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A legal update from Dechert's Financial Services Group

SEC Proposes Amended Rules for Money Market Funds

Introduction

The Securities and Exchange Commission ("SEC") on June 30, 2009 proposed for public comment amendments to Rule 2a-7 under the Investment Company Act of 1940 ("1940 Act") that are intended to enhance the regulatory regime for money market mutual funds ("money funds").[1] Specifically, the amendments would take steps designed to: (i) strengthen the risk-limiting requirements of Rule 2a-7 with respect to portfolio quality and maturity, and establish new liquidity requirements for money funds; (ii) require money funds to disclose portfolio information on a more frequent basis; and (iii) mitigate the negative impact felt by shareholders of money funds that liquidate upon "breaking the dollar" (i.e., where the market-based NAV per share of the fund falls below its stable share price of typically $1.00).

Background

The abrupt end to the credit boom and the ensuing financial crisis beginning in the summer of 2007 has been attributed to many factors, including delinquencies on sub-prime mortgages resulting from a sharp downturn in the U.S. housing cycle, declines in underwriting standards, breakdown in lending oversight by investors and credit rating agencies, and increased reliance on complex credit instruments.

While the financial crisis rapidly developed in 2007, investments by numerous money funds in structured investment vehicles ("SIVs") tied to sub-prime mortgage assets threatened to seriously impact the ability of money fund portfolios to maintain the $1.00 share price, as the secondary market for many such securities essentially became non-existent, except at distressed prices. To address the issues raised by these developments, the SEC Staff issued no-action letters beginning in the autumn of 2007 to allow affiliates of these funds to enter into credit support arrangements with affiliated funds or to purchase from the funds "Eligible Securities," as defined in Rule 2a-7, that were issued by then-illiquid SIVs.

The initial wave of credit support requests to the SEC Staff turned into a deluge after Lehman Brothers filed for the largest Chapter 11 bankruptcy protection in U.S. history on September 15, 2008. The next day, The Reserve Primary Fund ("Reserve"), an institutional fund with assets under management in excess of $62 billion, became the second money fund in history to break the dollar.[2]

In the days after Reserve broke the dollar, there was a run on prime money funds, with nearly $300 billion being withdrawn from those funds as a result of a "flight to quality." These extraordinary redemption requests resulted in severe liquidity pressures that impaired the

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1 *See* Money Market Fund Reform, SEC Release No. IC-28807 (June 30, 2009), *available at* www.sec.gov/rules/proposed/2009/ic-28807.pdf.

2 Unlike other firms, the Reserve Fund group was unable to secure credit support in time to meet significant demand for redemptions, and the illiquidity in the credit markets prevented its investment adviser from disposing of portfolio securities without impairing the share prices of its money funds. Faced with these circumstances, Reserve applied to the SEC for, and received, orders permitting the troubled funds of the Reserve Fund group to suspend redemptions. *See,* e.g., *In re* The Reserve Fund (File No. 812-13576), and SEC Release No. IC-28386 (Sept. 22, 2008) [73 FR 55572 (Sept. 25, 2008)] (order).

ability of money funds to provide liquidity to redeeming investors through ordinary means.[3] During this period, many firms requested and received no-action relief from the SEC Staff allowing asset purchase and credit support arrangements to be implemented with respect to more than 120 money funds facing credit or liquidity challenges.

The Federal Reserve Board and the Department of the Treasury ("Treasury") also responded to the crisis, announcing primary and secondary market support programs designed to improve market liquidity and assist money funds.[4]

Strengthening Rule 2a-7's Risk Limiting Requirements

Rule 2a-7 currently imposes three basic criteria with respect to the composition of a money fund's portfolio: quality, maturity, and diversification. The amendments would tighten the quality standards, shorten the maturity standards, and introduce new liquidity standards under the Rule.[5]

Quality

Rule 2a-7 limits the portfolio holdings of money funds to securities that, among other factors, are Eligible Securities. Eligible Securities are generally short-term securities that, at the time of acquisition, have received the highest or second highest short-term debt ratings from the requisite nationally recognized statistical rating organizations ("NRSROs") or, if unrated, have been deemed to be of comparable quality to such securities.[6]

Certain Eligible Securities are currently deemed to be "first tier securities" while others are deemed to be "second tier securities." A first tier security is generally any Eligible Security that has received the highest short-term debt rating from any two NRSROs (or an unrated security of comparable quality), a security that is issued by another registered money fund, or a "Government Security," as defined in Rule 2a-7. A second tier security is any Eligible Security that does not qualify as a first tier security.

The amendments would effectively limit money fund investments to the equivalent of first tier securities. Specifically, the amendments would: (i) redefine rated Eligible Securities to mean investments in securities that are rated in the *highest* NRSRO rating category (instead of one of the two highest, as in the current rule); (ii) include securities that are issued by other registered money funds and Government Securities in the definition of Eligible Securities (unrated securities of comparable quality to such securities would continue to be permissible investments under the Rule, as proposed to be amended); and (iii) delete references to first tier securities and second tier securities and all provisions relating to second tier securities from the Rule.

In addition to the credit rating requirements discussed above, the Rule also requires a money fund to limit its portfolio investments to securities that are determined to present minimal credit risks. Currently, if a portfolio security ceases to be a first tier security, or if the fund's adviser becomes aware that an unrated security or second tier security held in the fund's portfolio has been given a rating by any NRSRO that is below the second highest short-term debt rating category, the fund's board is required to reassess whether that security

3 While some of these funds held debt securities issued by Lehman Brothers, the liquidity difficulties encompassed many types of short term securities and were not limited to Lehman paper.

4 The Federal Reserve announced the "Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility" on September 19, 2008 and the "Commercial Paper Funding Facility" on October 7, 2008 (each was extended and currently expires on February 1, 2010), and announced the "Money Market Investor Funding Facility" on October 21, 2008 (expires on October 30, 2009). The Treasury announced the "Temporary Guarantee Program for Money Market Funds" on September 19, 2008 (extended twice and currently expires on September 18, 2009).

5 The amendments would not place additional restrictions on Rule 2a-7's diversification standards, other than to limit a money fund's investments in repurchase agreements to those that are collateralized fully by cash items or Government Securities, and to require fund boards or their delegates to evaluate the creditworthiness of all repurchase agreement counterparties. *See* "Investments in Repurchase Agreements" below.

6 Determining whether a security is an Eligible Security under the Rule involves different considerations for rated and unrated securities, and for securities that are subject to guarantees and demand features. The amendments would generally not impact the Rule's quality provisions with respect to securities that are subject to guarantees and demand features.

continues to present minimal credit risks and take such action as it deems to be in the best interests of the fund and its shareholders. Given the changes to the definition of Eligible Securities, the amendments would require such reassessments *only if* the fund's adviser becomes aware that an unrated security has received a rating from an NRSRO that is below the *highest* (instead of the second highest, as currently required) short-term rating category.

The SEC stated that eliminating a money fund's ability to invest in second tier securities is intended to reduce the possibility of the fund breaking the dollar. It explained that the market for second tier securities has remained relatively small since amendments to the Rule were adopted in 1991, and that, because second tier securities have weaker credit profiles, experience wider credit spreads during market disruptions, and are generally more susceptible to rapid deterioration in credit quality than first tier securities, money fund investments in second tier securities are more likely to result in reduced investor confidence and trigger a run on money funds.[7]

Maturity

To reduce exposure to risks associated with long-term investments, including interest rate risk, the current Rule requires money funds to maintain a dollar-weighted average portfolio maturity that is appropriate to the objective of maintaining a stable NAV per share; provided, however, that they may neither acquire instruments that have remaining maturities of greater than 397 calendar days (although funds that use the penny-rounding method of pricing may acquire Government Securities with a remaining maturity of up to 762 calendar days), nor maintain a dollar-weighted average portfolio maturity of more than 90 days.

The amendments would shorten the maximum dollar-weighted average maturity of a money fund's portfolio to 60 days from the current limit of 90 days in an attempt to decrease further the risks (e.g., higher levels of volatility, interest rate risk, liquidity risk, and wider credit spreads) related to longer-term investments. The SEC noted that during the recent financial crisis, money funds with shorter maximum weighted average maturities had proven to be better equipped to satisfy significant demands for redemption because a larger portion of their securities matured on a more frequent basis, thus making available the cash needed to pay redeeming investors.

Additionally, the amendments would remove the provision from the Rule that permits funds using the penny-rounding method of pricing to acquire Government Securities with extended maturities of up to 762 calendar days. The SEC explained that it is not aware of money funds that rely solely on the penny-rounding method of pricing or that hold fixed-rate Government Securities with remaining maturities of two years, and noted that fixed-rate Government Securities with remaining maturities of two years pose significant interest rate risk.

Finally, the amendments would add a new maturity test that would limit the "Average Weighted Life" maturity of money fund investments to 120 days, the calculation of which would be required to be made without regard to a security's interest rate reset dates. The SEC explained that the intended purpose of this more stringent method of calculating maturity (i.e., not permitting the use of interest rate reset dates to shorten maturity) is to reduce fund exposure to the risks associated with longer-term securities and to enable money funds to maintain a greater degree of stability during periods of market volatility.

Liquidity

Currently, money funds are limited, under a longstanding SEC interpretive position, to investing no more than 10% of their assets in illiquid securities.[8] For the first time, the proposed amendments would expressly incorporate the concept of liquidity into Rule 2a-7 itself, restricting all money fund portfolio investments to cash and securities that, at the time of acquisition, are considered to be "liquid securities." This term would be defined to mean securities that can be sold or disposed of in the ordinary course of business within seven calendar days at approximately their amortized cost. The SEC stated that, in its view, it is critical for a money fund to have sufficient liquidity in order to maintain a stable share price.

7 It should be noted that, immediately prior to the Lehman Brothers bankruptcy, Lehman paper qualified as first tier securities under the Rule.

8 *See* "Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145," SEC Release No. IC-17452 (Apr. 23, 1990).

Additionally, the amendments would require institutional and retail money funds to satisfy the following new liquidity requirements:[9]

- at a minimum, immediately after the acquisition of any security: (i) a *taxable fund* would be required to have invested at least 5% (if a retail fund) or 10% (if an institutional fund) of total assets in cash, U.S. Treasury securities, and securities convertible into cash in one business day; [10] and (ii) *all funds* would be required to have invested at least 15% (if a retail fund) or 30% (if an institutional fund) of total assets in cash, U.S. Treasury securities, and securities convertible into cash within five business days; and

- funds would be subject to an ongoing general requirement to hold highly liquid securities that would, upon sale, generate sufficient proceeds to meet reasonably foreseeable shareholder redemptions.[11]

Stress Testing

Further, the amendments would require the board of a money fund that uses the amortized cost method of pricing to adopt procedures providing for periodic "Stress Testing" of the fund's portfolio in order to assess whether it could maintain its stable NAV per share upon the occurrence of one or more hypothetical events enumerated in the proposing release, such as an increase in short-term interest rates or an increase in shareholder redemptions. Also, the fund's adviser would be required to make such assessments for events that are reasonably likely to occur in the upcoming year. The results of each "Stress Test" would be required to be reported to the fund's board at its next regularly scheduled meeting. The SEC explained that the purpose of the proposed stress testing requirements is to provide fund boards with information that will enable them to better understand and manage the risks to which money funds are exposed.

Investments in Repurchase Agreements

When a money fund enters into a repurchase agreement, the fund may "look through" the agreement (i.e., the securities underlying the repurchase agreement may be considered to be held directly by the fund) for purposes of Rule 2a-7's diversification calculations, provided the repurchase agreement is "Collateralized Fully." To reduce the potential risk of loss that may occur upon a default by a repurchase agreement counterparty (e.g., a broker-dealer or a bank), the amendments would limit the types of repurchase agreements that qualify as Fully Collateralized to those that are collateralized by cash items or Government Securities, and would require money fund boards or their delegates to evaluate the creditworthiness of all potential repurchase agreement counterparties, even if the repurchase agreement is Collateralized Fully.

Requiring More Frequent Disclosure of Portfolio Information

Currently, money funds are required to disclose their portfolio holdings only on a quarterly basis. To provide greater transparency to investors about the risks to which funds are exposed, the proposed amendments would require money funds to post updated information about their portfolio holdings on their websites on a monthly basis.

The amendments would also require funds, within two business days after the end of each month, to electronically file with the SEC, in an easily searchable format, information regarding detailed portfolio holdings and certain risk characteristics. The SEC would make such information publicly available two weeks after it is filed.

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9 The amendments would require a money fund's board to determine at least annually whether the fund is an institutional fund. Specifically, the amendments would define an "Institutional Fund" to generally mean a money fund whose board determines at least annually is intended to be offered primarily to institutional investors (or has the characteristics of such a fund) based on certain factors, such as the nature of the fund's shareholders of record and minimum initial investment requirements.

10 The SEC explained that the proposed amendments would impose higher liquidity requirements on institutional funds as compared to retail funds because institutional funds are subject to substantially larger redemption requests. The SEC excluded tax-exempt money funds from daily liquidity requirements because it would be unlikely for funds that typically generate much of their liquidity by investing in longer term floating- and variable-rate securities subject to seven-day demand features to be able to meet such liquidity requirements.

11 The SEC stated that, in order to comply with this requirement, fund managers will need to evaluate factors that may affect fund liquidity, such as, for example, the nature of the fund's investor base. It explained that a money fund with a volatile investor base would be required to maintain a greater degree of liquidity than a fund with a more stable investor base.

The SEC explained that these amendments would enable the SEC to create a database of money fund portfolio information that could be used to improve the SEC's ability to monitor the risk characteristics of individual money funds and the money fund industry in general, anticipate and respond to market events, and enhance the SEC's oversight of money funds.

Mitigating the Negative Impact on Shareholders of Money Funds that Break the Dollar

The amendments would require a money fund's board to determine annually that the money fund and its administrators have the operational capacity to process shareholder purchase and redemption transactions electronically at a price based on the fund's current market-based NAV per share (i.e., not merely at a price of $1.00 per share). The SEC explained that Reserve lacked such operational capacity, and that this limitation had resulted in significant delays in satisfying redemption requests after Reserve broke the dollar in September 2008. The SEC noted that the inability of money funds to price shares in accordance with market values has the potential to expose shareholders to unnecessary risks, such as the risk that a fund may not meet its obligation to process redemption requests within seven days.

Affiliated Buy-Outs of Portfolio Securities

The amendments would also expand the ability of affiliates to purchase portfolio securities from money funds.[12] Specifically, affiliates would be permitted to purchase distressed securities (e.g., Eligible Securities that have defaulted) and other portfolio securities (e.g., non-defaulted Eligible Securities that are purchased for any reason) from affiliated money funds;[13] provided that the purchase price of an Eligible Security that has not defaulted would be required to be paid in cash at the greater of its amortized cost value or market value, and any profit that is realized from a subsequent sale of such a security would be required to be remitted to the fund.[14] Prompt notice would also be required to be given to the SEC by email of any such purchase and the reasons for the purchase.

Suspension of Redemptions

Finally, in an attempt to reduce the vulnerability of investors to the effects of a run on money funds and to minimize the potential for disruption of the securities markets, the SEC is proposing a new rule that would permit money fund boards to suspend redemptions, upon email notification to the SEC, if a fund breaks the dollar and will be liquidated. In the event that a liquidating fund fails to devise or properly execute a plan of liquidation that protects shareholders, the SEC would retain the authority to rescind or modify the relief provided by the new rule.

Request for Comment

The SEC requested comment on other possible amendments to Rule 2a-7, such as whether the Rule should be amended to address risks presented by SIVs or similar asset backed securities, or whether it should impose industry concentration limitations.

Further, the SEC requested comment on whether to eliminate the ability of money funds to use the amortized cost method of pricing (i.e., eliminate the ability to use a stable NAV per share). The SEC noted that, although the $1.00 stable NAV per share enables money funds to be low-risk cash management vehicles, it creates the risk that there will be a run on money funds that break the dollar, which may further reduce their

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12 Currently, Rule 17a-9 under the 1940 Act permits an affiliate to purchase a security from a money fund only if that security has ceased to be an Eligible Security under Rule 2a-7. During the most recent crisis, the SEC Staff provided no-action assurance to enable fund affiliates to purchase securities that remained "eligible" but had become less liquid.

13 The SEC explained, however, that no-action relief would still be required for affiliates of a money fund to provide capital support agreements that support the NAV per share of the fund since such agreements are typically customized and terminate after a relatively short period of time.

14 In comparison, defaulted Eligible Securities would be required to satisfy only the existing requirements of Rule 17a-9 and not the proposed "claw-back" provision since any default would serve as an objective indication that the security is distressed, and the purchase of such defaulted Eligible Securities would therefore be in the best interests of the fund.

share price and negatively impact remaining shareholders.[15] At the same time, the SEC expressed concern that shareholders may respond to fluctuations in NAV by redeeming their shares and causing a run on money funds.

Finally, the SEC requested comment on whether Rule 2a-7 should require money funds to satisfy redemption requests in excess of a specific threshold through in-kind redemptions. The SEC noted that, among other benefits, this would reduce the impact of heavy redemptions on a money fund's NAV and result in a more equal distribution of liquidity risk.

The deadline for submitting comments is September 8, 2009.

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15 The SEC explained that, although a floating NAV would not eliminate an investor's incentive to redeem during a liquidity crisis, it would remove the potential that a shareholder could redeem shares for more than the current market value per share of the fund's portfolio.

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