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# Money Market Funds

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# *Chapter 9*

# Money Market Funds*

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## § 9:1 Introduction

Money market funds are subject to comprehensive regulation under the federal securities laws. The Securities and Exchange Commission (SEC) has, over a period of more than thirty years,[1] developed a complicated regulatory scheme designed to limit a money market fund's underlying portfolio risk and impose strict operational and procedural requirements. Money market funds are also subject to specific disclosure and advertising rules that do not generally apply to other registered investment companies. In an effort to enhance the resiliency of money market funds in the face of certain short-term market risks, such as the market illiquidity in the Fall of 2008 that threatened the ability of money market funds to meet redemptions, the SEC proposed amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (ICA),[2] and other changes to the regulatory scheme of money market funds in June 2009 (the "Proposed

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1. *See, e.g., In re* Scudder Cash Investment Trust, Investment Company Act Release No. 9,992 (Nov. 7, 1977) (early example of an exemptive application filed by a money market fund to permit the use of the amortized cost method for valuing portfolio securities). *See also* Investment Company Act Release No. 9,786 (May 31, 1977) (stating the SEC's view on the appropriateness of certain methods utilized by money market funds to value debt securities); and *In re* Intercapital Liquid Asset Fund, Inc., *et al.*, Investment Company Act Release No. 10,824 (Aug. 8, 1979) (order granting exemptive relief to permit use of the amortized cost method of valuation).
2. 15 U.S.C. §§ 80a-1 to 64 (2009). All references to rules in this chapter are references to rules under the ICA unless otherwise noted.

Amendments").[3] As of the date of this chapter, the Proposed Amendments remain outstanding, although the authors understand that the SEC Staff is working on presenting the amendments in final form to the Commission for adoption later this year. This chapter presents an overview of the current laws and regulations governing money market funds, as well as the SEC's proposed rule amendments, with an emphasis on Rule 2a-7.

## § 9:2 What Is a Money Market Fund?

A money market fund is an open-end investment company that is registered under the ICA and that has as its investment objective the generation of income and preservation of capital through investment in short-term, high-quality debt securities.[4]

Unlike other registered investment companies, money market funds seek to maintain a stable price per share of $1[5] through the use of either the amortized cost valuation method or the penny-rounding valuation

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3. *See* Money Market Fund Reform, Investment Company Act Release No. 28,807 (June 30, 2009) [hereinafter 2009 Proposing Release].

4. Investment Company Act Release No. 21,837 at section I (Mar. 21, 1996). According to the Investment Company Institute, as of October 1, 2009, approximately $3.43 trillion was invested in money market funds. *See* Investment Company Institute, Money Market Mutual Fund Assets (Oct. 1, 2009), *available at* www.ici.org/research/stats/mmf/mm_10_01_09. The increased popularity of money market funds has influenced the development of the financial product market, providing a deep source of short-term financing to corporate and municipal issuers. Issuers and underwriters commonly structure debt securities so that they are eligible for investment by money market funds. *See, e.g.*, Goldman, Sachs & Co. (pub. avail. Aug. 14, 1998) (eligibility under Rule 2a-7 of extendable variable rate notes).

5. The vast majority of money market funds seek to maintain a stable net asset value per share of $1, but a few may seek to maintain a stable net asset value per share of a different amount (*e.g.*, $10). For convenience, this chapter refers to a stable net asset value per share of $1. Where a money market fund is one series of an investment company with multiple series, the maintenance of a net asset value per share of $1 could result in disproportionate voting power in the hands of the shareholders of the money market fund with respect to matters required to be voted on by all series of the investment company, such as the election of directors. Accordingly, the SEC staff has permitted (although not required) investment companies to establish "dollar-based voting" in which each dollar of net asset value entitles a shareholder to one vote, as an alternative to the traditional "one share, one vote" rule. *See* Sentinel Group Funds, Inc. (pub. avail. Oct. 27, 1992), agreeing to not recommend enforcement action under section 18(i) of the ICA, which requires all shares issued by a registered investment company to be "voting securities."

method of accounting (discussed below).[6] This stable net asset value feature has contributed to the popularity of money market funds as a tool for cash management and, in the view of the SEC, has encouraged many investors to "view investments in money funds as an alternative to either bank deposits or checking accounts."[7] Accordingly, the policy goal of the SEC in regulating money market funds has historically been to limit the risk that a money market fund will be unable to maintain a stable price per share of $1 (that is, to limit the risk that a money market fund would "break the dollar").

The use of the amortized cost method or the penny-rounding method to compute a money market fund's current net asset value per share[8] requires exemptive relief from the ICA's pricing and valuation provisions,[9] which Rule 2a-7 provides. As a condition of providing this exemptive relief, however, Rule 2a-7 imposes the following on money market funds:

- requirements relating to oversight of the fund by its board of directors (a "Board");
- requirements relating to the implementation of specific compliance procedures;

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6. The use of the amortized cost or penny-rounding method of valuation is not mandatory. A fund can hold itself out as a money market fund and value its securities on a mark-to-market basis, as long as it complies with the Risk Limiting Provisions of Rule 2a-7 (discussed below). Substantially all money market funds rely on the amortized cost method of valuation, and not solely on the penny-rounding method of pricing. *See* 2009 Proposing Release, *supra* note 3, at section II.B.3. As discussed herein, the Proposed Amendments would tighten Rule 2a-7's quality standards, shorten the maturity standards, and introduce new liquidity standards under the Rule. The Proposed Amendments would not place additional restrictions on Rule 2a-7's diversification standards, other than to limit a money market fund's ability to invest 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 infra* section 9:3.4[C][1][c][i].
7. Investment Company Act Release No. 21,837 at section I. The SEC staff has further recognized this concept by taking the position that, for purposes of determining whether an issuer is an "investment company" subject to the ICA, shares of a money market fund that relies on Rule 2a-7 to maintain a stable net asset value per share of $1 can be treated as a "cash item" rather than an "investment security" for purposes of section 3(a)(1)(C) and Rule 3a-1. *See* Willkie Farr & Gallagher (pub. avail. Oct. 23, 2000).
8. Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors. Under the penny-rounding method, a money market fund's net asset value per share is rounded to the nearest cent. Rule 2a-7(a)(2) and (18).
9. *See infra* section 9:3.1.

- a complex array of portfolio maturity, quality and diversification requirements (referred to herein as Rule 2a-7's "Risk-Limiting Provisions"); and
- SEC reporting requirements.

The Proposed Amendments would take additional steps designed to:

- strengthen the risk limiting requirements of Rule 2a-7 with respect to portfolio quality and maturity;
- establish new liquidity requirements for money market funds;
- require money market funds to disclose portfolio information on a more frequent basis; and
- mitigate the negative impact felt by shareholders of money market funds that liquidate upon "breaking the dollar."

Although money market funds are open-end investment companies registered under the ICA, the policy concerns that arise from their popularity as an alternative to bank deposits or checking accounts, and the use of special methods to value their portfolio securities, have resulted in the development of a specialized regulatory scheme. For example, unlike most other investment companies, money market funds have limited flexibility with respect to the types of securities in which they may invest. Because this specialized regulatory scheme is mainly imposed through Rule 2a-7, which governs much of the day-to-day investment operations of money market funds, the primary focus of this chapter is to provide an overview of the conditions that Rule 2a-7 imposes on money market funds.[10]

## § 9:3 Rule 2a-7

### *§ 9:3.1 Exemption from Standard Valuation Procedures*

The ICA requires registered investment companies to value portfolio securities for which market quotations are readily available at current market value and to value all other securities and assets at their fair value, as determined in good faith by the company's Board.[11] The SEC adopted Rule 2a-7 in 1983 in response to the proliferation of

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10. Certain of Rule 2a-7's provisions discussed in this chapter in connection with guarantees, demand features, and asset backed securities do not apply to such instruments if they were issued on or before February 10, 1998. For a discussion of these "grandfather" provisions, see Investment Company Act Release No. 22,921 at section III.B.2 (Dec. 2, 1997).
11. Rule 2a-4(a)(1). *See* ICA § 2(a)(41) (definition of "value"). *See also* Rule 22c-1 (governing the pricing of redeemable securities for purposes of distribution, redemption, and repurchase).

applications for exemptive relief by registered investment companies seeking permission to deviate from the standard valuation rules.[12]

Prior to the adoption of Rule 2a-7, the SEC had expressed the view that the portfolio valuation provisions of the ICA required a money market fund to (i) determine the fair value of short-term debt securities for which market quotations were not readily available by reference generally to current market factors, and (ii) calculate its price per share to an accuracy of within 0.10% (that is, $0.01 based on a share price of $10). The SEC had considered the use of the amortized cost method for determining the fair value of debt securities which matured at a date more than sixty days after the valuation date to be inconsistent with the ICA's valuation requirements, and had concluded that the practice of rounding to the nearest $0.01 where a fund sought to maintain a $1 net asset value per share could have a dilutive effect on shareholders.[13] Accordingly, without an exemption, the use of the amortized cost method or the penny-rounding method with respect to securities having a remaining maturity of more than sixty days is prohibited under the ICA.

Since money market funds were less predictably able to maintain a stable net asset value per share without using amortized cost or penny-rounding, however, the SEC adopted Rule 2a-7 to permit money market funds to operate outside the ICA mandates for valuing portfolio securities, provided that certain requirements are met and the fund adheres to the Risk-Limiting Provisions of Rule 2a-7.[14]

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12. Investment Company Act Release Nos. 12,206 (Jan. 29, 1982) (proposing release) and 13,380 (July 11, 1983) (adopting release) [hereinafter Release No. 13,380].

13. *See* Investment Company Act Release No. 9,786. In this release, the SEC concluded that a registered investment company could value a debt security maturing in sixty days or less using amortized cost without the need for exemptive relief. The SEC subsequently stated, however, that this position could not be relied upon by a money market fund measuring the extent of deviation between its amortized cost price per share and the market-based net asset value per share of its portfolio. *See* Release No. 13,380, *supra* note 12, at text accompanying n.44. During the market illiquidity crisis in the Fall of 2008, the SEC Staff took a temporary no-action position allowing money market funds to rely on Release 9,786 for purposes of measuring their deviation. *See* Investment Company Institute (pub. avail. Oct. 10, 2008).

14. As noted in *infra* section 9:8, the SEC requested comment on future amendments to Rule 2a-7 in the 2009 Proposing Release that are more far-reaching than the changes discussed in this chapter, including whether to continue to allow money market funds to use the amortized cost method of pricing. *See* 2009 Proposing Release, *supra* note 3, at section III.A.

### § 9:3.2 Holding Out and Use of Names and Titles

Rule 2a-7 prohibits a registered investment company from the following actions without first complying with Rule 2a-7's Risk Limiting Provisions:

- Holding itself out as a money market fund or as the equivalent of a money market fund in any document filed or transmitted pursuant to the ICA or in sales literature required to be filed under the ICA,[15] which includes sales literature filed with the Financial Industry Regulatory Authority (formerly the National Association of Securities Dealers, Inc.) in lieu of the SEC.[16]
- Using the term "money market" or a similar term in its name or in the title of any redeemable securities it issues.[17] The SEC has deemed names including terms such as "cash," "liquid," "money," "ready assets" or similar terms to violate Rule 2a-7 in the absence of compliance with Rule 2a-7's portfolio maturity, quality, and diversification requirements.[18]

### § 9:3.3 Board Findings and Procedures for Rule 2a-7 Reliance

#### [A] Required Board Findings

The use by a money market fund of either the amortized cost method or the penny-rounding method to value portfolio securities requires the fund's Board to determine initially in good faith that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, and that the fund will only do so as long as the board continues to believe that the

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15. Rule 2a-7(b)(1).
16. *See* ICA § 24(b) and Rules 24b-2 and 24b-3 (governing the filing of sales material by registered investment companies).
17. Rule 2a-7(b)(2). These restrictions apply only to registered investment companies. Under the investment company "names rule," a fund with a name suggesting investment in certain types of securities must invest at least 80% of its assets in accordance with its name and adopt a conforming policy. Rule 35d-1. A generically named money market fund is not required to specifically adopt a policy to invest at least 80% of its assets in money market securities since Rule 2a-7 requires money market funds to invest all of their assets in securities eligible for investment under Rule 2a-7. However, a money market fund with a name suggesting a focus on a certain type of money market security, such as the "XYZ U.S. Treasury Money Market Fund," would be required to adopt a policy under Rule 35d-1 to invest at least 80% of its assets in U.S. Treasury securities. *See* SEC, Frequently Asked Questions about Rule 35d-1, Question No. 13 (pub. avail. Dec. 4, 2001), *available at* www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm.
18. Rule 2a-7(b)(3).

stable net asset value per share or price per share fairly reflects the fund's market-based net asset value per share.[19]

In addition, the Proposed Amendments would require a money market fund's board to determine annually that the money market 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 (that is, not only at a price of $1 per share).[20]

### [B] Required Procedures: Amortized Cost Method

The Board of a money market fund that uses the amortized cost method to value portfolio securities must establish written procedures that are reasonably designed, taking into account current market conditions and the fund's investment objective, to stabilize the fund's net asset value per share at a single value.[21] These written procedures must also provide for "shadow pricing" of the fund's portfolio securities, and under the Proposed Amendments to Rule 2a-7, would also have to provide for periodic "Stress Testing" of money market fund portfolios.

#### *[B][1] Shadow Pricing*

The shadow pricing provisions of Rule 2a-7 require the Board of a money market fund that uses amortized cost to establish an

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19. Rule 2a-7(c)(1). The SEC has instituted and settled administrative proceedings against the portfolio manager of a money market fund based on allegations that, among other things, the portfolio manager willfully aided and abetted and caused violations of Rule 22c-1 by continuing to value two structured notes at amortized cost for purposes of calculating the fund's net asset value in the face of steep market declines for the two structured notes instead of tracking the deviation between amortized cost and market value by using market quotations or appropriate substitutes. The SEC stated that as a result, the fund sold and redeemed shares at the price of $1 per share when the fund was no longer eligible to rely on Rule 2a-7 to price its shares using amortized cost. The portfolio manager was barred from association with any broker, dealer, or investment company, and was ordered to pay a civil money penalty. *See In re* Michael P. Traba, Investment Company Act Release No. 23,952 (Aug. 19, 1999).

20. *See* proposed Rule 2a-7(c)(1) (new last two sentences). The SEC explained that The Reserve Primary Fund 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 market 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. *See* 2009 Proposing Release, *supra* note 3, at section II.G.

21. Rule 2a-7(c)(7)(i).

appropriate and reasonable interval, based on market conditions, for the calculation of the deviation, if any, between the fund's net asset value per share based on currently available market quotations (or an appropriate substitute that reflects current market conditions) and the fund's net asset value per share calculated using the amortized cost method (the "Deviation").[22]

The Board must periodically review the amount of and the methods used to calculate the Deviation,[23] and the fund must maintain records of the Deviation and the Board's deliberations in connection with the Deviation.[24] In the event that the Deviation exceeds ½ of 1% (that is, the per share net asset value on a mark-to-market basis is less than $0.995 or greater than $1.005), Rule 2a-7 requires the Board to promptly convene a meeting to consider what action, if any, should be taken to reduce the Deviation.[25] Further, regardless of the extent of the Deviation, Rule 2a-7 imposes on the Board a duty to take appropriate action whenever the Board believes a Deviation may result in material dilution or other unfair results to investors or current shareholders.[26]

Although Rule 2a-7 establishes a ½ of 1% standard for mandatory Board deliberation, many money market funds have built a lower tolerance level into their procedures, requiring notification of a Deviation to be given to the Board whenever the Deviation exceeds some lower threshold. For example, a fund's procedures might require that the Board or a committee thereof be notified of any Deviation greater than 1/4 of 1% (that is, where the per share net asset value on a mark-to-market basis is less than $0.9975 or greater than $1.0025) and be informed as to the investment adviser's proposed course of action in response to the Deviation.

Under normal circumstances, the shadow pricing requirement of Rule 2a-7 typically has been discharged by a weekly calculation of the Deviation by the fund's investment adviser, administrator, or pricing agent, and by quarterly review of the Deviation at the regularly scheduled Board meetings. Since the liquidity crisis in the Fall of 2008, many funds have begun to monitor the level of Deviation on a daily basis, whether formally under their procedures or informally

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22. Rule 2a-7(c)(7)(ii)(A)(1). Market prices may not be readily available if a money market fund's portfolio securities become illiquid. In this case, it may be necessary to use fair valuation techniques to value such securities for purposes of calculating the Deviation. *See infra* section 9:3.5[D][1].
23. Rule 2a-7(c)(7)(ii)(A)(2).
24. Rule 2a-7(c)(7)(ii)(A)(3).
25. Rule 2a-7(c)(7)(ii)(B).
26. Rule 2a-7(c)(7)(ii)(C). Any action taken with respect to a Deviation in excess of ½ of 1% must be reported on the fund's Form N-SAR. Rule 2a-7(c)(10)(vii). *See* Form N-SAR, item 77N.

through daily shadow pricing by the fund's adviser. In addition, the recent adoption of an interim final temporary rule has the effect of requiring at least some funds to monitor Deviation on a daily basis. Under Rule 30b1-6T, a money market fund with a market-based NAV per share lower than $0.9975 on any business day ("Report Date") must:[27]

- no later than the next business day, notify the SEC that its NAV is less than $0.9975 and provide the SEC with a portfolio schedule as of the Report Date; and[28]
- until the fund's market-based NAV per share is $0.9975 or greater, provide the SEC a portfolio schedule as of the last business day of each week, no later than the second business day of the following week.[29]

The portfolio schedules under the new rule must contain specific portfolio and valuation information, such as the fund's most recent market-based NAV (both with and without the value of any capital support agreement), the fund's total net assets, and the maturity date of each security held by the fund.[30] All information provided to the SEC under the new rule will be "nonpublic to the extent permitted by law." By its terms, Rule 30b1-6T is effective on September 18, 2009 and expires on September 17, 2010.[31]

### *[B][2] Proposed Stress Testing Requirement*

The Proposed Amendments would also require the board of a money market 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 2009 Proposing Release, such as an increase in

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27. *See* Disclosure of Certain Money Market Fund Portfolio Holdings, Investment Company Act Release No. 28,903 (Sept. 18, 2009).
28. Rule 30b1-6T(a)(1).
29. Rule 30b1-6T(a)(2). The SEC has provided a template on its website for filing portfolio information under this interim final temporary rule. *See* SEC, Money Market Fund Reporting of Portfolio Schedules, *available at* www.sec.gov/divisions/investment/guidance/30b1-6t.htm.
30. For information required to be included in each portfolio schedule, see Rule 30b1-6T(b)(3). The SEC explained that these amendments would enable the SEC to create a database of money market fund portfolio information that could be used to improve the SEC's ability to monitor the risk characteristics of individual money market funds and the money market fund industry in general, anticipate and respond to market events, and enhance the SEC's oversight of money market funds.
31. Rule 30b1-6T(d).

short-term interest rates or an increase in shareholder redemptions.[32] The fund's adviser would also be required to make such assessments for events that are reasonably likely to occur in the upcoming year.[33]

### [C] Required Procedures: Penny-Rounding Method

The Board of a money market fund that uses the penny-rounding method must assure, to the extent reasonably practicable, taking into account current market conditions, that the fund's price per share, rounded to the nearest 1%, will not deviate from the single price established by the Board.[34]

### [D] Specific Procedures: Amortized Cost Method and Penny-Rounding Method

A money market fund that uses either the amortized cost method or the penny-rounding method to value portfolio securities must include in its procedures specific provisions with respect to the following, as applicable:

- ongoing review of a security's minimal credit risk if its maturity is determined by reference to a demand feature (discussed below);[35]
- periodic review of a determination that a fund will not rely on a demand feature or guarantee (discussed below) in the determination of a portfolio security's quality, maturity, or liquidity;[36]
- periodic review of whether an interest rate formula for a variable or floating rate security, upon readjustment of the interest rate, can reasonably be expected to cause the security to have a market value that approximates its amortized cost value;[37] and

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32. *See* proposed Rule 2a-7(c)(8)(ii)(D). 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 market funds are exposed. *See* 2009 Proposing Release, *supra* note 3, at section II.C.3.
33. The proposed Stress Test was based on a proposal described in ICI's money fund report ("ICI Report"). According to the ICI Report, many money market fund advisers have already implemented some version of Stress Testing for their funds. *See* INVESTMENT COMPANY INSTITUTE, REPORT OF THE MONEY MARKET WORKING GROUP 75 (Mar. 17, 2009), *available at* www.ici.org/pdf/ppr_09_mmwg.pdf.
34. Rule 2a-7(c)(8).
35. Rule 2a-7(c)(9)(i).
36. Rule 2a-7(c)(9)(ii).
37. Rule 2a-7(c)(9)(iii). This requirement only applies where the security is not subject to a demand feature and the maturity of the security has been determined pursuant to the maturity rules for adjustable rate government securities, short-term variable rate securities, or short-term floating rate securities.

- periodic determination in the case of an asset backed security (ABS)[38] of the number of 10% obligors (defined below) who are deemed to be the issuers of all or a portion of the ABS.[39]

In addition to the above procedures, the Board may find it advisable to consider putting in place a process requiring more frequent and more detailed minimum credit risk determinations during times of volatile and illiquid markets.[40]

### *§ 9:3.4 The Risk-Limiting Provisions*

Rule 2a-7 establishes three basic criteria with respect to the composition of a money market fund's portfolio: maturity, quality, and diversification. The Proposed Amendments would add a fourth criteria—liquidity.

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38. An asset backed security is any fixed income security (other than a government security) issued by a special purpose entity. A special purpose entity is a trust, corporation, partnership, or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from qualifying assets, but does not include a registered investment company. Qualifying assets are financial assets, either fixed or revolving, that by their terms convert to cash within a finite period of time, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders. Rule 2a-7(a)(3). An example of an ABS would be an interest in a pool of credit card receivables issued by a trust. It is not uncommon for a sponsor of an ABS to provide or arrange for the provision of guarantees to the special purpose entity to assure the proper servicing or timely distribution of proceeds to investors. Investments in ABSs are subject to special diversification requirements under Rule 2a-7. *See infra* section 9:3.4[C][1][c][ii].

39. Rule 2a-7(c)(9)(iv). However, if the Board, or its delegate, has determined at the time of acquisition that the ABS will not have or is unlikely to have any 10% obligors who are deemed to be the issuers of all or a portion of the ABS, and a record of this determination is maintained, then it is not required for the fund's procedures to mandate periodic determinations. "Acquisition" would include any purchase or subsequent rollover, but would not include the failure to exercise a demand feature. Rule 2a-7(a)(1).

40. For instance, a more detailed minimum creditworthiness requirement might be included in the procedures governing certain instruments, such as collateralized debt obligations or structured investment vehicles. Likewise, a detailed "approved list" may be maintained to monitor whether a money market fund's securities continue to pose minimal credit risk. As used in Rule 2a-7, the concept of "minimal credit risk" is separate from the credit rating status of the security and relates to whether an instrument is likely to default or become ineligible under the quality requirements during the period that the fund intends to hold the security. *See infra* section 9:3.4[B][2]. If the issuer of the instrument and the provider of any demand feature or guarantee (discussed below) are different parties, then the minimal credit risk determination may be required for each party.

## [A] Maturity

### *[A][1] Portfolio Maturity*

To reduce exposure to risks associated with long-term investments, including interest rate risk, Rule 2a-7 requires money market funds to maintain a dollar-weighted average portfolio maturity that is appropriate to the objective of maintaining a stable net asset value per share;[41] provided, however, that the funds may not:

- acquire any instrument that has a remaining maturity of greater than 397 calendar days[42] (although currently, money market funds that rely exclusively on the penny-rounding method of pricing are permitted to acquire Government Securities with a remaining maturity of up to 762 calendar days),[43] and
- maintain a dollar-weighted average portfolio maturity of more than ninety days.[44]

#### [A][1][a] Effect of Proposed Amendments on Portfolio Maturity

The Proposed Amendments would remove the provision from Rule 2a-7 that permits funds using the penny-rounding method of pricing to acquire Government Securities with extended maturities of up to 762 calendar days.[45] The Proposed Amendments also would shorten the maximum dollar-weighted average maturity of a money market fund's portfolio to sixty days from the current limit of ninety days in an attempt to decrease further the risks related to longer-term investments (for example, higher levels of volatility, interest rate risk,

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41. Rule 2a-7(c)(2).
42. Rule 2a-7(c)(2)(i).
43. Rule 2a-7(c)(2)(ii).
44. Rule 2a-7(c)(2)(iii). Many bond funds that seek generation of income as their objective have abandoned maturity measurement in favor of measurement of portfolio duration. Duration is a measure of the sensitivity of debt securities to changes in market interest rates, based on the cash flow associated with a security, including pre-payments of principal prior to the security's maturity. However, Rule 2a-7 continues to impose a limit based on average dollar-weighted portfolio maturity, and, therefore, duration measurement currently is not a permitted substitute for compliance with Rule 2a-7's maturity requirements.
45. In the 2009 Proposing Release, noting that fixed-rate Government Securities with remaining maturities of two years pose significant interest rate risk, the SEC explained that it is not aware of money market funds that rely solely on the penny-rounding method of pricing or that hold fixed-rate Government Securities with remaining maturities of two years. *See* 2009 Proposing Release, *supra* note 3, at section II.B.3.

liquidity risk, and wider credit spreads).[46] Finally, the Proposed Amendments would add a new maturity test that would limit the "Average Weighted Life" maturity of money market 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.[47]

### *[A][2] Maturity of Portfolio Securities*

Generally, the maturity of a portfolio security under Rule 2a-7 is the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount of the security must unconditionally be paid, or, in the case of a security that is called for redemption, the date on which the redemption payment must be made (the "final maturity").[48] However, Rule 2a-7 contains several specific exceptions to the general method for determining the maturity of a portfolio security which address, in part, the effect of demand features[49] and other maturity shortening devices, as discussed below.

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46. In the 2009 Proposing Release, the SEC noted that during the 2007–2009 financial crisis, money market 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. *See* 2009 Proposing Release, *supra* note 3, at section II.B.1.

47. In the 2009 Proposing Release, 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 market funds to maintain a greater degree of stability during periods of market volatility. *See* Proposing Release, *supra* note 3, at section II.B.2.

48. Rule 2a-7(d). A security that is subject to a "mandatory tender feature" (*i.e.*, a feature providing that the principal amount of the security will be paid off on a specified date unless the holder affirmatively elects to remain invested) can be treated as having a maturity measured by reference to the payment date of the tender feature. Investment Company Act Release No. 21,837 at n.151. It should be noted that Rule 2a-7 does not contain a specific exception to the general method for determining the maturity of funding agreements (*i.e.*, insurance contracts between a fund and an insurance company). Funding agreements are generally illiquid and can present difficult valuation issues.

49. A demand feature must provide a legal right to sell the security, and mechanisms such as "Dutch auctions" and "best efforts" agreements by securities dealers to make a market in the security do not qualify as demand features. *See* Goldman, Sachs and Co. (pub. avail. Sept. 7, 1988) and Paul B. O'Kelly, Esq. (pub. avail. June 5, 1986) (stating that a dealer's undertaking to provide an auction mechanism or secondary market in a debt security is not the equivalent of a demand feature that can be used to shorten the maturity of a variable or floating rate debt instrument under Rule 2a-7).

### [A][2][a] Adjustable Rate Government Securities

Currently, a variable rate[50] government security[51] that has an interest rate readjustment at least once every 762 calendar days is deemed to have a maturity equal to the period remaining until the next interest rate adjustment. The Proposed Amendments would revise this maturity-shortening provision of the rule for variable-rate government securities to require the variable rate of interest to be readjusted no less frequently than every 397 days, instead of 762 days as currently permitted.[52]

A floating rate[53] government security is deemed to have a remaining maturity of one day.[54]

### [A][2][b] Variable Rate Securities

A variable rate security, the principal amount of which is scheduled to be paid unconditionally in 397 calendar days or less, is deemed to have a remaining maturity equal to the shorter of the period until the

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50. A variable rate security is a security providing for the adjustment of the interest rate on set dates and that, upon each adjustment until final maturity or until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost. Rule 2a-7(a)(29).

51. For purposes of the ICA, including Rule 2a-7, a "government security" is any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the government of the United States pursuant to authority granted by the U.S. Congress, and any certificate of deposit for such securities. *See* ICA § 2(a)(16) and Rule 2a-7(a)(14).

52. *See* proposed Rule 2a-7(d)(1).

53. A floating rate security is a security that provides for an interest rate adjustment whenever a specified interest rate changes and that, at any time until final maturity or until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost. Rule 2a-7(a)(13).

54. Rule 2a-7(d)(1). Thus, Rule 2a-7 prohibits a fund using the amortized cost method of valuation from purchasing an adjustable rate government security having a final maturity in excess of 397 days unless the interest reset mechanism of the security can reasonably be expected to maintain the instrument's market value at a level that approximates its amortized cost or the instrument is subject to a demand feature. If the instrument has a final maturity of less than 397 days and the interest reset mechanism would not cause its value to approximate amortized cost, the instrument could still be purchased or held by a fund, but maturity would have to be measured by reference to the final maturity date of the instrument. If, after a long-term adjustable rate government security is acquired by a fund, the interest rate reset mechanism no longer causes market value to approximate amortized cost value, the fund would be required to dispose of the instrument unless the Board makes certain findings. *See infra* section 9:3.3.

next interest rate adjustment or until the principal amount can be recovered through exercise of a demand feature.[55] A variable rate security, the principal amount of which is scheduled to be paid in more than 397 calendar days and that is subject to a demand feature is deemed to have a maturity equal to the longer of the period until the next interest rate adjustment or until the principal amount can be recovered through exercise of the demand feature.[56]

### [A][2][c] Floating Rate Securities

A floating rate security, the principal amount of which must be paid unconditionally in 397 calendar days or less, is deemed to have a maturity of one day.[57] A floating rate security, the principal amount of which is scheduled to be paid in more than 397 calendar days and that is subject to a demand feature is deemed to have a maturity equal to the period remaining until the principal amount can be recovered through exercise of the demand feature.[58]

### [A][2][d] Repurchase Agreements

A repurchase agreement is deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur. However, if the repurchase agreement is subject to a demand, the maturity is deemed to be the notice period applicable to the demand for the repurchase of the securities.[59]

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55. Rule 2a-7(d)(2). Prior to the 1996 amendments to Rule 2a-7, a short-term variable rate security's maturity was deemed to be the longer of the period remaining until the next interest rate adjustment or the date on which principal could be recovered through demand.
56. Rule 2a-7(d)(3). Although preferred stock is technically an equity security and may therefore not have a stated "maturity," under certain circumstances preferred stock with a resetting dividend rate and a demand feature may be treated as a variable rate security that is eligible for investment by a money market fund. *See* Merrill Lynch Investment Managers (pub. avail. May 10, 2002); *see also*, Eaton Vance Management (pub. avail. June 13, 2008) (permitting the issuance of liquidity protected preferred shares eligible for purchase by money market funds).
57. Rule 2a-7(d)(4). This conclusion by the SEC is based on the supposition that a floating rate security, by its nature, should always have a market value that approximates its amortized cost value. *See* Investment Company Act Release No. 21,837 at section II.F.
58. Rule 2a-7(d)(5).
59. Rule 2a-7(d)(6). Repurchase agreements entered into by money market funds must also comply with ICA § 12(d)(3) (prohibition on fund acquisition of an interest in a broker-dealer, underwriter, or investment adviser). To determine compliance with § 12(d)(3), Rule 5b-3 permits funds, subject to certain conditions, to treat a repurchase agreement as an acquisition of the underlying collateral. *See* Investment Company Act Release No. 25,058 (July 5, 2001) (codifying SEC staff no-action positions treating

### [A][2][e] Portfolio Lending Agreements

A portfolio lending agreement is deemed to have a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned. However, if the portfolio lending agreement is subject to a demand, the maturity is deemed to be the notice period applicable to the demand for the return of the loaned securities.[60]

### [A][2][f] Money Market Fund Shares

Money market fund shares are deemed to have a maturity equal to the period of time within which the money market fund issuing the shares (the "acquired fund") is required to make payment upon redemption, or any shorter period of time agreed to in writing with the acquired fund.[61]

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a repurchase agreement as an acquisition of the underlying collateral if the repurchase agreement is "Collateralized Fully," as defined under Rule 5b-3(c)(1)). In the 2009 Proposing Release, *supra* note 3, the SEC proposed changes regarding when a repurchase agreement would be deemed to be "Collateralized Fully." *See infra* section 9:3.4[C][1][c][i]. In Release No. 25,058, the SEC eliminated the requirement included in SEC staff no-action positions that a fund's board or its delegate evaluate the creditworthiness of the counterparty to a repurchase agreement. *See* Release No. 25,058 at section II.A.3. However, in the 2009 Proposing Release, *supra* note 3, the SEC reintroduced the requirement for money market fund boards or their delegates to evaluate the creditworthiness of all repurchase agreement counterparties, regardless of whether the agreement is Collateralized Fully. *See* section 9:3.4[C][1][c][i]. A fund's adviser, rather than the fund's board, typically assumes primary responsibility for monitoring and evaluating the fund's use of repurchase agreements. *See, e.g.*, Investment Company Institute (pub. avail. June 15, 1999). If the issuer of a repurchase agreement should default, the collateral will become part of the money market fund's portfolio. Accordingly, although a repurchase agreement may be collateralized by securities with a maturity of greater than 397 days, if such collateral should become part of the fund's portfolio as the result of a default, the collateral must be disposed of as soon as possible. Investment Company Act Release No. 12,206 (Jan. 29, 1982) at n.23.

60. Rule 2a-7(d)(7). The SEC staff has developed guidelines that all registered investment companies should observe when engaging in securities lending transactions. Early SEC no-action letters developing the securities lending guidelines include State Street Bank & Trust Co. (pub. avail. Jan. 29, 1972); State Street Bank & Trust Co. (pub. avail. Sept. 29, 1972); Salomon Brothers (pub. avail. Sept. 29, 1972); Standard Shares, Inc. (pub. avail. Aug. 28, 1974); and Adams Express Co. (pub. avail. Oct. 20, 1979). For a more current discussion on the future of securities lending and potential regulatory solutions, see materials from an SEC roundtable held in September 2009. *See, e.g.*, Press Release, SEC, SEC Announces Panelists for Securities Lending and Short Sale Rolundtable (Sept. 25, 2009), *available at* www.sec.gov/news/press/2009/2009-207.htm.

61. Rule 2a-7(d)(8). Many money market funds have disclosed that they intend to make payment upon redemption on either a same day or next day basis. Whether this disclosure is sufficient to create the contractual arrangement

### [B] Portfolio Quality

A second criteria for the composition of a money market fund's portfolio under Rule 2a-7 relates to portfolio quality. Rule 2a-7 limits the portfolio holdings of money market funds to securities that are denominated in U.S. dollars, that pose minimal credit risk to the fund, and that are "Eligible Securities" under Rule 2a-7.[62]

#### *[B][1] U.S. Dollar Denominated Securities*

For a security to qualify as U.S. dollar denominated under Rule 2a-7, all principal and interest payments must be payable to the holder in U.S. dollars under all circumstances. Further, the interest rate, principal amount to be repaid, and timing of payments related to the security must not vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than the U.S. dollar.[63] Although a money market fund may not acquire a security that is denominated in a foreign currency, it may acquire the securities of foreign issuers if the securities are denominated in U.S. dollars, assuming such securities are otherwise eligible for investment under Rule 2a-7.[64]

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required under Rule 2a-7 will depend on the nature of the acquired fund's undertaking. For example, it would seem unlikely that a statement of mere intention of the acquired fund to provide same day redemption payment, without some binding commitment or undertaking by the acquired fund, would satisfy Rule 2a-7(d)(8)'s standard. In the absence or a binding commitment, the maturity of money market fund shares would be seven calendar days, the statutory period beyond which payment of a redemption may not be deferred in the absence of unusual circumstances. ICA § 22(e).

62. Rule 2a-7(c)(3)(i).

63. Rule 2a-7(a)(27). In two SEC no-action letters, Five Arrows Short-Term Investment Trust (pub. avail. Sept. 26, 1997) and SSgA International Liquidity Fund (pub. avail. Dec. 2, 1998), the SEC staff stated that it would not recommend enforcement action if funds that invested only in debt securities denominated in a specified foreign currency (the Pound Sterling, Deutsche Mark, Canadian Dollar, and the Euro) held themselves out as money market funds and otherwise complied with the terms of Rule 2a-7. These funds seek to maintain a constant net asset value in their designated currency and only accept purchases and effect redemptions in that currency. This relief permitted the funds, in part, to consider government securities issued by the relevant foreign government to be "government securities" for purposes of complying with Rule 2a-7's diversification and maturity standards, subject to certain conditions.

64. For example, many money market funds hold securities of foreign banks that are denominated in U.S. dollars.

### [B][2] Securities Posing Minimal Credit Risk

A money market fund must limit its portfolio investments to securities that the Board determines present minimal credit risk.[65] This determination is in addition to Rule 2a-7's credit rating requirements (discussed below), and must be based on factors that impact the credit quality of the issuer in addition to any ratings assigned to the securities. Accordingly, it is not sufficient for a money market fund simply to rely on the ratings assigned to securities by rating agencies. Rather, the investment adviser should assemble and maintain a credit file for each issuer to support the determination that the security presents minimal credit risk to the fund.

Rule 2a-7 permits the responsibility for determining minimal credit risk to be delegated by the Board.[66] As a matter of practice, Boards typically take advantage of this flexibility by delegating the responsibility to the fund's investment adviser. However, the Board remains ultimately responsible for the minimal credit risk determination and its oversight. This responsibility has been emphasized by the staff of the SEC's Division of Investment Management in two interpretive letters.[67]

In these interpretive letters, the SEC staff emphasized that a money market fund's Board has a duty to make a minimal credit risk finding regardless of the credit ratings status of the security. The letters also stated that, in making the minimal credit risk determination, the Board should take into account the following considerations:

(1) macro-economic factors that might affect the issuer's or guarantor's current and future credit quality;

(2) the strength of the issuer's or guarantor's industry within the economy relative to economic trends;

(3) the issuer's or guarantor's market position within its industry;

(4) cash flow adequacy;

(5) the level and nature of earnings;

(6) financial leverage;

(7) asset protection;

(8) the quality of the issuer's or guarantor's accounting practices and management;

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65. Rule 2a-7(c)(3)(i).
66. *See infra* section 9:3.7.
67. *See* SEC no-action letters to The Investment Company Institute (pub. avail. Dec. 6, 1989) and to Investment Company Registrants (pub. avail. May 8, 1990).

(9) the likelihood and nature of event risks;

(10) an assessment of the issuer's ability to react to future events, including a review of the issuer's competitive position, cost structure and capital intensiveness;

(11) an analysis of the issuer's liquidity, including bank lines of credit and alternative sources of liquidity to support its commercial paper;

(12) a "worst case scenario" evaluation of the issuer's ability to repay its short-term debt from cash sources or asset liquidations in the event the issuer's backup credit facilities are unavailable;

(13) the length to maturity of the security; and

(14) the percentage of the fund's portfolio represented by securities of that issuer.

In addition, in light of recent events, the minimal credit risk determination should also take into account the depth of the market for the securities of the issuer in question, both historically and projected going forward. While a money market fund currently can invest up to 10% of its net assets in illiquid securities,[67.1] the absence of a robust secondary market for an issuer's securities can, in some instances, indicate problems with the creditworthiness of the issuer.

These determinations must be made by the Board, or its delegate, on an ongoing basis for each investment held by a fund. Whenever a credit event occurs with respect to a portfolio holding, the Board, or its delegate, must again determine whether the security continues to present minimal credit risk. All such determinations, and the reasons therefor, should be recorded in a memorandum or other written document maintained in the credit file for that security.

### *[B][3] Eligible Securities*

At the time a money market fund acquires a security, the security must meet the definition of an "Eligible Security" under Rule 2a-7.[68] Determining whether a security is an Eligible Security involves different considerations for rated securities, unrated securities, and securities that are subject to guarantees and demand features.

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67.1. For a discussion of current and proposed liquidity restrictions, see *infra* section 9:3.5[D].

68. The term "Eligible Security" is defined in Rule 2a-7(a)(10). As discussed below, a security that is subject to a guarantee is eligible if the guarantee meets the definition of an Eligible Security.

### [B][3][a] First Tier and Second Tier Securities

There are currently two tiers of Eligible Securities under Rule 2a-7: first tier and second tier. A "First Tier Security" is any Eligible Security that is:[69]

- a rated security (discussed below) that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations; or
- an unrated security (discussed below) that is of comparable quality to a security meeting the requirements for a First Tier rated security, as determined by the Board, or its delegate; or
- a security that is issued by a registered money market fund; or
- a government security.[70]

A "Second Tier Security" is any Eligible Security that is not a First Tier Security.[71] The distinction between a First Tier and a Second Tier security is significant because Rule 2a-7 imposes different diversification requirements (discussed below) on an Eligible Security based on whether the security is First or Second Tier.

### [B][3][b] Rated Securities

A rated security[72] may be determined to be an Eligible Security under Rule 2a-7 if it has a remaining maturity of 397 calendar days or less, and it has received a rating from the Requisite NRSROs[73] that is in one of

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69. Rule 2a-7(a)(12).
70. For the definition of "government security," see *supra* note 61.
71. Rule 2a-7(a)(22).
72. To qualify as a rated security, the security (or a guarantee of that security) must have received a short-term rating from a nationally recognized statistical rating organization (NRSRO), or have been issued by an issuer (or guarantor in the case of a guarantee) that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security (or guarantee). Rule 2a-7(a)(19)(i) and (ii). A security is not considered to be a rated security if it is subject to an external credit support agreement that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement or the credit support agreement itself has received a short-term rating. Rule 2a-7(a)(19)(iii). An NRSRO that is an affiliate of the issuer of the security or of any insurer or provider of a credit support for the security is excluded from the definition of an NRSRO with respect to that security. Rule 2a-7(a)(17).
73. "Requisite NRSROs" means any two NRSROs that have issued a rating with respect to a security or a class of debt obligations of the issuer of the security or, if only one NRSRO has issued such a rating, that NRSRO. Rule 2a-7(a)(21).

the two highest short-term rating categories.[74] As noted above, if the short-term rating that the security receives from the Requisite NRSROs is in the highest short-term rating category for debt obligations, then the security may further be classified as a First Tier Security.

### [B][3][c] Unrated Securities

An unrated security may be determined to be an Eligible Security only if the Board of the money market fund, or its delegate, determines that the security is of comparable quality to a rated Eligible Security,[75] provided that:

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74. Within such short-term rating categories, there may be sub-categories or gradations indicating relative standing. Rule 2a-7(a)(10)(i). On May 23, 2007, the SEC approved rules to implement provisions of the Credit Rating Agency Reform Act of 2006 (enacted on Sept. 29, 2006, the "Rating Agency Reform Act"). *See* Exchange Act Release No. 55,857 (June 18, 2007). To introduce competition in the credit rating industry and thus promote greater rating reliability, the new rules require a credit rating agency that desires to hold itself out as an NRSRO to be registered with the SEC instead of obtaining no-action relief. The new rules are expected to increase the number of NRSROs to thirty (as of June 2007, S&P and Moody's comprised 80% of the credit rating market, as measured by revenues). *See* Release No. 55,857 at section VIII.D. The increase in the number of NRSROs may necessitate the need to revise Rule 2a-7 to address certain concerns; for example, that quality measurement statistics (generally represented by symbols, numbers and other designations to distinguish the creditworthiness of rated issuers) are not currently standardized under Rule 2a-7. *See, e.g.*, Comment Letter from Elizabeth Krentzman, General Counsel, ICI, on Exchange Act Release No. 55,231 (File No. S7-04-07) (Feb. 2, 2007), dated Mar. 12, 2007. The SEC stated that "[b]ased on the uncertainty of how many credit rating agencies ultimately will register as NRSROs, the [SEC] intends to monitor for now how the NRSRO regulatory program impacts Rule 2a-7 and the [SEC's] other rules using the term "NRSRO." As the program develops, the [SEC] will evaluate whether modifications to these rules would be appropriate." *See* Release No. 55,857 at section IV. On February 2, 2009, the SEC adopted rule amendments that impose additional requirements on NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies. *See* Exchange Act Release No. 59,342 (Feb. 2, 2009). In 2008, the SEC had proposed to eliminate the use of NRSRO ratings in rules under the ICA, including Rule 2a-7. *See* 2009 Proposing Release, *supra* note 3, at II.A.3; *see also* Investment Company Act Release No. 28,327 (July 1, 2008). In the 2009 Proposing Release, *supra* note 3, the SEC once again sought comment on whether to modify provisions of Rule 2a-7 that incorporate minimum ratings by NRSROs to reflect changes made to the federal securities laws by the Rating Agency Reform Act. *See* 2009 Proposing Release, *supra* note 3, at section II.A.3.

75. Rule 2a-7(a)(10)(ii). A written record of any comparable quality finding, including the rationale for the finding, should be included in the credit file for the issuer.

- An unrated security that had a remaining maturity of more than 397 calendar days when it was issued, but currently has a remaining maturity of 397 calendar days or less, cannot be determined to be an Eligible Security if it has received a long-term rating from any NRSRO that is not within that NRSRO's three highest long-term rating categories unless the security also has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories.[76]
- An unrated ABS is not an Eligible Security unless substantially all of the qualifying assets of the ABS consist of obligations of one or more municipal issuers.[77]

As noted above, if the Board, or its delegate, further determines that an unrated security is of comparable quality to a security meeting the requirements for a First Tier rated security, then the security may also be classified as a First Tier Security.

#### [B][3][d] Securities Subject to Guarantees or Demand Features

The analysis of whether a security is an Eligible Security is more complex if the security is subject to a guarantee or a demand feature.

A "Guarantee" is an unconditional obligation of a person other than the issuer of the underlying security to pay the principal amount of the underlying security plus accrued interest when due or upon default.[78] Examples of Guarantees include letters of credit, financial guarantee (bond) insurance, and unconditional demand features (other than ones provided by the issuer of the securities), as discussed below.

A "Demand Feature" is a feature that permits the holder of a security to sell the security at an exercise price approximately equal to the amortized cost of the security plus any accrued interest at the time of exercise.[79] In the context of an ABS, a Demand Feature is a feature that permits the holder of the ABS to unconditionally receive principal and interest within 397 calendar days of making demand.[80]

An "Unconditional Demand Feature" is a Demand Feature that would be readily exercisable in the event of a default in payment of

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76. Within such long-term rating categories, there may be sub-categories or gradations indicating relative standing. Rule 2a-7(a)(10)(ii)(A).
77. Rule 2a-7(a)(10)(ii)(B).
78. Rule 2a-7(a)(15).
79. Rule 2a-7(a)(8)(i). A Demand Feature must be exercisable either at any time on no more than thirty calendar days' notice, or at specific intervals not exceeding 397 calendar days and upon no more than thirty days' notice.
80. Rule 2a-7(a)(8)(ii).

principal or interest on the underlying security.[81] Accordingly, an Unconditional Demand Feature (other than one provided by the issuer of the underlying security) is deemed to be a Guarantee under Rule 2a-7. In comparison, a "Conditional Demand Feature," which is defined simply as a Demand Feature that is not an Unconditional Demand Feature, is not a Guarantee under Rule 2a-7.[82]

The determination of whether a security that is subject to a Guarantee may be determined to be an Eligible Security (or a First Tier Security) under Rule 2a-7 may be based solely on whether the Guarantee is an Eligible Security or First Tier Security, as applicable.[83] In addition, with respect to a security that is subject to a Guarantee, the Guarantee must have received a rating from an NRSRO or the Guarantee must have been issued by a guarantor that has received a rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee.[84] Also, with respect to a security that is subject to a Guarantee or Demand Feature, if the Guarantee or Demand Feature is permitted to be substituted with another Guarantee or Demand Feature, then the issuer of the Guarantee or Demand Feature, or some other entity (such as a securities dealer), must have undertaken to promptly notify the holder of the underlying security in the event of such substitution or replacement.[85]

Securities that are subject to Conditional Demand Features face more stringent requirements to qualify as Eligible Securities (or First Tier Securities, as applicable). A security that is subject to a Conditional Demand Feature may be determined to be an Eligible Security

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81. Rule 2a-7(a)(26).
82. Rule 2a-7(a)(6).
83. Rule 2a-7(c)(3)(iii).
84. Rule 2a-7(a)(10)(iii)(A). This rating is not required, however, if the Guarantee is issued by a person that, directly or indirectly, controls, is controlled by, or is under common control with the issuer of the security (other than a sponsor of a special purpose entity with respect to an ABS), or the security is a repurchase agreement that is collateralized fully, or the Guarantee is itself a government security. Rule 2a-7(a)(10)(iii)(A)(1)–(3). In the 2009 Proposing Release, *supra* note 3, the SEC proposed changes regarding what it means for a repurchase agreement to be "Collateralized Fully." *See infra* section 9:3.4[C][1][c][i]. A fund may disregard a Demand Feature or Guarantee for all purposes under Rule 2a-7 if the fund is not relying on it to determine the quality, maturity, or liquidity of a portfolio security. Rule 2a-7(c)(5). A record of this determination must be made and maintained.
85. Rule 2a-7(a)(10)(iii)(B). Where this undertaking is not reflected in the offering circular or other documents relating to the underlying security, the fund should obtain the undertaking in writing and include it in the credit file for the security.

(or First Tier Security, as applicable) under Rule 2a-7 only if the following four conditions are satisfied:

- First, the Conditional Demand Feature must be an Eligible Security (or First Tier Security, as applicable).
- Second, at the time the fund acquires the security, the Board, or its delegate, must have determined that the risk of circumstances resulting in the Conditional Demand Feature not being exercisable is minimal.[86]
- Third, the conditions limiting exercise must be able to be readily monitored by the fund or relate to the taxability of the interest payments on the security, or the terms of the Conditional Demand Feature must require that the fund will be given notice of the occurrence of the condition and will be given an opportunity to exercise the Demand Feature in accordance with its terms.[87]
- Fourth, the underlying security or any Guarantee of the security (or the comparable debt securities of the issuer or guarantor) must have received either a rating from the Requisite NRSROs in the two highest categories (short-or long-term, as applicable) or, if unrated, must have been determined by the Board, or its delegate, to be of comparable quality to a security that has been rated in the two highest categories by the Requisite NRSROs.[88]

#### [B][3][e] First Tier and Second Tier Securities under the Proposed Amendments to Rule 2a-7

The Proposed Amendments would effectively limit money market fund investments to the equivalent of First Tier Securities. Specifically, the Proposed Amendments would:

- permit Rated Securities to qualify as Eligible Securities only if the securities are rated in the highest NRSRO rating category (instead of one of the two highest, as in the current rule);[89]
- include, in the definition of Eligible Securities, securities that are issued by other registered money market funds and Government Securities;[90] and

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86. A written record of this determination should be retained by the fund.
87. Rule 2a-7(c)(3)(iv)(B).
88. Rule 2a-7(c)(3)(iv).
89. *See* proposed Rule 2a-7(a)(11)(iii).
90. *See* proposed Rule 2a-7(a)(11)(i)-(ii). Unrated securities of comparable quality to such securities would continue to be permissible investments under Rule 2a-7, as proposed to be amended.

- delete references to First Tier Securities and Second Tier Securities, and all provisions relating to Second Tier Securities from Rule 2a-7.[91]

### [C] Portfolio Diversification[92]

In addition to maturity and quality, a third criteria for the composition of a money market fund's portfolio under Rule 2a-7 concerns diversification.

Rule 2a-7 requires money market funds to be diversified with respect to securities issuers. The diversification requirements, which are designed to limit a money market fund's exposure to the credit risk of any single issuer, do not apply with respect to U.S. government securities (which are considered by the SEC not to present significant credit risk), or to securities that are subject to Guarantees issued by non-controlled persons (which instead are required to be diversified according to the diversification rules applicable to Guarantees).[93]

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91. In the 2009 Proposing Release, the SEC requested comment on whether there would be a proportionately greater impact of eliminating Second Tier Securities on particular types of funds, such as single-state tax exempt funds. *See* 2009 Proposing Release, *supra* note 3, at section II.A.1.

92. If a money market fund satisfies Rule 2a-7's diversification requirements, it is deemed to have satisfied the issuer diversification standards set forth in ICA § 5(b)(1). Rule 2a-7(c)(4)(v). However, compliance with Rule 2a-7's diversification requirements does not ensure that a money market fund will be in compliance with the diversification requirements under Subchapter M of the Internal Revenue Code of 1986, as amended ("Subchapter M"), which is generally necessary in order to avoid federal taxation at the fund level. For example, except for a repurchase agreement that is collateralized fully with Government Securities, the staff of the Internal Revenue Service (IRS) currently considers a repurchase agreement to be issued by the counterparty for purposes of determining compliance with Subchapter M's diversification requirements. (For a repurchase agreement that is collateralized fully with Government Securities, the IRS currently permits a look through the repurchase agreement to the Government Securities, if so elected by the fund. *See* Rev. Proc. 2004-28, 2004-22 I.R.B. 984.) In comparison, a money market fund may always look through to the underlying collateral for diversification purposes under Rule 2a-7 if the repurchase agreement meets certain conditions. Rule 2a-7(c)(4)(ii)(A). *See infra* section 9:3.4[C][1][c][i]. Another example where a money market fund may be in compliance with Rule 2a-7's diversification requirement but not with those of Subchapter may arise where a fund holds a large percentage of its assets in securities issued by a single entity that are subject to Guarantees. Under certain circumstances, a fund may disregard the underlying issuer for Rule 2a-7 diversification purposes where the security is subject to a Guarantee issued by a non-controlled person. *See infra* section 9:3.4[C][2][b]. However, a fund may not be able to take a similar position under Subchapter M.

93. Rule 2a-7(c)(4)(i). Securities subject to Guarantees and Demand Features are subject to separate diversification requirements, which are discussed below.

The diversification requirements vary depending on whether the fund is taxable or single-state tax exempt. Further, Rule 2a-7 establishes specialized diversification requirements for Second Tier Securities, ABSs, and securities that are subject to Demand Features and Guarantees.

### *[C][1] Issuer Diversification*

#### [C][1][a] General Diversification Requirements

The portfolio diversification requirements that apply to taxable and national funds differ from those that apply to single state funds.

##### *[C][1][a][i] Taxable and National Funds*

A "Taxable Fund" under Rule 2a-7 is a money market fund that does not hold itself out as distributing income exempt from regular federal income tax.[94] In comparison, a "National Fund" is a money market fund that holds itself out as distributing income exempt from regular federal income tax, although it does not hold itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state or subdivision, as applicable.[95]

Immediately after acquiring any security, a Taxable Fund or a National Fund must not have invested more than 5% of its total assets[96] in securities issued by the same entity.[97] This diversification requirement applies to 100% of the fund's total assets.[98] However, there is a temporary "safe harbor" from this diversification requirement that permits a Taxable or National Fund to invest up to 25% of its total assets in the First Tier Securities of a single issuer for up to three business days after the acquisition of the security. A fund may not utilize this safe harbor with respect to more than one issuer at any time.[99]

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94. A "Tax-Exempt Fund" under Rule 2a-7 is any money market fund that holds itself out as distributing income exempt from regular federal income tax. Rule 2a-7(a)(24).
95. Rule 2a-7(a)(23), (24).
96. Total assets means, with respect to a fund using the amortized cost method, the total amortized cost of all its assets, and with respect to any other fund, the total market-based value of its assets. Rule 2a-7(a)(25).
97. Rule 2a-7(c)(4)(i)(A).
98. For a diversified non-money market fund, the fund must not invest more than 5% of its assets in any issuer with respect to 75% of its assets.
99. The ability of a fund to rely on this temporary safe harbor will also depend on whether the investment is consistent with the investment policies set forth in the fund's registration statement, which may be more restrictive than Rule 2a-7.

#### *[C][1][a][ii] Single State Funds*

A "Single State Fund" under Rule 2a-7 is any money market fund that holds itself out as:

- distributing income exempt from regular federal income tax, and
- seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and, where applicable, subdivisions thereof.[100]

The general diversification requirements for a Single State Fund are not as stringent as the diversification requirements for Taxable and National Funds. Specifically, with respect to 75% of its total assets, immediately after acquiring any security, a Single State Fund may not have invested more than 5% of its total assets in securities issued by the same entity. Accordingly, Single State Funds have a permanent 25% safe harbor from the 5% issuer diversification standard. However, a Single State Fund may only utilize this 25% basket (and thus invest more than 5% of its total assets in the securities of any one issuer) with respect to First Tier Securities.[101]

### [C][1][b] Diversification Requirements for Second Tier Securities

As noted above, Rule 2a-7 establishes specialized portfolio diversification requirements for Second Tier Securities.

#### *[C][1][b][i] Taxable Funds*

Immediately after acquiring a Second Tier Security, a Taxable Fund may not have invested more than:

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100. Rule 2a-7(a)(23). Any issuer of tax-exempt bonds (*e.g.*, states, municipalities, and their political subdivisions) may be deemed to be an "issuer" under ICA § 5(b)(1) (definition of "diversified company"). *See* Investment Company Act Release No. 9,785 (May 31, 1977). For purposes of § 5(b)(1), a political subdivision would be deemed to be the sole issuer of a security if the assets and revenues of the subdivision (or agency, authority or instrumentally, as applicable) are separate from those of the government creating the subdivision and the security is backed only by the assets and revenues of the subdivision. Likewise, for purposes of § 5(b)(1), a nongovernmental user would be deemed to be the sole issuer if the assets and revenues of the nongovernmental user provide the only backing for the security (*e.g.*, an industrial development bond). *See* Investment Company Act Release No. 9,785 (May 31, 1977). As noted above, if a money market fund satisfies Rule 2a-7's diversification requirements, it is deemed to have satisfied the issuer diversification standards set forth in ICA § 5(b)(1). *See* Rule 2a-7(c)(4)(v).

101. Rule 2a-7(c)(4)(i)(B).

- 5% of its total assets in all Second Tier Securities held by the fund.[102]
- The greater of 1% of its total assets or one million dollars in Second Tier Securities issued by a particular issuer.[103]

#### *[C][1][b][ii] Tax Exempt Funds*

Tax Exempt Funds are permitted to invest in Second Tier Securities to a greater extent than Taxable Funds. However, immediately after acquiring a Second Tier Security, a Tax Exempt Fund may not have invested more than:

- 5% of its total assets in conduit securities that are Second Tier Securities.[104]
- The greater of 1% of its total assets or one million dollars in second tier conduit securities issued by a particular issuer.[105]

A "Conduit Security" is a security issued by a municipal issuer involving an arrangement or agreement entered into, directly or indirectly, with a person other than a municipal issuer that provides for or secures repayment of the security. Industrial development bonds are common examples of Conduit Securities.[106]

### [C][1][c] Guidelines for Calculating Issuer Diversification

To facilitate the determination of whether a money market fund is in compliance with the issuer diversification requirements discussed above, Rule 2a-7 establishes guidelines for the treatment of repurchase

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102. Rule 2a-7(c)(3)(ii)(A).
103. Rule 2a-7(c)(4)(i)(C)(1).
104. Rule 2a-7(c)(3)(ii)(B).
105. Rule 2a-7(c)(4)(i)(C)(2).
106. Rule 2a-7(a)(7). By structuring the definition to identify what is not a Conduit Security, the SEC intended to make it easier for a fund to identify a Conduit Security without obtaining a legal or other expert opinion. Rule 2a-7 applies diversification requirements to Second Tier Conduit Securities because these securities are not backed by revenues of an essential public facility or governmental taxing authority and thus may be at greater risk of default. Rule 2a-7 provides that a Conduit Security does not include a security that is: (i) fully and unconditionally guaranteed by a municipal issuer; (ii) payable from a municipal issuer's general revenue (unless the revenue is pursuant to an agreement with a non-municipal entity providing for or securing repayment of the security); (iii) related to a project owned and operated by a municipal issuer; or (iv) related to a facility leased to and controlled by an industrial or commercial enterprise that is part of a public project owned and controlled by a municipal issuer.

agreements, refunded securities, Conduit Securities, ABSs, and shares of other money market funds.

#### *[C][1][c][i] Repurchase Agreements, Refunded Securities, and Conduit Securities*[107]

When a money market fund enters into a repurchase agreement, the fund may "look through" the agreement (that is, the securities underlying the repurchase agreement may be considered to be held directly by the fund) for purposes of diversification calculations, provided the repurchase agreement is collateralized fully.[108] Rule 2a-7 uses the definition of "collateralized fully" under ICA Rule 5b-3(c)(1), which means that the collateral could consist entirely of:[109]

A. cash items;

B. Government Securities;

C. securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the Requisite NRSROs; or

D. Unrated Securities that are of comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the investment company's board of directors or its delegate.

#### *[C][1][c][ii] Impact of Proposed Amendments*

The Proposed Amendments would limit a money market fund's investments in repurchase agreements to repurchase agreements

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107. A refunded security is defined as a debt security, the principal and interest payments on which are to be paid by government securities that have been irrevocably placed in an escrow account pursuant to an agreement between the issuer of the debt security and an unaffiliated escrow agent. Rule 2a-7(a)(20). The definition contains additional requirements with respect to the terms of the escrow arrangement.

108. Rule 2a-7(c)(4)(ii)(A). "Collateralized fully" in the case of a repurchase agreement means that the value of the securities collateralizing the repurchase agreement (less transaction costs if the seller defaults) is, and during the entire term of the repurchase agreement will be, at least equal to the price paid to the seller plus the accrued resale premium on such price. Rules 2a-7(a)(5). The definition also contains custody and, as discussed in this section, collateral requirements. If the repurchase agreement is not collateralized fully, the fund must consider the counterparty to be the issuer for purposes of diversification compliance, and the agreement (or portion thereof) that is not collateralized fully would be deemed to be an unsecured loan that itself would have to meet Rule 2a-7's quality requirements with respect to the five percent diversification test. *See* 1991 Adopting Release, at n.31.

109. *See* proposed Rule 2a-7(a)(5).

that are collateralized fully by cash items or Government Securities. The Proposed Amendments would also require fund boards or their delegates to evaluate the creditworthiness of all repurchase agreement counterparties, regardless of whether the agreement is collateralized fully.[110]

Acquisition of refunded securities similarly is deemed to be acquisition of the escrowed government securities.[111] A Conduit Security is deemed to be issued by the person ultimately responsible for payments of interest and principal on the security, rather than by the municipality.[112]

#### *[C][1][c][iii] Asset Backed Securities*

Rule 2a-7 provides a complex procedure for determining diversification status with respect to investments by a money market fund in ABSs.

As a general rule, an ABS that is acquired by a fund (the "primary ABS") is deemed to be issued by the special purpose entity that issued the ABS (that is, the trust, corporation, partnership, or other entity organized for the sole purpose of issuing the ABS).[113] This treatment permits a fund to disregard the identity of the sponsor of the ABS in determining compliance with Rule 2a-7's issuer diversification requirements. However, if the obligations of any issuer constitute 10% or more of the qualifying assets of the primary ABS, that issuer will be deemed to be the issuer of that portion of the primary ABS that is comprised of its obligations (such an issuer is referred to as a "10% obligor"). For example, if 20% of the qualifying assets in a particular ABS's asset pool is comprised of securities issued by one issuer (issuer A)

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110. *See* proposed Rule 2a-7(c)(4)(ii)(A). The SEC had eliminated this requirement in 2001 in light of amendments to relevant bankruptcy laws. In the 2009 Proposing Release, however, the SEC stated that it is proposing to once again require the evaluation of the creditworthiness of all repurchase agreement counterparties because it is concerned that in the midst of a crisis following the bankruptcy of a counterparty (*e.g.*, that of Lehman Brothers in the Fall of 2008), a money market fund may find it difficult to protect fully its interests in the collateral without incurring losses. *See* 2009 Proposing Release, *supra* note 3, at II.E.

111. Rule 2a-7(c)(4)(ii)(B). This provision codifies and updates a prior SEC staff position relating to escrowed securities. *See* T. Rowe Price Tax-Free Funds (pub. avail. June 24, 1993) (permitting investment in a municipal bond refunded with escrowed U.S. government securities to be treated as an investment in U.S. government securities for purposes of determining compliance with the diversification requirements of section 5(b)(1)).

112. Rule 2a-7(c)(4)(ii)(C).

113. Rule 2a-7(c)(4)(ii)(D)(1).

and a money market fund invests 5% of its assets in securities issued by that ABS, the fund would be deemed to have 1% of its assets (0.20[114] × 0.05[115]) invested in securities issued by issuer A, and 4% of its assets in securities issued by the ABS. This requirement is commonly referred to as the ABS "look-through" rule.[116]

Further, because the qualifying assets of a primary ABS may be comprised of securities issued by other ABSs that are 10% obligors of the primary ABS (each, a secondary ABS), Rule 2a-7 requires a fund to look through each secondary ABS and treat any 10% obligor of a secondary ABS as a proportionate issuer of the primary ABS. However, money market funds are not required to look beyond a secondary ABS.[117] Due to the revolving nature of ABS qualifying assets, Rule 2a-7 requires a fund that holds an ABS to make periodic determinations of compliance with applicable diversification requirements and to maintain records of those determinations pursuant to written procedures.[118]

#### *[C][1][c][iv] Shares of Money Market Funds*

A money market fund is permitted to acquire shares of another money market fund in excess of amounts otherwise permitted under Rule 2a-7's issuer diversification limitations if the Board of the

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114. The percentage of the pool that is represented by obligations of issuer A.
115. The percentage of the fund's assets invested in the securities issued by the ABS.
116. Rule 2a-7(c)(4)(ii)(D)(1)(i). This example assumes that there are no other 10% obligors of the primary ABS.
117. Rule 2a-7(c)(4)(ii)(D)(1)(ii). Rule 2a-7 provides an exception from this look-through requirement for a 10% obligor that is a special purpose entity and that does not issue its securities to any entity other than another specific ABS issuer (a "restricted special purpose entity"). Thus, a fund is not required to look through to restricted special purpose entities even if they have issued more than 10% of the qualifying assets comprising the primary ABS's asset pool. Rule 2a-7(c)(4)(ii)(D)(2).
118. Rule 2a-7(c)(9)(iv) and (c)(10)(v). Rule 2a-7 provides that such periodic determinations are not required with respect to any ABS that a fund's Board, or its delegate, initially has determined will never have, or is unlikely to have, any 10% obligors. However, a record supporting this determination should be made. Under the ABS diversification requirements, if a 10% obligor is deemed to be the issuer of a portion of the ABS, the fund must also satisfy the Demand Feature and Guarantee diversification requirements, discussed below, with respect to any Demand Features or Guarantees to which the 10% obligor's obligations are subject. Rule 2a-7(c)(4)(ii)(D)(3). Some money market funds have chosen to avoid the complexities of the ABS look-through provisions by only acquiring ABSs that do not have, and are not likely to ever have, 10% obligors.

acquiring fund reasonably believes that the acquired fund is in compliance with Rule 2a-7's issuer diversification requirements.[119]

### *[C][2] Demand Feature and Guarantee Diversification*

#### [C][2][a] Diversification Requirements for Demand Features and Guarantees

In addition to conventional issuer diversification requirements, Rule 2a-7 imposes diversification requirements on securities that are issued by, or that are subject to Demand Features and Guarantees from, the same entity.[120] Rule 2a-7 applies the same diversification standards to a security that is issued by or subject to Guarantees (which, by definition, includes Unconditional Demand Features) as it does to Conditional Demand Features from the same entity. Moreover, these requirements apply uniformly to both taxable and tax exempt money market funds. To prevent "double counting," however, Rule 2a-7 does not require a fund to satisfy the Demand Feature diversification standards with respect to a Demand Feature issued by the same entity that issued the underlying security. Further, the Demand Feature and Guarantee diversification requirements do not apply to Demand Features or Guarantees that are government securities.[121]

Rule 2a-7's Demand Feature and Guarantee diversification requirements provide that, with respect to 75% of the fund's total assets,

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119. Rule 2a-7(c)(4)(ii)(E). This treatment tracks ICA § 5(b), which permits a fund to exceed the ICA's diversification requirements with respect to investments in other investment companies. The determination of the maturity of investments in other money market funds is discussed above. Prior to the adoption of Rule 12d1-1 of the ICA in Investment Company Act Release No. 27,399 (June 20, 2006), the acquisition of shares of another money market fund was required to comply with restrictions contained in ICA § 12(d)(1) or be conducted pursuant to appropriate exemptive relief from those restrictions. The exception from Rule 2a-7's diversification standards, along with ICA § 12(d)(1)(E), permit a money market fund to be organized in a "master-feeder" structure. Effective as of July 31, 2006, Rule 12d1-1 provides an exemption from ICA § 12(d)(1), which allows funds to invest in shares of registered and unregistered money market funds in excess of the limits of ICA § 12(d)(1). Rule 12d1-1 also provides exemptions from ICA § 17(a) and Rule 17d-1 of the ICA (restrictions on a fund's ability to enter into transactions and joint arrangements with affiliated persons).

120. Rule 2a-7(c)(4)(iii)(A). Accordingly, although these requirements are characterized as Demand Feature and Guarantee diversification, the requirements also relate to other securities issued by the entity providing the Demand Feature or Guarantee.

121. Rule 2a-7(c)(4)(iii). Rule 2a-7's issuer diversification standards would apply to the underlying security. A Guarantee or Demand Feature that is a government security is not subject to the Guarantee, Demand Feature, or issuer diversification rules.

immediately after the acquisition of any Demand Feature or Guarantee or of any security subject to a Demand Feature or Guarantee, no more than 10% of the fund's total assets may be invested in securities that are issued by or subject to Demand Features or Guarantees from the entity that issued the Demand Feature or Guarantee.

In addition, with respect to 100% of the fund's total assets,

- immediately after the acquisition of a second tier Demand Feature or Guarantee (or a security after giving effect to the Demand Feature or Guarantee), the fund may have no more than 5% of its total assets invested in securities issued by or subject to Demand Features or Guarantees from the entity that issued the second tier Demand Feature or Guarantee,[122] and
- immediately after the acquisition of a security subject to a Demand Feature or Guarantee, a fund may have no more than 10% of its total assets invested in securities issued by, or subject to Demand Features or Guarantees from, the same entity unless, with respect to any security subject to Demand Features or Guarantees from that entity (other than securities issued by the entity), the Demand Feature or Guarantee is issued by a non-controlled person.[123]

In other words, a money market fund can utilize the 25% non-diversification basket available under Rule 2a-7(c)(4)(iii) to exceed the 10% diversification requirement applicable to securities issued by or subject to Demand Features or Guarantees from the same entity only with respect to first tier Demand Features or Guarantees issued by a non-controlled person.

### [C][2][b] Guidelines for Calculating Demand Feature and Guarantee Diversification

Rule 2a-7 provides diversification guidelines for "fractional" and "layered" Demand Features and Guarantees.[124] The issuer of a frac-

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122. Rule 2a-7(c)(4)(iii)(B).

123. Rule 2a-7(c)(4)(iii)(C). A Demand Feature or Guarantee issued by a non-controlled person is defined to mean a Demand Feature or Guarantee issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature or Guarantee. Rule 2a-7(a)(9)(i) and Rule 2a-7(a)(16)(ii). A Demand Feature or Guarantee issued by a sponsor of an ABS may be treated as issued by a "non-controlled person," and therefore eligible for inclusion in the 25% basket for Guarantees and Demand Features. Rule 2a-7(a)(9)(ii) and Rule 2a-7(a)(16)(ii).

124. Fractional Demand Features or Guarantees are those that apply only to a portion of the principal value of the underlying security. Layered Demand Features or Guarantees are multiple Demand Features or Guarantees with

tional Demand Feature or Guarantee will be deemed to have issued the Demand Feature or Guarantee only with respect to that portion of the underlying security to which the Demand Feature or Guarantee applies.[125] Each issuer of a layered Demand Feature or Guarantee will be deemed to have issued the Demand Feature or Guarantee with respect to the entire principal amount of the underlying security.[126]

If a fund is not relying on a particular Demand Feature or Guarantee to determine the quality, maturity, or liquidity of a portfolio security, the fund may choose to disregard that Guarantee or Demand Feature for all purposes under Rule 2a-7, provided that such non-reliance is documented in the fund's records.[127] If the fund is not relying on the Guarantee for any purpose, the minimal credit risk determination with respect to the underlying security must be made independent of the Guarantee, notwithstanding a rating agency's use of the Guarantee to rate the security. However, if a fund is relying on separate Guarantees or Demand Features to satisfy one or more of Rule 2a-7's quality or maturity requirements, or to determine the liquidity of a portfolio security, each of these Guarantees or Demand Features will be subject to Rule 2a-7's Guarantee and Demand Feature diversification requirements.

## § 9:3.5 Downgrades and Defaults of Portfolio Securities

In addition to the Risk-Limiting Provisions, Rule 2a-7 establishes specific procedures that must be followed in the event a portfolio security is downgraded or a default or certain other events occur with respect to a portfolio security.

### [A] Downgrades

Currently, upon the occurrence of either of the following

(i) a portfolio security ceases to be first tier (either because it is no longer rated in the highest rating category by the Requisite NRSROs or, in the case of an unrated security, because the

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respect to the same underlying security that are not contractually limited (*i.e.*, each applies to the entire underlying principal value of the obligation). Some ABSs are supported by Guarantees that cover all losses up to the amount of expected loss likely to be experienced by the ABS. These are referred to as "first loss Guarantees" and may be treated as fractional Guarantees when calculating compliance with Rule 2a-7's Guarantee and Demand Feature diversification requirements. Investment Company Act Release No. 22,921 at section I.B.3.b.v (Dec. 2, 1997).

125. Rule 2a-7(c)(4)(iv)(A).

126. Rule 2a-7(c)(4)(iv)(B).

127. Rule 2a-7(c)(5). A memorandum or notation included in the credit file for the issuer would satisfy this requirement.

Board, or its delegate, has determined the security is no longer comparable to a First Tier Security), or

(ii) the fund's investment adviser becomes aware that any 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 rating category

the fund's Board is required to promptly reassess whether that security continues to present minimal credit risk and must take such action as it deems is in the best interests of the fund and its shareholders.[128] However, this reassessment is not required if, in accordance with the fund's procedures, the security is disposed of (or matures) within five business days of the event requiring reassessment.[129]

#### *[A][1] Impact of Proposed Amendments*

Given the changes to the definition of Eligible Securities discussed above,[130] the Proposed Amendments would require such reassessments *only* in connection with the second prong above, and then, *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.[131]

### [B] Securities Subject to Demand Features

Rule 2a-7 requires that if, after giving effect to a downgrade, more than 5% of a money market fund's total assets are invested in Second Tier Securities that are issued by or subject to Demand Features from a

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128. Rule 2a-7(c)(6)(i)(A). This obligation of the Board may be delegated to the fund's investment adviser or officers. *See infra* section 9:3.7.

129. Rule 2a-7(c)(6)(i)(B).

130. See *supra* section 9:3.4[B][3][e] regarding references to First Tier Securities and Second Tier Securities and all provisions relating to Second Tier Securities being proposed to be deleted from Rule 2a-7.

131. The SEC stated that eliminating a money market 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 Rule 2a-7 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 market fund investments in Second Tier Securities are more likely to result in reduced investor confidence and trigger a run on money market funds. *See* 2009 Proposing Release, *supra* note 3, at section II.A.2. (It should be noted that, immediately prior to the Lehman Brothers bankruptcy, Lehman paper qualified as First Tier Securities under Rule 2a-7.)

single institution, the fund must reduce its investments in such securities to no more than 5% of its total assets by exercising the Demand Feature at the next exercise date. However, the fund is not required to eliminate its excess positions if the Board determines that disposing of the securities would not be in the best interests of the fund.[132]

### [C] Defaults and Other Events Requiring Disposition

A money market fund is required to dispose of a portfolio security as soon as practicable, consistent with achieving an orderly disposition of the security,[133] if:

- there is a default with respect to the portfolio security (other than an immaterial default that is unrelated to the financial condition of the issuer), or
- the portfolio security ceases to be an Eligible Security, or
- a determination is made that the portfolio security no longer presents minimal credit risk, or
- an event of insolvency[134] occurs with respect to the issuer of the portfolio security or the provider of any Demand Feature or Guarantee.

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132. Rule 2a-7(c)(6)(i)(C). Responsibility for this determination cannot be delegated by the Board.

133. Rule 2a-7(c)(6)(ii). Any action taken with respect to defaulted securities or events of insolvency must be reported on the fund's Form N-SAR. Rule 2a-7(c)(10)(vii). In addition, a fund must report on Form N-SAR any securities it holds on the final day of the relevant reporting period that are not Eligible Securities.

134. An event of insolvency with respect to a person is defined as: (1) an admission of insolvency, the application by a person for the appointment of a trustee or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; (2) the institution of similar proceedings by another person against the person which are not contested; or (3) the institution of similar proceedings by a government agency responsible for the activities of the person, whether or not contested by the person. Rule 2a-7(a)(11). An instrument subject to a Demand Feature or Guarantee is not deemed to be in default, and an event of insolvency with respect to the issuer is not deemed to have occurred, if: (1) the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest, or (2) the provider of the Guarantee is continuing, without protest, to make payments as due on the instrument. Rule 2a-7(c)(6)(iv).

However, the fund will not be required to dispose of the portfolio security if the Board determines that such course of action would not be in the best interests of the fund.[135]

### [D] Liquidity and Valuation Issues

Rule 2a-7 does not currently address the impact of market liquidity on an Eligible Security. If the market for one or more of a fund's portfolio securities becomes impaired or illiquid, the Board, or its delegate, should determine the impact of these events on each security's valuation. Moreover, the Board, or its delegate, should determine if the securities continue to be Eligible Securities, including whether the securities continue to present minimal credit risk.

#### *[D][1] Portfolio Liquidity*

Currently, money market funds are limited, under a longstanding SEC interpretive position, to investing no more than 10% of their net assets in illiquid securities.[136] Although this requirement generally would not force a fund to liquidate any portfolio instrument where the fund would suffer a loss on the sale,[137] beginning in the summer of 2007, market events revealed how otherwise Eligible Securities have the potential of becoming illiquid or suffering market valuation declines, even in the absence of a downgrading or other credit event.[138]

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135. Responsibility for this determination cannot be delegated by the Board. In making this determination, a Board should consider "any and all factors that it believes to be material in assessing whether retention of a security is in the best interests of a fund." In addition to illiquidity in the marketplace for a security, a Board may take the existence of insurance against payment defaults, issuer insolvencies, and other credit-related events into consideration in making the determination. *See* ICI Mutual Insurance Company (pub. avail. July 27, 1998).

136. *See* "Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145," Investment Company Act Release No. 17,452 (Apr. 23, 1990). Illiquid securities are securities that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund is carrying the security. *See* Investment Company Act Release No. 21,837 at n.65. *Cf.* Proposed Rule 2a-7(a)(18) (definition of "liquid security"). In comparison, non-money market funds are subject to a 15% limitation on illiquid assets.

137. *See* Investment Company Act Release No. 13,380 at n.38 (July 11, 1983).

138. It is for this reason that a Board should not simply rely on the ratings assigned to securities by rating agencies, and the investment adviser should independently support the determination that the security presents a minimal credit risk to the fund. When the financial crisis rapidly developed in 2007, investments by numerous money market funds in structured investment vehicles (SIVs) tied to sub-prime mortgage assets

Accordingly, when the market for one or more of a money market fund's portfolio securities becomes impaired or illiquid, the Board or its delegate should promptly reassess whether the fund has sufficient liquidity to meet redemptions.

### [D][1][a] Liquidity of Investments Under the Proposed Amendments

The SEC's Proposed Amendments would, for the first time, expressly incorporate the concept of liquidity into Rule 2a-7 itself, restricting all money market fund portfolio investments to cash and securities that, at the time of acquisition, are considered to be "liquid securities."[139] This term would be defined to mean securities that can

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threatened to seriously impact the ability of money market fund portfolios to maintain the $1 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 issued by then-illiquid SIVs. The initial wave of credit support requests to the SEC Staff was renewed and intensified after Lehman Brothers filed for Chapter 11 bankruptcy protection on September 15, 2008. The following day, The Reserve Primary Fund ("Reserve"), an institutional fund with assets under management in excess of $62 billion, became the second money market fund in history to break the dollar. In the days after Reserve broke the dollar, there was a run on prime money market 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 ability of money market funds to provide liquidity to redeeming investors through ordinary means. 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 market funds facing credit or liquidity challenges. The Federal Reserve Board and the Department of the Treasury ("Treasury") also responded to the market illiquidity, announcing primary and secondary market support programs designed to improve market liquidity and assist money market funds. For example, 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), and the Treasury announced the "Temporary Guarantee Program for Money Market Funds" on September 19, 2008 (expired on September 18, 2009).

139. *See* proposed Rule 2a-7(c)(5)(i). The SEC stated that, in its view, it is critical for a money market fund to have sufficient liquidity in order to maintain a stable share price. *See* 2009 Proposing Release, *supra* note 3, at section II.C.1.

be sold or disposed of in the ordinary course of business within seven calendar days at approximately their amortized cost.[140]

Additionally, the Proposed Amendments would require institutional and retail money market funds to satisfy the following new liquidity requirements:[141]

- 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; 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;[142] 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.[143]

### *[D][2] Valuation In Illiquid Markets*

Valuing portfolio securities for which market quotations are not readily available is a challenge that money market funds may face in illiquid markets. To facilitate the good faith determination by a Board, or its delegate, of the fair value[144] of portfolio securities in an illiquid market, pricing services may be utilized and quotes may be obtained from brokers. However, Boards ultimately remain responsible for pricing.

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140. *See* proposed Rule 2a-7(a)(18).
141. The Proposed Amendments would require a money market fund's board to determine at least annually whether the fund is an "institutional fund." *See* proposed Rule 2a-7(c)(5)(v). Specifically, the Proposed Amendments would define an "Institutional Fund" to generally mean a money market fund whose board determines at least annually that it 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. *See* proposed Rule 2a-7(a)(17).
142. *See* proposed Rule 2a-7(c)(5)(iii)-(iv).
143. *See* proposed Rule 2a-7(c)(5)(ii). The SEC stated that, in order to comply with this requirement, fund managers would 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 market 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. *See* 2009 Proposing Release, *supra* note 3, at section II.C.2.
144. *See generally* ICA § 2(a)(41).

Where market events affect the valuation of a significant portion of a fund's portfolio, the level of Deviation can increase to an extent that can become problematic. Even if the fund is not in danger of breaking the dollar share price, it may be difficult for the fund to meet redemptions by selling portfolio securities that have become thinly traded. Several options may be available to a Board, or its delegate, for supporting a money market fund that holds a problematic level of illiquid securities, including the following:[145]

- In the case of a smaller money market fund, the investment adviser or an affiliate could purchase shares of the fund, which would reduce the level of Deviation.
- The investment adviser of the money market fund or one of its affiliates could agree to purchase portfolio securities from the money market fund for cash at amortized cost.[146]
- The investment adviser of the money market fund could provide a Guarantee to the fund in the form of a capital support agreement or similar arrangement.[147]

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145. In many cases, the options that are available to a Board, or its delegate, for supporting a money market fund may require no action relief under ICA § 12(d)(3) (generally making it unlawful for any registered investment company to acquire any security issued by, or any interest in the business of, any broker-dealer, any person engaged in the business of underwriting, or an investment adviser of an investment company, or an investment adviser registered under the ICA), § 17(a)(1) (generally making it unlawful for any affiliated person of a registered investment company, or an affiliated person of such person, acting as principal, to knowingly sell any security or other property to the registered investment company), and § 17(d) (generally making it unlawful for any affiliated person of a registered investment company, or any affiliated person of such a person, acting as principal to effect any transaction in which the registered investment company is a joint or joint and several participant with such person in contravention of rules and regulations adopted by the SEC). *See infra* note 138.

146. *See, e.g.*, 1784 Funds (pub. avail. July 17, 1995) (use of Standby Purchase Agreement allowing money market fund's investment adviser or affiliate to purchase certain securities from the fund necessary to prevent the deviation between the fund's market-based net asset value per share and the fund's amortized cost net asset value per share from exceeding ½ of 1%); *see also infra* section 9:4.

147. *See, e.g.*, SEI Daily Income Trust—Prime Obligation Fund (pub. avail. Nov. 8, 2007) and SEI Daily Income Trust—Money Market Fund (pub. avail. Nov. 9, 2007) (capital support agreement entered into by money market fund and affiliate to prevent losses realized upon ultimate disposition of securities from causing money market fund's market based net asset value per share to fall below a minimum permissible net asset value specified in the capital support agreement by obligating affiliate to make a cash contribution to the money market fund, up to a maximum amount

- The investment adviser of the money market fund or one of its affiliates could engage in reverse repurchase agreements with the fund, effectively allowing the fund to borrow against its portfolio securities to meet redemptions.[148]
- The Board, or its delegate, could ensure that the money market fund has access to a line of credit or other credit facility from an affiliated bank[149] or from an unaffiliated bank with affiliated payment obligations.[150]
- The money market fund and any other funds in the same fund complex could seek to obtain an inter-fund lending order (or rely on such an order if one has been previously obtained).[151]

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specified in the capital support agreement); *see also* Wells Fargo Funds Trust (pub. avail. Feb. 13, 2008); Dreyfus Cash Management Plus, Inc. (pub. avail. Oct 20, 2008); Russell Investment Company (pub. avail. Oct. 24, 2008); The Hartford Mutual Funds, Inc., Hartford Series Fund, Inc. (pub. avail. Feb. 17, 2009); and ING Funds Trust, ING Investors Trust, ING Series Fund, Inc. (pub. avail. Feb. 19, 2009) (capital support agreement between money market fund and affiliate to limit potential losses resulting from default by issuer of commercial paper and to prevent any downgrade in money market fund rating by committing affiliate to make specified cash contributions to the money market fund to cover all losses realized on a specific portion of the commercial paper).

148. *See, e.g.*, Dreyfus Cash Management (pub. avail. Sept. 25, 2008).

149. *See, e.g.*, STI Classic Funds (pub. avail. Oct. 26, 2007) (issuance by an affiliated bank of an irrevocable standby letter of credit deemed to be a First Tier Security, pursuant to which money market fund would continue to hold the illiquid securities and value them based on the letter of credit but would transfer them to the affiliated bank in consideration of any amounts paid to the money market fund under the letter of credit). It should be noted that many lines of credit typically require notification for accessing lines of credit to be provided by around 2:00 p.m., although money market funds would not usually know whether they will need to access funds from their lines of credit until around 4:00 p.m. Accordingly, advisers of money market funds should take steps to ensure that they can meet the notification cut-off times for accessing funds from their lines of credit if necessary to meet redemptions of fund shares.

150. *See, e.g.*, Overland Express MMF (pub. avail. July 7, 1995) (issuance by an unaffiliated bank of a first tier credit enhancement in the form of irrevocable standby letters of credit pursuant to a Credit Enhancement Agreement setting forth certain rights and obligations of the parties in the event of one or more draws by money market fund against a letter of credit in the event principal and interest are not received by the final maturity date of the securities and in certain other circumstances).

151. Although inter-fund lending orders have been issued by the SEC, *see, e.g.*, Pioneer Bond Fund, et al., Investment Company Act Release No. 28,144 (Feb. 5, 2008), their high administrative costs (*e.g.*, independent committee requirements; specific standards of use; market rate acquisition requirements; etc.) may make them less than ideal for use by some money market funds.

- The money market fund could enter into a put agreement with an affiliate obligating the affiliate to purchase certain securities for cash at amortized cost at a future date.[152]

#### [E] Notice to the SEC

If there is (1) a default with respect to a portfolio security (other than an immaterial default that is unrelated to the financial condition of the issuer) or an event of insolvency with respect to the issuer of a portfolio security or of any Demand Feature or Guarantee to which such security is subject, and (2) immediately before the default, that security (or securities subject to Demand Features or Guarantees from the issuer) accounted for ½ of 1% or more of a money market fund's total assets, the fund must promptly notify the SEC of this circumstance and of the actions the fund intends to take in response.[153]

### *§ 9:3.6 Recordkeeping*

Rule 2a-7 requires that money market funds maintain and preserve written records of the following:[154]

- the Board's considerations and actions taken in the discharge of its responsibilities under Rule 2a-7;[155]
- the determination that a security presents minimal credit risk, as well as a record of any ratings used to determine a security's status as an Eligible Security, First Tier Security, or Second Tier Security;[156]

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152. *See, e.g.*, Centennial Money Market Trust (pub. avail. Sept. 17, 1999) (put agreement executed by money market funds and affiliate pursuant to which money market funds have the right to sell to the affiliate, at a price equal to the amortized cost plus accrued interest, a portion of funding agreements owned by the money market funds in an amount such that the deviation between the market value of the money market fund's assets, after giving effect to the put agreement as to such portion of the applicable funding agreement, and the amortized cost of the money market fund's assets does not equal or exceed $0.003 per share).
153. Rule 2a-7(c)(6)(iii). The notice must be made telephonically or by email or fax, followed by a letter sent by first class mail, directed to the attention of the Director of the Division of Investment Management. *See id.* This notice likely will trigger an inquiry from the SEC staff, and may result in an on-site inspection of the fund.
154. These records must be made available for inspection by the SEC in accordance with ICA § 31(b). Rule 2a-7(c)(10)(vi).
155. Rule 2a-7(c)(10)(ii).
156. Rule 2a-7(c)(10)(iii). This record should include the basis upon which the credit quality of an unrated security is determined to be comparable to an Eligible Security.

- the determination regarding the deviation, if any, between the market value and the amortized cost value of any adjustable rate security that does not have a Demand Feature;[157]
- the determination regarding the number of 10% obligors deemed to be the issuers of all or a portion of an ABS, and certain specific information in connection therewith;[158] and
- the determination that the fund is not relying on a Demand Feature or Guarantee to determine the quality, maturity, or liquidity of the underlying security.[159]

Further, Rule 31a-1 under the ICA requires, in part, that each fund maintain records identifying:

(1) each portfolio security by its legal name;

(2) any liquidity or credit enhancements associated with a security; and

(3) any coupons, accruals, maturities, puts, calls, or any other information necessary to identify, value, and account for each security.[160]

### *§ 9:3.7 Delegation of Board Responsibilities*

Rule 2a-7 permits a money market fund's Board to delegate most day-to-day responsibilities under Rule 2a-7 to the fund's investment adviser or officers, provided the Board adopts guidelines and procedures to govern the exercise of the delegated authority and exercises oversight to assure that the procedures are being followed.[161] Thus, for example, the Board may delegate responsibility for approving purchases of unrated or single-rated securities, for the determination that a security presents minimal credit risk, and for credit reassessments in the event of downgrades where a portfolio security ceases to be first tier, or where an unrated or second tier portfolio security has been given a rating by an NRSRO below the second highest short-term category. However, Rule 2a-7 specifically prohibits the Board from delegating any of its responsibilities for the following:

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157. Rule 2a-7(c)(10)(iv).
158. Rule 2a-7(c)(10)(v).
159. Rule 2a-7(c)(10)(vi).
160. Rule 31a-1(b)(1).
161. Rule 2a-7(e).

- the determination that the use of amortized cost or penny-rounding pricing procedures is in the best interests of the fund and its shareholders, and that either procedure may be continued only so long as share prices so determined fairly reflect market-based prices;[162]
- the determination that the fund should continue to hold downgraded securities if, after giving effect to the downgrade, more than 5% of the fund's total assets are invested in securities issued by or subject to Demand Features from a single entity that are Second Tier Securities;[163]
- the determination that the fund should continue to hold securities subject to default, securities that are no longer Eligible Securities or that no longer present minimal credit risk, or securities whose issuer has experienced an event of insolvency;[164]
- the establishment of the fund's written procedures to stabilize the fund's net asset value or price per share;[165]
- the implementation of shadow pricing and the consideration of action where the Deviation exceeds ½ of 1%;[166] and
- the determination of whether the Deviation may result in material dilution or other unfair results to investors or existing shareholders, and the appropriate action to be taken, if any.[167]

## § 9:4 Buyouts of Problematic Securities

Currently, Rule 17a-9 under the ICA provides an exemption from ICA § 17(a) to permit an affiliate of a money market fund to purchase a security from the fund only if that security has ceased to be an Eligible Security. The purchase price must be paid in cash and must equal the greater of the security's amortized cost or market price, plus accrued interest in each case. Rule 17a-9 updated and codified SEC staff positions taken in the aftermath of the 1994 Orange County bankruptcy and in other circumstances where securities were in default or became ineligible under Rule 2a-7.[168] Rule 17a-9 does not

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162. Rule 2a-7(c)(1).
163. Rule 2a-7(c)(6)(i)(C).
164. Rule 2a-7(c)(6)(ii).
165. Rule 2a-7(c)(7)(i) and Rule 2a-7(c)(8).
166. Rule 2a-7(c)(7)(ii)(A), (B).
167. Rule 2a-7(c)(7)(ii)(C).
168. *See, e.g.*, Lehman Brothers Daily Income Fund (pub. avail. July 7, 1995) (permitting the purchase of Orange County notes by an affiliated person of a fund at par value plus accrued interest); *see also* Liquid Green Trust (pub. avail. Dec. 19, 1991) (permitting the purchase of defaulted commercial

currently provide relief to permit an affiliate to purchase a security that remains an Eligible Security, even if that presents potential pricing issues due to illiquidity or other market events, although the SEC staff has issued no-action letters permitting such buyouts under certain circumstances.[169] (It should be noted that Rule 17a-9 creates no legal obligation for any affiliate to make purchases permitted by the rule.)

### § 9:4.1 Proposed Expansion of Buyout Relief

The Proposed Amendments would expand the ability of affiliates to purchase portfolio securities from money market funds.[170] Specifically, affiliates would be permitted to purchase distressed securities (for example, Eligible Securities that have defaulted) and other portfolio securities (for example, non-defaulted Eligible Securities that are purchased for any reason) from affiliated money market funds;[171] 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

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paper by an affiliated person of a fund). For a discussion of other options available to a Board, or its delegate, to support a money market fund, see *supra* section 9:3.5[D][2]. The Internal Revenue Service held in a Technical Advice Memorandum (TAM 200247004 (July 29, 2002)) that contributions by an investment adviser to money market funds to avoid having the funds break a dollar were deductible by the adviser because the payments were primarily made to protect, maintain, and preserve the adviser's business. The Treasury subsequently issued regulations under section 263 of the Internal Revenue Code that specifically include an example that allows an investment adviser of a money market fund to deduct payments made by adviser to the fund for the purpose of avoiding a net asset value of less than $1 per share. The example indicates that the payment was made to preserve the reputation of the adviser and that it was not made in exchange for any ownership interest in the fund. *See* Example 6 of Treas. Reg. § 1.263(a)-4(l).

169. *See, e.g.*, TD Asset Management USA Funds Inc.—TDAM Money Market Portfolio (pub. avail. Dec. 31, 2007) (purchase by adviser from money market fund of certain credit-linked certificates at amortized cost including accrued and unpaid interest satisfying Rule 17a-9 requirements except for credit-linked certificates continuing to constitute an Eligible Security); Dreyfus Money Funds (pub. avail. Oct. 20, 2008) and MainStay VP Series Fund—MainStay VP Cash Management Portfolio (pub. avail. Oct. 22, 2008); *see also supra* section 9:3.5[D].

170. *See* proposed Rule 17a-9(a).

171. *See* proposed Rule 17a-9(b)(2). The SEC explained, however, that no-action relief would still be required for affiliates of a money market 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. *See* 2009 Proposing Release, *supra* note 3, at section II.H.

from a subsequent sale of such a security would be required to be remitted to the fund.[172] Prompt notice would also be required to be given to the SEC by email of any such purchase and the reasons for the purchase.[173]

## § 9:5 Industry Concentration

Section 8(b)(1)(E) of the ICA requires a recital of a fund's policy concerning "concentrating investment in a particular industry or group of industries."[174] This recital must be included in a fund's registration statement. Neither a definition of "concentration" nor an industry classification system is contained in the ICA or in any rules thereunder. However, the staff of the SEC has taken the position that a fund will be concentrated if it invests 25% or more of its assets in a particular industry.[175] A fund generally may not change its policy with respect to concentration of investments unless such change is approved by shareholders.[176]

Further, funds may not elect to concentrate pursuant to management's investment discretion.[177] The SEC has, however, recognized an exception from this rule that permits money market funds to declare a policy with respect to industry concentration that reserves freedom of action to concentrate their investments in government securities (as defined in the ICA) and in certain instruments issued by domestic banks (which may include U.S. branches of foreign banks or foreign branches of U.S. banks in certain circumstances).[178] In order for a

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172. 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. *See* 2009 Proposing Release, *supra* note 3, at section II.H.

173. *See* proposed Rule 2a-7(c)(7)(iii)(B).

174. The requirement of choosing a concentration policy is also reflected in Item 2.(b) of Form N-1A.

175. The SEC has stated that "25% is an appropriate benchmark to gauge the level of investment concentration. . . ." *See* Investment Company Act Release No. 23,064 (Mar. 13, 1998).

176. *See* § 13(a)(3) of the 1940 Act.

177. *See* Investment Company Act Release No. 9,011 (Oct. 30, 1975).

178. *See* Guide 19 to Form N-1A, Investment Company Act Release No. 13,436 (Aug. 12, 1983) ("Guide 19"). Although the Guides were removed from Form N-1A in connection with the 1998 amendments to the form, the authors are aware of no authority issued by the SEC or its staff indicating that the substance of Guide 19 no longer accurately reflects the staff's position with respect to industry concentration. *See* Investment Company Act Release No. 23,064 (Mar. 13, 1998).

money market fund to take advantage of this position, the fundamental policy on industry concentration contained in its registration statement should reserve the ability to concentrate in government securities and domestic bank instruments. Further, additional disclosure should be included in the fund's Statement of Additional Information regarding "the type and nature of the various instruments in which the [fund] intends to invest and the criteria used . . . in evaluating and selecting such investments."[179]

## § 9:6 Disclosure and Advertising Standards

In addition to the requirements applicable to money market funds under Rule 2a-7, the SEC's rules and forms also impose certain disclosure and advertising standards on money market funds that are in addition to or different from those applicable generally to registered investment companies.[180]

### *§ 9:6.1 Disclosure*

Form N-1A,[181] the disclosure form applicable to all registered open-end management investment companies, requires that a money market fund[182] disclose in the narrative risk disclosure section of its prospectus that an investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and that, although the fund seeks to preserve the value of shareholder investments at a net asset value per share of $1, it is possible to lose money by investing in a money market fund.[183]

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179. Guide 19.

180. This discussion focuses only on disclosure and advertising requirements unique to money markets funds. Other disclosure and advertising requirements generally applicable to registered investment companies in most cases are equally applicable to money market funds.

181. 17 C.F.R. § 274.11A.

182. As defined in Form N-1A, an open-end management investment company registered under the ICA that holds itself out as a money market fund and meets the maturity, quality, and diversification requirements of Rule 2a-7. Form N-1A, General Instructions—Definitions.

183. Form N-1A, Item 2(c)(1)(ii). Prior to amendments to Form N-1A effective in 1998, the Form required that disclosure relating to these points be placed on a money market fund's prospectus cover page. As a result of the amendments, a money market fund may continue to place this disclosure on the cover page of its prospectus, but is not required to. In addition, prior to the 1998 amendments, a single-state fund that was not diversified as to 100% of its assets was required to make prospectus cover page disclosure that the fund might be riskier than other money market

Other prospectus disclosure rules specific to money market funds include the following:

(1) unlike other funds, money market funds are not required to provide a "management discussion of fund performance";[184]

(2) in addition to providing a table in the prospectus showing average annual total return for the past one, five, and ten calendar years, a money market fund may either provide the fund's seven-day yield as of the end of the most recent calendar year or provide a toll-free or collect telephone number for investors to obtain the fund's current seven-day yield. Further, although Form N-1A now mandates disclosure of certain performance information on an after-tax basis in fund prospectuses, the after-tax disclosure requirements do not apply to money market funds;[185]

(3) a money market fund is not required to disclose in its prospectus whether it may engage in active and frequent trading to achieve its principal investment strategies,[186] and may omit the fund's portfolio turnover rate generally required in the financial highlights section of the prospectus;[187] and

(4) a money market fund need not disclose information identifying and describing the persons primarily responsible for the day-to-day management of the fund's investment portfolio.[188]

With respect to rules specific to money market funds in shareholder reports, a money market fund is exempt from including a portfolio schedule, provided that this information is filed with the SEC on Form N-CSR and is provided to shareholders upon request, free of charge.[189]

### [A] Proposed Disclosure Requirements

In addition, the Proposed Amendments would require money market funds to post updated information about their portfolio holdings on their websites on a monthly basis to provide greater transparency to investors about the risks to which funds are exposed.[190] The Proposed

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funds because of its concentration in relatively fewer issuers. This requirement has been eliminated. However, to adequately disclose the principal risks of investing in a single-state money market fund, it may be necessary to provide disclosure to this effect in the fund's prospectus.

184. Form N-1A, Item 5. A non-money market fund must provide this discussion in the prospectus or in the fund's annual report to shareholders.
185. Form N-1A, Item 2(c)(2)(iii).
186. Form N-1A, Item 4, Instruction 7.
187. Form N-1A, Item 9, Instruction 4(c).
188. Form N-1A, Item 6(a)(2), Instruction 1.
189. Investment Company Act Release No. 26,372 (Feb. 27, 2004).
190. *See* proposed Rule 2a-7(c)(12).

Amendments would also require money market funds to electronically file with the SEC information regarding detailed portfolio holdings and certain risk characteristics under certain circumstances.[191]

### *§ 9:6.2 Advertising*

Rule 482 under the Securities Act of 1933, as amended (the "Securities Act"), generally governs a fund's use of "omitting prospectus" advertising,[192] and Rule 34b-1 under the ICA generally governs any sales literature addressed to or intended to be circulated to prospective investors. Under both Securities Act Rule 482 and ICA Rule 34b-1, a money market fund must include a legend in its marketing materials stating that the fund is not insured and that it is possible to lose money investing in the fund.[193]

All advertising materials presenting yield information must contain a quotation of a money market fund's yield computed in accordance with the standardized formula set forth in Form N-1A.[194] Further:

- quotations of current yield[195] must identify the length of, and the date of the last day in, the base period used in computing the quotations;[196]

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191. *See supra* section 9:3.3[B][1].
192. Rule 482 provides that advertising meeting the conditions of that rule will be deemed to be a prospectus under § 10(b) of the Securities Act, and thereby permitted for use pursuant to § 5(b)(1) of the Securities Act.
193. Rule 482(b)(4) and Rule 34b-1(a). An additional legend (i) identifying either a toll-free (or collect) telephone number or a website where an investor may obtain performance data, and (ii) disclosing that performance data represents past performance and that current performance may be lower or higher than the performance data quoted, must also be included prominently on advertising or sales literature that contains performance data. Rule 482(b)(3).
194. Rule 482(e)(1) and Rule 34b-1(b)(1)(ii)(A). For instructions on standardized performance calculations for registered investment companies, see Item 21 of Form N-1A.
195. "Current yield" for a money market fund is based on income received on a hypothetical investment over a given seven-day period (less expenses accrued during the period), and then "annualized" (*i.e.*, assuming that the seven-day yield would be received for fifty-two weeks, stated in terms of an annual percentage return on the investment). "Effective yield" for a money market fund is calculated in a manner similar to that used to calculate current yield, but when annualized, the income earned is assumed to be reinvested. Effective yield will be slightly higher than the current yield because of the compounding effect of this assumed reinvestment. Only investment income may be included in the yield of a money market fund.
196. Rule 482(e)(1)(i) and Rule 34b-1(b)(1)(ii)(A). Rule 482 generally requires that all performance information must be of the most recent practicable date considering the type of investment company and the media through which the data will be conveyed.

- quotations of effective yield may be included in an advertisement or sales literature only if those quotations are accompanied by quotations of the fund's current yield for the same base period, presented in equal prominence with the effective yield presentation;[197]
- quotations of tax-equivalent yield or tax-effective yield in advertisements or sales literature must be accompanied by a quotation of current yield for the same base period, presented in equal prominence with the tax-equivalent or tax-effective yield calculation, and must state the income tax rate used in the calculation;[198] and
- quotations of total return in money market fund advertisements or sales literature are permitted only if they are accompanied by quotations of current yield, with the quotations adjacent to each other and shown in the same type size, and, if there is a material difference between total return and yield, there must be a statement that the yield quotation more closely reflects the current earnings of the fund.[199]

## § 9:7 Fund Liquidation—Proposed Rulemaking

When The Reserve Primary Fund broke the dollar in September 2008, the fund applied to the SEC and obtained an order permitting the fund to suspend the right of redemption of its outstanding redeemable securities and to postpone payment for shares that were submitted for redemption for which payment was not made in order to allow for orderly liquidation.[200] Subsequently, in an attempt to reduce

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197. Rule 482(e)(1)(ii) and Rule 34b-1(b)(1)(ii)(A). A fund may advertise its current yield without including its effective yield.
198. Rule 482(e)(1)(iii) and Rule 34b-1(b)(1)(ii)(B).
199. Rule 482(e)(2) and Rule 34b-1(b)(1)(ii)(C).
200. *See In re* The Reserve Fund, Investment Company Act Release No. 28,386 (Sept. 22, 2008) (order). Because immediate action was required under the circumstances, the SEC issued the order before it provided an opportunity for interested persons to request a hearing, which was subsequently provided in a notice of application on October 24, 2008. *See* The Reserve Fund, Investment Company Act Release No. 28,465 (Oct. 24, 2008) (notice). Other Reserve funds also obtained a similar order from the SEC on October 24, 2008. *See* Reserve Municipal Money-Market Trust, *et al.*, Investment Company Act Release No. 28,466 (Oct. 24, 2008) (order). On October 2, 2009, the shareholders of The Reserve Primary Fund began to receive a fifth *pro rata* distribution of principal in the amount of approximately $1 billion, which, along with the four previous distributions to shareholders, represented approximately 92% of fund assets as of the date the fund suspended redemptions. *See* Press Release, The Reserve, Reserve Primary Fund Distributes $1 Billion (Oct. 2, 2009), *available at* http://ther.com/pdfs/Press_Release_Primary_Fifth_Distribution_2009-10-02.pdf.

the vulnerability of investors to the effects of a run on money market funds and to minimize the potential for disruption of the securities markets, the SEC proposed a new rule, Rule 22e-3, that would permit money market fund boards to suspend redemptions, upon email notification to the SEC, if a fund breaks the dollar and will be liquidated.[201] 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.[202]

## § 9:8 Conclusion

In addition to the proposals discussed in this chapter, the SEC requested comment in the 2009 Proposing Release on other possible amendments to Rule 2a-7, including whether the ability of money market funds to use the amortized cost method of pricing should be eliminated (that is, eliminate the ability to use a stable NAV per share).[203] Many in the industry believe that such a step would mean the end of the $3.5 trillion money market fund industry, eliminating a deep source of short-term credit for corporate issuers, municipalities, and other institutional borrowers.

Money market funds have proven to be successful financial intermediaries, making short-term capital from investors available to a broad range of borrowers. Nevertheless, recent market illiquidity has emphasized that money market funds do present investment risks, and that those risks need to be fully disclosed to, and understood by, investors. Such disclosure, combined with more stringent investment standards, as suggested by the Investment Company Institute and proposed by the SEC, can ensure that the success of money market funds will be able to continue.

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201. *See* 2009 Proposing Release, *supra* note 3, at section II.I.1. A temporary rule, Rule 22e-3T, under Treasury's guarantee program for money market funds, provided a similar exemption for money market funds that participated in the program. The SEC adopted temporary Rule 22e-3T within a few days of The Reserve Primary Fund breaking the dollar and receiving an order from the SEC under ICA section 22(e) to suspend redemptions and postpone payments in the midst of a run on the fund. This new proposed rule, Rule 22e-3, is intended to replace Rule 22e-3T (Treasury's guarantee program expired on September 18, 2009).
202. See proposed Rule 22e-3(c).
203. *See* 2009 Proposing Release, *supra* note 3, at section III.A.