not exempt. The exclusion for moneys from pension, retirement, profit sharing and other tax exempt trusts in the Subpart is identical to the provisions of the trust regulation of the Comptroller of the Currency (12 C.F.R. § 9.18), and the Comptroller's interpretations of that provision apply.

Money market funds may only exclude from covered credit funds from sources that a bank would be permitted to commingle.

TAX EXEMPT BOND FUNDS

The Board has received comments regarding certain money market funds which, by their investment objectives, are limited to the purchase of tax exempt bonds of state and local governments and their agencies. The Board's Credit Restraint regulation is not generally intended to limit extensions of credit to state and local governments. Moreover, the tax exempt assets have generally low yields and will appeal to a very limited class of investors who would in all likelihood purchase such securities directly in the absence of the funds. Accordingly, these funds may reduce their covered credit for both base and weekly calculations by the proportion of their extensions of credit which are tax exempt obligations.

UNIT INVESTMENT TRUSTS

The Board has received comments regarding the provisions of the original Subpart that assigned a base of zero to newly established unit investment trusts. Commenters felt that this represented different treatment for sponsors of those trusts than was accorded to the investment advisors of open end management funds, which were permitted to retain an existing base. However, the base provided for the management funds serves generally to benefit existing shareholders, and cannot, consistent with the fund's fiduciary duties, serve as a basis for major expansion of fund's activities. Accordingly, the Board has revised the definition of the term base for unit investment trusts to permit unit holders of record in those trusts in existence on March 14, 1980, to roll over their investments into new trusts when the old ones expire without incurring a special deposit liability for the trust. The unit holders and persons who subsequently purchase units from them could continue to roll over their units into new trusts. To prevent the expansion of a sponsor's activity through the creation of trusts with a partial base, any new trust must consist entirely of prior unit holders. A new trust for prior unit holders must also be marketed with substantially similar fees as the sponsor's previous trusts. The Board is aware that the sponsors of some unit investment trusts do not market them directly but through broker-dealers. Where the sponsor does not know the identity of its unit holders, it may treat the broker-dealers as holders of record

The Board has also received questions about the period during which unit investment trusts must maintain special deposits. While the trust is established by the exchange of any assets, such as a contract for purchase of a certificate of deposit and letters of credit, for the units of the trust, the special deposit must be maintained starting when the trust acquires its investment assets, such as a certificate of deposit, which typically occurs at the end of an initial underwriting period. The special deposit must be held from that day until the day before the trust dissolves. However, in the event that a unit holder elects to redeem his units, the trust may request from the Federal

Reserve Bank a pro rata return of the special deposit. The Subpart has been amended to reflect this possibility.

MINIMUM BASE

Several comments suggested that small money market funds that had not yet achieved viable size would be unfairly disadvantaged by the Subpart. The Board has amended the definition of base to permit a fund in operation, but with less than \$100 million in extensions of credit on March 14, 1980, to calculate its base as if it had \$100 million in extensions of credit on March 14, 1980. For example, a fund which has \$50 million in extensions of credit and has 50 per cent of its shares owned by bank trust departments has covered credit of \$25 million. However, it may calculate its base as 50 per cent of \$100 million = \$50 million. If during a later weekly reporting period it has \$80 million in covered credit and 25 per cent of its shareholders are bank trust departments, it would report \$60 million of covered credit for the week, and its special deposit requirement would be \$1.5 million.

OTHER COMMENTS

The Board also considered requests that it exempt money market funds that provide corporate cash management services and exempt funds that invest solely in securities of the Small Business Administration and the Farmers Home Administration. The Board rejected the former request because such funds serve to expand types of credit which the Board wishes to restrain and because moneys invested in such funds might otherwise be invested in regional markets. The Board rejected the second request because it believes it would be difficult to make meaningful distinctions between these securities and obligations of a wide variety of other Federal government agencies.

WEEKLY REPORTING

Under the original regulation, funds would have reported on a monthly basis and held a special deposit for a period of roughly one month beginning approximately two weeks after the end of the reporting period. Thus, a special deposit could be held as long as two and one half months after the increase in covered credit for which it was required. Since the shareholders of a fund may change considerably over such a period, the return of the later shareholders could be reduced by the investments of the earlier shareholders. In order to lessen the impact of such changes, the Board has changed to weekly reporting periods running from Monday of each week to Sunday of the following week, with a weekly report due on the following Wednesday. Except for the first two reporting periods, the special deposit will be maintained for a week beginning eight days after the end of the reporting week. For example, for the week of April 7 to 13, 1980, a report must be filed by April 16, 1980, and a special deposit maintained for the week of April 21 to 27, 1980. For the first three weekly reporting periods, which begin on March 17, 24, and 31, 1980, reports must be filed by April 10, 1980, and a special deposit equal to the sum of the special deposits required for the three periods must be maintained for the week of April 14 to April 20.

BASE REPORTING DATE

In view of the amendments to the regulation and related revisions of reporting forms, the Board has extended the time for filing of base reports to April 8, 1980.

These actions are being taken in view of the comments received, as indicated above, on Subpart B of the Board's Credit Restraint regulation. Because these revisions affect the operations and compliance responsibilities of creditors covered by the regulation, the Board therefore for good cause finds that further notice, public procedure, and deferral of effective date provisions of 5 U.S.C. § 553(b) with regard to these actions are impracticable and contrary to the public interest.

Pursuant to its authority under the Credit Control Act (12 U.S.C. §§ 1901-1909) the Board hereby amends Subpart B of its Credit Restraint regulation (12 C.F.R. Part 229) effective March 28, 1980, as follows:

SECTION 229.11--AUTHORITY, PURPOSE, AND SCOPE

(a) Authority. This Subpart is issued by the Board of Governors of the Federal Reserve System pursuant to the Credit Control Act (12 U.S.C. §§ 1901 - 1909), as implemented by Executive Order 12201.

(b) Purpose and Scope. This Subpart is intended to curb inflation generated by the extension of credit by certain of those financial intermediaries that are not subject to either the amendments of law effected by Pub. L. 89-597, as amended, or section 19 of the Federal Reserve Act, as amended (12 U.S.C. § 461), and that are primarily engaged in the extension of short-term credit, specifically money market funds and other similar creditors.

SECTION 229.12--DEFINITIONS

(a) For the purposes of this Subpart, the terms "credit," "creditor," and "extension of credit" shall have the meanings given them in the Credit Control Act. In addition, the following definitions apply.

(b) "Base" means:

- (1) for a managed creditor that was a managed creditor on March 14, 1980, the amount of covered credit it held on March 14, 1980: provided, however, that a managed creditor (A) that was engaged in continuously offering its shares to the public on March 14, 1980, or, in the case of a collective investment fund or closed-end investment company, held investment assets on March 14, 1980, and (B) that held less than \$100 million in total extensions of credit on March 14, 1980, may calculate its base as if it held \$100 million in total extensions of credit on March 14, 1980.

- (2) for a managed creditor that becomes a managed creditor after March 14, 1980, the amount of covered credit with maturities of 13 months or less that it held on March 14, 1980; and
- (3) for a unit investment trust in existence on March 14, 1980, the amount of covered credit it held on the date it acquired investment assets;
- (4) for a unit investment trust established after March 14, 1980, zero: provided, however, that a unit investment trust shall have a base equal to the amount of covered credit it held on the date it acquired investment assets if (A) the sales charges and other fees of the unit investment trust are substantially identical to those of previous trusts of the same sponsor, and (B) the units are held (i) entirely by persons

who held units in an expiring trust of the same sponsor with a base equal to the amount of its covered credit, and (ii) in amounts not exceeding the individual holdings of such persons in expiring trusts.

(c) "Covered credit" means all extensions of credit originated through the acquisition of a security, deposit, or other instrument,^{1/} including but not limited to domestic and Eurodollar certificates of deposit, U.S. Treasury bills, repurchase agreements, commercial paper, bankers acceptances, and State and local government obligations, and any interest accrued thereon, held as assets by a covered creditor, multiplied by the proportion of shares, units, or other interests in a covered creditor not held (1) by a bank, trust company or other fiduciary provided all moneys invested therein would be eligible for collective investment by a bank in its capacity as a trustee executor, administrator or guardian, and are held incidentally to the management of other trust assets, or (2) by or as agent for the trustee of a retirement, pension, profit sharing, stock bonus, or other trust that is exempt from Federal income taxation under the Internal Revenue Code and whose funds are eligible for collective investment by a bank. To determine its covered credit, a covered creditor whose stated investment objective is to invest 80 per cent or more of its assets in obligations of State and local governments and agencies and subdivisions thereof, the income from which are exempt from Federal income taxation, shall further multiply its covered credit as determined above by the proportion of its extensions of credit that are not tax exempt.

(d) "Covered creditor" means any creditor (1) that is (A) an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940, (B) any series of shares or

^{1/} Assets should be valued for purposes of this Subpart by the same procedure used by a registered investment company to value assets in calculating net share or unit value under the Investment Company Act of 1940 and rules promulgated thereunder.

units of such a company, or (C) any collective investment fund maintained by a bank or trust company; and (2) whose investment portfolio consists primarily of securities, deposits or other instruments with maturities of 13 months or less,^{2/} including but not limited to domestic and Eurodollar certificates of deposits, U.S. Treasury bills, repurchase agreements, commercial paper, and State and local obligations. However, a unit investment trust is not a covered creditor unless its investment portfolio consists primarily of securities, deposits, or other instruments with maturities of 13 months or less^{2/} at the time the unit investment trust acquires those assets.

(e) "Managed creditor" means any covered creditor that is not a unit investment trust.

(f) "Unit investment trust" means any unit investment trust as defined in the Investment Company Act of 1940, or a series of units of such a trust.

(g) "Collective investment fund" means collective investment fund as defined in section 9.18 of regulations of the Comptroller of the Currency (12 C.F.R. § 9.18).

(h) "Security" means any security as defined in the Securities Act of 1933.

SECTION 229.13--REPORTS

(a) Each managed creditor that holds covered credit shall file a base report and weekly reports. The base report shall state the amount of the covered creditor's base and shall be submitted no later than April 8, 1980, or in the case of a managed creditor that becomes a managed creditor or begins holding covered credit after March 14, 1980, within one week of acquiring or holding assets or accepting trust moneys that require it to file reports. Weekly reports shall be filed for reporting periods which begin on Monday and end on the following Sunday, and shall state the amount by which the average of the daily amounts of covered credit outstanding during the reporting period exceeds the base. Reports for the reporting periods beginning March 17, 24, and 31, 1980, shall be submitted by close of business on April 10, 1980. Reports for each succeeding period, or in the case of a covered creditor that becomes a covered creditor after March 14, for each full reporting period after it becomes a covered creditor, shall be filed by close of business on the first Wednesday following the reporting period.

(b) A covered creditor that is a unit investment trust established after March 14, 1980, shall file a base report stating its base and the amount of covered credit it holds. This report shall be filed 2 days prior to acquisition of investment assets by the unit investment trust.

^{2/} This includes variable rate securities, deposits or other instruments with longer nominal maturities but with interest rates subject to adjustment at intervals shorter than 13 months.

(c) All reports shall be filed with the Federal Reserve Bank in the District where the covered creditor has its principal place of business.

SECTION 229.14--MAINTENANCE OF SPECIAL DEPOSIT

(a)(1) Each managed creditor that holds covered credit shall maintain a non-interest bearing special deposit equal to 15 per cent of the amount by which the average of the daily amounts of its covered credit outstanding during each reporting period exceeds its base.

(2) During the seven-day deposit maintenance period beginning April 14, 1980, each managed creditor shall maintain a special deposit equal to the sum of the special deposits required for the reporting periods beginning March 17, March 24, and March 31. During the seven-day deposit maintenance period beginning April 21, 1980, and for each seven-day deposit maintenance period thereafter, each managed creditor shall maintain the special deposit required for the reporting period ending eight days prior to the beginning of the corresponding deposit maintenance period.

(b) Each covered creditor that is a unit investment trust established after March 14, 1980, shall maintain a non-interest bearing special deposit equal to 15 per cent of the amount by which the covered credit it holds as of the date it acquires investment assets exceeds its base. This special deposit shall be maintained during the period beginning the day the covered creditor acquires assets consisting of covered credit and ending one day prior to final distribution of trust assets by the trustee pursuant to the terms of the trust agreement. Upon two weeks notice, the special deposit will be returned to the trustee one day prior to maturity or final distribution pursuant to the terms of the trust agreement. The deposit may also be returned pro rata in the event of redemption of units of the trust.

(c) Special deposits shall be maintained in collected funds in the form of U.S. dollars at the Federal Reserve Bank to which the covered creditor reports.

SECTION 229.15--PENALTIES

For each willful violation of this Part, the Board may assess against any creditor, or officer, director or employee thereof who willfully participates in the violation, a maximum civil penalty of \$1,000. In addition, a maximum criminal penalty of \$1,000 and imprisonment of one year may be imposed for willful violation of this Part.